

Inclusive Growth, Full Employment, and Structural Change

Implications and Policies
for Developing Asia

Second Edition

Jesus Felipe



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A mis padres (Jesús y María Jesús) y hermanos (Pablo, Carlos, Antonio, Isabel, Víctor, y María Jesús)



Contents

Illustrations	vii
Abbreviations	x
Foreword by William Mitchell	xiii
Preface and Acknowledgments	xix
Executive Summary	xxix
Chapter 1: What Is Inclusive Growth?	1
Chapter 2: What Is the Main Constraint that Developing Countries Face?	7
Chapter 3: Why Full Employment and Who Should Be Responsible for Trying to Achieve It?	17
Chapter 4: Why Is Growth <i>Unstable</i> ?	29
Chapter 5: What Is the Role of Agriculture in the Process of Structural Change and in Delivering Full Employment? Full Employment I	35
Chapter 6: What Is the Role of Investment in Delivering Full Employment? Full Employment II	57
Chapter 7: Why Is “Planning Development” Necessary?	69
Chapter 8: What Is Industrial Policy? Full Employment III	75
Chapter 9: Structural Transformation, Industrialization, and Technological Change in Developing Asia: What Does the Empirical Evidence Show?	83
Chapter 10: Why Do Export Diversification and Sophistication Matter?	157
Chapter 11: Unemployment Versus Inflation: Which One Should Be <i>the</i> Public Enemy Number One?	179
Chapter 12: What Should Be the Role of Fiscal and Monetary Policies <i>for</i> Development? Full Employment IV	189

Chapter 13: Is It Possible to Achieve Full Employment in the Presence of Structural Transformation?	227
Chapter 14: Should the Government (Public Sector) Intervene Directly and Become the Employer of Last Resort? Full Employment V	231
Chapter 15: Can <i>Competitiveness</i> and <i>Globalization</i> Deliver Inclusiveness and Full Employment?	235
Chapter 16: Export-Led Growth or Domestic Demand–Led Growth?	261
Chapter 17: Is Education a Key Ingredient of Inclusive Growth?	279
Chapter 18: Conclusions: How Can Developing Countries Implement an Inclusive-Growth and Full-Employment Strategy?	289
References	297

Illustrations

List of Tables

Table 1.1.	People's Republic of China: Key Indicators of Economic and Social Development, 2005–2010	5
Table 9.1.	Manufacturing Structure by Decade, Developing Asia (% of Total Manufacturing)	89
Table 9.2.	Regional Shares of Manufacturing Value-Added by Subsector (%)	90
Table 9.3.	Developing Asia Manufacturing Output Shares by Decade (%)	95
Table 9.4.	Developing Asia Manufacturing Employment Shares by Decade (Manufacturing as % of Total Employment)	97
Table 9.5.	Predicted vs. Actual Manufacturing Output Shares (% , 2000)	101
Table 9.6.	Share of World Manufacturing by Type of Technology and Decade (%)	115
Table 9.7.	Technology Gap Regression	129
Table 10.1.	Percentage Share of Top 10 Exports, PRODY and EXPY Scores (1986 and 2006)	162
Table 10.2.	Correlation Coefficients between EXPY and Gini Coefficient	165
Table 10.3.	PRODY Scores for Sectors Classified by Technology and Economies of Scale	166
Table 10.4.	EXPY and Growth (Dependent Variable is Output Growth)	168

List of Figures

Figure A.	Framework for Full, Productive, and Decent Employment	xx
Figure 1.1.	Percentage Change in Labor Force Projections, 2005–2030	6
Figure 2.1.	Economy with Underutilized Resources	8
Figure 2.2.	Growth Due to Improvements in Allocative Efficiency	11
Figure 2.3.	What are the Factors Limiting Employment?	14
Figure 5.1.	Agricultural Output and Employment Shares vs. Per Capita GDP, 1970–2004 (All Countries in the World)	36

Figure 5.2.	Structural Change: Causes and Outcomes	38
Figure 9.1.	Output Growth vs. Change in Manufacturing Output Share (%)	86
Figure 9.2.	Share of Global Manufacturing Value-Added, Developing Asia	87
Figure 9.3.	Total Labor Productivity (2000 \$), Logarithmic Scale	98
Figure 9.4.	Manufacturing Output Share vs. Per Capita GDP, 1970–2004 (All Countries in the World)	99
Figure 9.5.	Fitted Regression Line of Manufacturing Output Share vs. GDP Per Capita, 2000	100
Figure 9.6.	Technology and Scale Index	118
Figure 9.7.	Shares of Manufacturing Groups in GDP based on Technology and Scale (%): Republic of Korea, Malaysia, Pakistan, and Philippines	118
Figure 9.8.	Shares of Manufacturing Groups in GDP based on Technology and Scale (%): People's Republic of China, India, Indonesia, and Taipei, China	119
Figure 9.9.	Intrasector and Intersector Shares of Labor Productivity Growth (%)	125
Figure 9.10.	Sector Contributions to Labor Productivity Growth (%)	126
Figure 9.11.	Baumol's Structural Bonus: Industry vs. Services	126
Figure 10.1.	Specialization Index of Developing Economies in Asia: Manufacturing Value-Added	158
Figure 10.2.	Export Sophistication Score (EXPY)	161
Figure 10.3.	Correlation between EXPY and Gini Coefficient	164
Figure 10.4.	The Product Space	172
Figure 10.5.	Malaysia in the Product Space, 1975 and 2000	173
Figure 10.6.	Pakistan in the Product Space, 1975 and 2000	174
Figure 10.7.	The Open Forest (2006)	175

List of Boxes

Box 1.1.	The People's Republic of China's Harmonious Society: The 11th Five-Year Plan	3
Box 2.1.	The Production Possibility Frontier	8
Box 2.2.	The Growth Diagnostics Methodology	9
Box 5.1.	Structural Change	37
Box 5.2.	Philippine Population Policy	44
Box 5.3.	Land Reform Programs in the Philippines	48
Box 6.1.	The People's Republic of China's Development Model: Does It Need Rebalancing?	61
Box 8.1.	Institutions for Industrial Policy	77
Box 8.2.	Building the Biotechnology Industry in Singapore	80

Box 8.3.	Industrial Policy in the Republic of Korea and India	80
Box 8.4.	Reviving the Republic of Korea's Shoe Industry	82
Box 9.1.	Regularities in Patterns of Growth and Development	84
Box 9.2.	Kaldor's Laws	85
Box 9.3.	What Accounts for India's Undersized Manufacturing Sector?	104
Box 9.4.	Why Did Philippine Industrialization Stagnate?	106
Box 9.5.	Structural Transformation Patterns in the Transition Economies of the Former Soviet Union	109
Box 9.6.	What Options Do the Pacific Islands Have?	112
Box 9.7.	Is the Republic of Korea Close to the Technological Frontier?	120
Box 10.1.	The Product Space: On Forests, Trees, Monkeys... and Structural Change	169
Box 12.1.	The Philippines: A Case of Self-Imposed Constraints	211
Box 12.2.	Pakistan Has to Go to the International Monetary Fund Again	213
Box 12.3.	The Money Multiplier	218
Box 15.1.	Globalization and the Myth of Free Trade	239
Box 15.2.	The Classical Theory of Competitive Advantage	241
Box 15.3.	The O-Ring Theory of Development	243
Box 15.4.	Global Value Chain Theory	246
Box 15.5.	Technological Catching Up in the People's Republic of China's Global Value Chains	249
Box 15.6.	Global Value Chains in India	253
Box 15.7.	Some Myths about the People's Republic of China and India	258
Box 16.1.	What Was <i>Thaksinomics</i> ?	271
Box 17.1.	Education and Structural Transformation: What Does the Microeconomic Evidence Say?	287

List of Appendixes

Table A5.1.	Total and Sector Growth Rates by Decade	51
Table A5.2.	Output and Employment Shares by Sector and Decade	54
Table A9.1.	Share of Manufacturing Subsector by Decade— Developing Asia (%)	131
Table A9.2.	Value-Added Share by Manufacturing Subsector (% Manufacturing)	138
Table A9.3.	Employment Share by Manufacturing Subsector (% Manufacturing)	146
Table A9.4.	Decomposition of the Growth Rate of Labor Productivity	153

Abbreviations

ADB	Asian Development Bank
AFG	Afghanistan
ASEAN	Association of Southeast Asian Nations
AZE	Azerbaijan
BAN	Bangladesh
BHU	Bhutan
BOP	balance of payments
BPO	business process outsourcing
BSP	Bangko Sentral ng Pilipinas (Central Bank of the Philippines)
CAD/CAM	computer-aided design/computer-aided manufacturing
CAM	Cambodia
CARP	Comprehensive Agrarian Reform Program (Philippines)
CEO	chief executive officer
DDLG	domestic demand-led growth
ELG	export-led growth
EU	European Union
FDI	foreign direct investment
FIJ	Fiji Islands
FY	fiscal year
GBC	government budget constraint
GDP	gross domestic product
GVC	global value chain
HKG	Hong Kong, China
ILO	International Labour Organization
IMF	International Monetary Fund
IND	India
INO	Indonesia
ISIC	International Standard Industrial Classification of all Economic Activities
IT	information technology
KAZ	Kazakhstan

KOR	Republic of Korea
KGZ	Kyrgyz Republic
Lao PDR	Lao People's Democratic Republic
MAL	Malaysia
MLD	Maldives
MNCs	multinational companies
MON	Mongolia
MYA	Myanmar
NEP	Nepal
OBM	original brand manufacturer
ODM	original design manufacturer
OECD	Organisation for Economic Co-operation and Development
OEM	original equipment manufacturer
OLS	ordinary least squares
PAK	Pakistan
PHI	Philippines
PNG	Papua New Guinea
NAIRU	nonaccelerating inflation rate of unemployment
NIEs	newly industrialized economies
PES	public employment services
PIDE	Pakistan Institute of Development Economics
PRC	People's Republic of China
R&D	research and development
SBP	State Bank of Pakistan
SIN	Singapore
SITC	Standard International Trade Classification
SMEs	small and medium-sized enterprises
SOL	Solomon Islands
SRI	Sri Lanka
TAJ	Tajikistan
TAP	Taipei, China
THA	Thailand
TKM	Turkmenistan
TON	Tonga
UNCTAD	United Nations Conference on Trade and Development
UNIDO	United Nations Industrial Development Organization
US	United States

UZB	Uzbekistan
VAT	value-added tax
VIE	Viet Nam
WTO	World Trade Organization

Foreword

World poverty is closely related to unemployment and underemployment. This is especially the case in developing Asia, where about 500 million unemployed and underemployed people have to cope without significant government welfare support. Recently, institutions such as the World Bank and the Asian Development Bank have started using the term *inclusive growth* in setting their policy agendas. In this book, Jesus Felipe argues that if policy makers across developing Asia care about inclusive growth defined as *growth with equal opportunities*, then achieving true full employment should become the paramount objective of Asian governments.

The best strategy to reduce poverty in developing Asia is to introduce a set of policies that will generate full employment. While a number of policy initiatives will be useful—particularly those that target productivity improvements in agriculture and stimulate investment in industry, and those that condition the broader macroeconomic environment (monetary, fiscal, and exchange rate policies)—the key is to coordinate their implementation to ensure that they pull the economy toward full employment.

This policy mix is important because ongoing structural change, the key to development, makes the attainment of full employment a moving target and governments are continually confronted with political and economic choices that at times seem to be conflicting. But at all times, the policy process must aim at ensuring that there are enough jobs available to meet the needs of the labor force.

Agriculture remains the largest employer in many Asian countries, including the two largest developing economies, i.e., India and the People's Republic of China. It is thus clear that any viable development plan must place special focus on agriculture. Any such plan has to involve investment initiatives that improve agricultural productivity and alternative job creation strategies that provide opportunities for rural workers displaced by technological advances. These job creation initiatives must take into account the effects of structural change if full employment is to be achieved. Localized job creation programs will also be necessary to ensure that urban structures are not flooded with workers displaced from the modernized agriculture sector.

The conduct of fiscal and monetary policies at the aggregate level will be crucial in how successful each nation is in achieving the aim of inclusive

growth. Ultimately, full employment is the responsibility of the national government. While the private sector makes a significant contribution to employment growth across all economies, it remains a fact that this sector does not provide enough jobs to satisfy the desires for work of the labor force. For this reason, the public sector has a strong role to play as a direct employer in its own right, in addition to providing a policy framework that maximizes private employment growth. When considering the conduct of macroeconomic policy, the neoliberal era has been marked by a focus on low inflation and certain presumptions regarding national budget deficits. During this era, unemployment has become a policy tool to reduce inflation rather than a policy target, and governments have been encouraged to generate budget surpluses. There is a solid body of evidence that shows that this strategy has not delivered sustainable growth in any country, and that it has not contributed in many countries across developing Asia to the generation of the required levels of employment. In this book, Jesus Felipe contends that the policy targets should be realigned to full employment and price stability, and that the size of budget deficit should not be considered a policy target but an outcome of what is required to achieve these other overarching goals.

To make progress toward these goals, budget deficits must be demystified. Jesus Felipe argues, rightly, that the reliance in recent decades on monetary policy to stabilize the business cycle (with the concomitant requirement that fiscal policy becomes passive) has failed to deliver outcomes consistent with the goal of inclusive growth. To remedy this, fiscal policy has to resume primacy among the aggregate policy instruments and be used to ensure that private savings can be financed. Another more conventional way of thinking about this is that when the private sector desires to save some of the national income, aggregate demand will be insufficient to fully employ the workforce unless net government spending fills the spending gap. In this way, the budget deficit serves to provide the spending necessary to generate the income that finances the saving. As a consequence, any particular budget outcome will be market-determined by the desired net saving of the private sector. If the private sector desires to save less, then the resulting budget deficit will be smaller, and vice versa.

What are the limits on the size of the budget deficit? Jesus Felipe maintains that sound fiscal conduct will ensure that aggregate spending (the sum of private and public demand) is sufficient to achieve full employment. If fiscal policy stimulates nominal demand beyond this point, then inflation will necessarily follow. National governments should thus feel comfortable running continuous deficits within this limit, in the knowledge that they are underpinning private saving and also maintaining full employment.

In addition to recognizing the essential role of net government spending in stabilizing aggregate demand, many developing countries also need

fundamental fiscal reforms aimed at increasing the efficiency of the public sector so that more resources can be allocated for productive investment and/or direct job creation. The two insights complement each other. Strong fiscal policy is essential but so is an effective use of the resources that the government deploys.

While full employment was an objective of central banks and governments across the developed world between the end of World War II and the 1970s, during the last 30 years this goal has been abandoned. The results of this regime shift in policy practice have been that most societies have been forced by their governments to endure persistently high unemployment and rising levels of underemployment. While the income losses associated with persistent labor underutilization have been huge and dwarf any measured costs of so-called microeconomic inefficiencies, the related social pathologies have also been significant. Increased rates of family breakdown, escalating crime rates, rising drug abuse, and arguably rising political instability and extremism have all been closely tied to entrenched joblessness.

While these costs are disproportionately borne by the most disadvantaged members of our communities, the externalities that arise (for example, crime, terrorism) affect us all. However, the public debate, which has been significantly conditioned by neoliberal commentators, has tended to consider unemployment as a personal issue rather than a systemic failure of the economy to generate enough jobs. In this respect, the debate has placed too much stress on inflation and downplayed the costs of unemployment, which are of a higher order of magnitude than the costs arising from mild inflation levels. Jesus Felipe claims that no rigorous evidence is available to conclude that mild inflation damages the economy to such an extent that would justify to have it as the key economic policy concern; and to induce policy makers to use sustained high unemployment to control it.

Much of the economic debate surrounding inflation has presented wrongly the underlying causality. An inflationary process caused by effective demand hitting full capacity during an economic expansion is significantly different from what happened in the world during 2007–2008. In the first case, the economic bonanza would probably lead to an increase in employment and wages, and necessitate economic policy to dampen nominal demand sufficiently to keep the real economy as close as is possible to full employment.

However, this situation does not describe the 2007–2008 inflation episode in developing countries. The combination of increases in oil and food prices has brought misery to millions of people around the world. The additional problem is that inflation coincided with a major slowdown in the world economy that started in the developed countries (especially in the United States [US]). There is clearly a different approach being adopted

by the US Federal Reserve relative to how the European Central Bank saw the problem (at least initially). While the former lowered interest rates significantly in an effort to reactivate economic growth, the latter maintained a firm focus on controlling inflation until late 2008. Only as the global economic crisis deepened significantly did the G20 nations display the semblance of a united strategy aimed at stimulating demand to protect jobs.

Further, the ultimate driver of the increase in oil prices is still not entirely understood. Most likely it was a combination of the control that the suppliers exercised on price with the massive growth in demand coming from the People's Republic of China and India. There is also evidence that financial institutions (hedge funds, etc.) hoarded oil and used it for speculative purposes. What about food prices? Early on it was said that the price increases were due to poor harvests in some key countries, in which case they should be a temporary phenomenon. We were told that the situation was probably leading to inflationary expectations and that sooner or later workers would demand increases in wages. The reality, however, is that central banks do not have solid knowledge about how their own actions affect inflation expectations and how these in turn affect inflation. Little is known about firms' inflation expectations and how, if at all, these beliefs influence pricing decisions. The point being made is that before we can design and implement effective policies we do need to understand the underlying economic and social processes that combine to generate these problems.

As indicated earlier, over the last three decades there has been an important change in the way the public debate constructs unemployment and its causes. Previously, unemployment was thought to result from insufficient aggregate demand—that is, a systemic failure beyond the control of any one individual. In recent times, individuals are deemed to be responsible for their own economic outcomes: people are unemployed because they have not invested in the appropriate skills, because they have not made an effort to search for jobs, or because they have become too choosy in what they might consider doing. Further, the policy structures that were implemented during the full employment period to provide support to workers who were temporarily unemployed are now considered to be complicitous in sustaining unemployment. So, critics of government suggest that welfare provisions are excessively generous and distort individual decision making toward unemployment.

Developing Asia has experienced fast growth rates for decades and is the envy of most other regions in the world. However, Jesus Felipe shows that this perception is lopsided. While high growth is seen as the key parameter for evaluating developing Asia's success, there is abundant evidence that this growth is not translating into sufficient job creation. In particular, labor absorption by industry is low and most of the new

employment is being created by services. So this period of development is seeing workers being transferred directly from agriculture into services without an industrial base being developed. This is a significant departure from the development path previously followed by many developed countries and even by the first wave of successful East Asian countries. It is clear that policy makers across developing Asia need to understand these trends to avoid the pitfalls that it is likely to present as time passes.

The book spells out the main constraint that many countries across developing Asia face for their development: a lack of capital equipment and productive capacity. Therefore, the purpose of development must be to increase a country's productive capacity to achieve the full employment of labor. However, rapid structural transformation, competition, and globalization limit the capacity and autonomy of Asia's developing countries to achieve full employment without significant public sector involvement.

Despite the political and technical difficulties in achieving and maintaining full employment, governments across the region should not be deterred. In the final analysis, unemployment and underemployment are states that can be largely prevented by sound government policy. The motivation by policy makers to pursue full employment should be conditioned by the desire to maximize incomes, by the desire to ensure that human rights are maintained, and by the desire to achieve social stability. Allowing high rates of unemployment to persist reflects a diminution of government responsibility and leadership. The decision to pursue full employment policies requires political choices to be made and for the government to engender a sense of collective will. However, over the last three decades governments have progressively tried to undermine this collective approach.

Jesus Felipe takes the view that employment is a human right, and that full employment as an objective of economic policy is firmly entrenched in the United Nations' Universal Declaration of Human Rights (article 23) and in the Charter of the United Nations (articles 55 and 56). Moreover, since 2006, the concept of decent work has been a target of the first Millennium Development Goal (to eradicate extreme poverty and hunger).

But pursuing full employment can also be constructed as a rational public choice for other reasons. An economy running at full employment or "high pressure" maximizes income creation. This leads to more buoyant markets, businesses, investment, and employment. This is an economy that will provide everyone with opportunities.

The late US President John F. Kennedy coined the phrase, "A rising tide lifts all boats," which recognizes the upgrading benefits of the high pressure economy. Governments that use fiscal policy to ensure that their economies stay as close to full employment as possible generate massive advantages: both the strong and the weak prosper, labor participation is

strong, unemployment is at the irreducible minimum, labor productivity is high, wages are high, children from disadvantaged families get a chance to transcend poverty, and workers who are displaced by global economic changes are able to be re-absorbed into productive work. In this regard, direct public sector job creation must be a significant part of the national government's responsibilities.

All this means that a fully employed economy delivers great individual and social benefits. Unemployment and underemployment have direct economic costs and lead to poverty, misery, stress, malnutrition, and social injustice. Persistent unemployment and underemployment act as a form of social exclusion that violates basic concepts of membership and citizenship, thus prohibiting inclusive growth. Full employment in the developing world also contributes to political stability, as the consumption of much of the population will be higher than when many people are unemployed. Therefore, it should be an ethical imperative in today's world. As a consequence, a rational person will rightly note that developing countries cannot afford unemployment and underemployment. This construction is eminently more plausible (and evidence-based) than its opposite—that they cannot afford full employment.

Finally, Jesus Felipe also argues that while the private sector is the generator of wealth and most employment in a market economy, governments should be held accountable for their efforts and commitment to achieve full employment. This follows from an understanding of the policy options available to a national government. But it also reflects the observation that when unemployment rises, the public always blames the government rather than the private sector.

Overall, it is clear that governments and the private sector must collaborate strategically to generate a fully employed economy. Both strong investment from the private sector and a strong commitment from the public sector to job creation and public infrastructure development are necessary to achieve this goal.

I view this book as an important contribution in the fields of economic development and policy making in developing countries. Its strength is that it challenges the *status quo* and forces us all to rethink our priorities and reconsider the way we conduct economic policy.

William Mitchell
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University of Newcastle, Australia

Preface and Acknowledgments

The only thing we have to fear is fear itself.

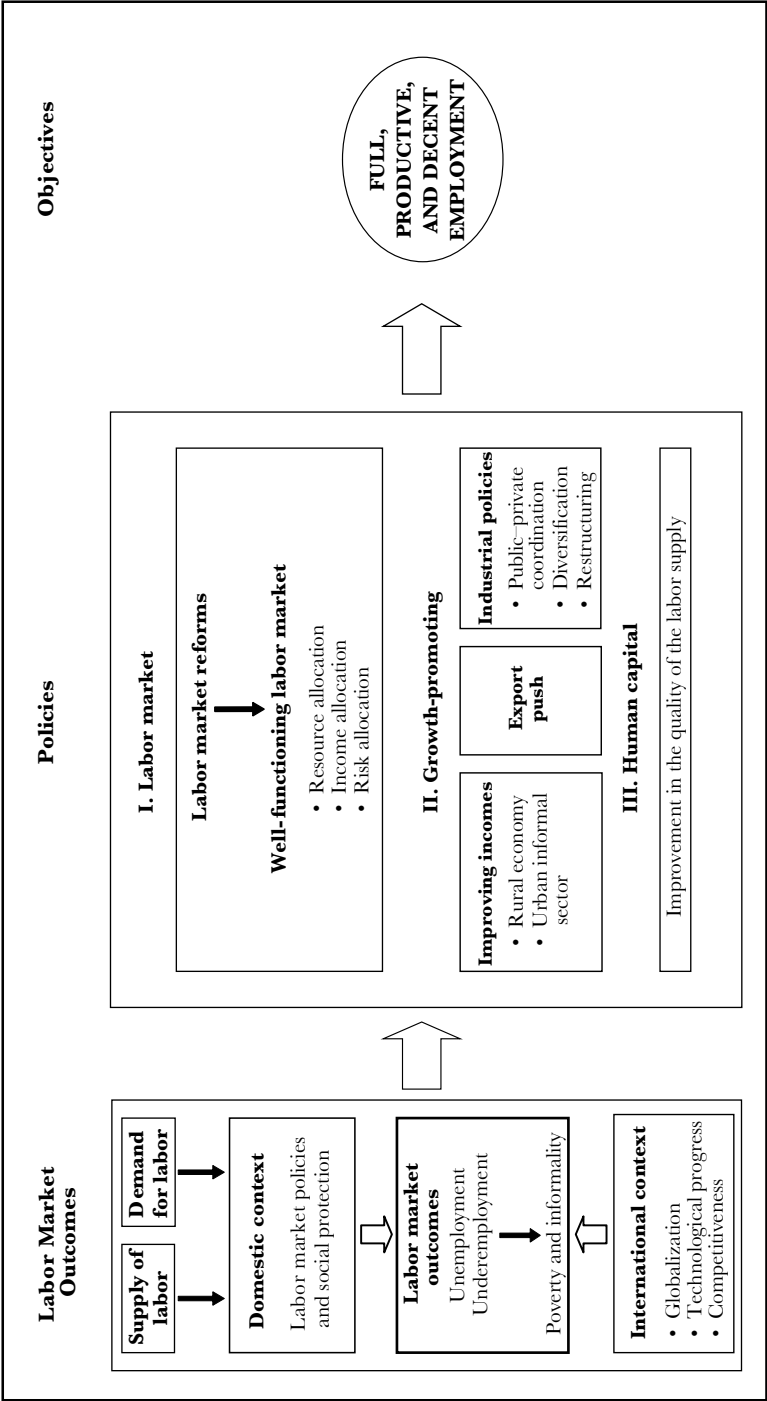
—Franklin Delano Roosevelt

In this book, I expand on my previous work (with Rana Hasan) on unemployment and underemployment in developing Asia, *Labor Markets in Asia: Issues and Perspectives* (2006). Here, I reiterate and stress my view that while economists and social scientists in general have praised developing Asia's unmatched growth record since the mid-1960s, they may have missed the important point that the region is failing to provide employment to its huge and still-growing labor force. Sooner or later this problem will become policy makers' biggest headache.¹ The attainment of full employment, understood amid the problems posed by structural change (or transformation), globalization, and fast technical progress, should be the ultimate goal of economic policy. Figure A reproduces the framework used in *Labor Markets in Asia* to understand and conceptualize full employment and the policies to achieve it. In this book, I move one step forward and analyze the policies to achieve full employment during fast structural change. I view my work as contributing to the concern among policy makers in the developing world that growth has to be inclusive, that is, that it has to provide equal opportunities. In my view, opportunities come through employment.

In early 2008, the International Labour Organization (ILO) announced that as a result of the expected global economic cooling following the turbulence in financial markets, world unemployment would increase. Policy makers have to be aware of this problem and start implementing policies to tackle unemployment as soon as possible. This will require substantial changes in policies and priorities. In my view, this is the biggest challenge that policy makers across much of the region will face in the coming decades. Growth will be useless if it is not accompanied by employment opportunities.

¹ Rana Hasan and I estimated that developing Asia is home to about 500 million people who are unemployed and/or underemployed.

Figure A. Framework for Full, Productive, and Decent Employment



Source: Felipe, Jesus, and Rana Hasan. 2006. *Labor Markets in Asia: Issues and Perspectives*.

I concluded a few years ago that the “development problem,” from the point of view of development policy, is an embarrassment, a puzzle that economists have failed to complete and even understand (Felipe 2006). Growth theory adds more and more variables to the discussion, but at the end of the day we do not know how to put all the pieces together. Development is about fundamental change in economic structures, about the movement of resources out of agriculture and into services and industry, about migration to cities and the movement of labor across countries, and about transformations in trade and technology. Social inclusion and change—change in health and life expectancy, in education and literacy, in population size and structure, and in gender relations—are at the heart of the story. The policy challenge is to help release and guide these forces of change and inclusion.

As a consequence of this failure, I have come to the following two conclusions: first, that we know relatively little about the crucial growth questions; and second, that no unique way exists to put all the pieces of the puzzle together. Hence, each country has to find its own way to complete the puzzle. I believe that the different policies I analyze here are important components of the big picture; but each country will have to decide the precise way to implement them and how to proceed.

Part of the problem lies in the complexity of the subject. But economics, as a discipline, must also change in the coming decades. Often, one has to go outside mainstream treatments of development to find challenging and provocative ideas. Mainstream analyses still rely on policy recommendations stemming from the neoclassical model of growth (both in its original formulation and in that of the endogenous growth models developed since the 1980s), in which development is seen simply as a problem of factor accumulation: poor countries are like rich countries, but have less of key factors such as physical and/or human capital. I have written extensively on this issue and I am convinced that orthodox approaches are largely a futile effort. There is a strong movement within the profession expressing discontent with the way standard models, many of which have little to do with reality, are rehearsed over and over again.

During the last 15 years I have been greatly influenced by six critical areas of work: (i) the theoretical work by Frank Fisher (with whom I have collaborated in two papers) on aggregation in production functions, which questions the pillar of neoclassical growth models (the aggregate production function); and the work by John McCombie (with whom I have also been collaborating for 15 years) on the accounting identity critique of production functions estimated with value data; (ii) the work on functional finance and the employer of last resort by Randall Wray and William Mitchell, which questions the idea that sovereign governments have a budget constraint and provide a solid proposal to achieve full employment with price stability;

(iii) the work by Anwar Shaikh reviving the classical research program; (iv) the work by Ricardo Hausmann on structural change; (v) the work by Dani Rodrik questioning free-trade fundamentalism; and (vi) the work by Tony Thirlwall on the balance-of-payments constrained growth.

Although the target of the book is policy makers across developing Asia, I have done my best to write a book that can be read by a wide audience, including readers without grounding on the subject, policy makers in other parts of the world, and scholars. Some readers will find some of my ideas thought-provoking. My efforts have been directed at developing proposals that challenge policy makers' views and compel them to "think outside the box." To support and develop the arguments, I have drawn upon references to a wide body of literature. Some of these references are rather old, but extremely relevant and not outdated. Other references are to recent work (particularly on structural change, economic diversification, and upgrading). The ultimate purpose of the book is to open a debate about the priorities and policies for development in Asia during the next decades. In some areas, I express clear views and opinions; while in others, I simply present different arguments and points of view and let the reader decide.

Underlying my work are two important tenets about how I view policy making in developing countries. The first tenet is that policy makers in developing countries must be capable of undertaking systemic social, political, and economic analyses. These analyses must consider, among other factors, the effects of growth on the environment, the increasing differentiation among developing countries, and the erosion of the core-periphery dichotomy, as well as racial tensions and the political outcomes of elections. As a development practitioner, I feel that globalization—the integration of the world through trade, investment, and technologies such as the internet—has thrown development economics into a quagmire. Globalization has exposed the limitations of the existing models and theories. Development theory needs to revert to the agenda of classical political economy along the lines of Adam Smith, David Ricardo, and Karl Marx, and be grounded on an analysis of historical processes. It cannot continue under the aegis of the neoclassical growth research program. Governance and institutions have become part of mainstream analyses of growth in recent times, but their treatment is similar to that given to any of the other variables that economists include as arguments in the standard aggregate production function, the tool used to analyze growth. Living in the Philippines for many years, I have concluded that development theory cannot be apolitical. Development has a deep political character, as it is shaped by social interests and political projects.

The second tenet is that I do not advocate massive and widespread reforms. Policy makers should set priorities based on an analysis of a country's binding constraints.

Policy making is about choosing economic policies (instruments) in an uncertain environment to achieve some objectives.² The choices of both objectives and policies are most often based on a mix of economic reasoning and one's view of the world (including political beliefs); actual circumstances (e.g., high oil prices); assessment of the global environment (e.g., elections and political instability in certain key countries); interpretation of events (e.g., increases in prices amid the weakening of the global economy in 2007–2008); and differentiation between short-run issues and long-run questions. Policy making entails the possibility of choosing contradictory courses of action (e.g., unsynchronized fiscal and monetary policies) and of making mistakes (e.g., due to an incorrect interpretation of events). Moreover, any choice made today (e.g., increasing spending, increasing interest rates, implementing a new educational system, lowering tariffs) will have an impact into the future.

Let me provide an example of what policy makers across developing Asia were dealing with during the first part of 2008. Inflation was rising, mostly because of higher food and energy prices.³ For example, the price of pork increased in the People's Republic of China (PRC) by about 60% in 2007 and that of vegetables by almost 50%. The PRC's inflation surged to 8.7% during February 2007–February 2008 (however, nonfood prices increased by less than 2% in 2007), the highest in 12 years. And in early 2008, the PRC suffered from severe snowstorms that damaged crops and disrupted traffic. Inflation in India, Indonesia, Thailand, and Singapore was also on the rise (slightly above 4%). Was inflation at these levels a serious problem? Was the fear of returning to the 1970s justified or misplaced? Was it only a temporary phenomenon caused by one-off supply factors? What were policy makers across developing Asia more concerned about, inflation or the possibility of a slowing economy? Central banks were reluctant to increase interest rates when the United States (US) was lowering them to weather its recession. How increases in interest

² Harberger defines “good” economic policies as “those that promote the efficient operation of the economy and at the same time intelligently support the process of growth” (Harberger 1998, 203). I am not sure if I completely agree with Harberger, as the term “efficient” in his definition most likely refers to the allocation of resources in terms of microeconomic neoclassical optimality (i.e., equilibrium in production is determined by marginal costs and equilibrium in consumption by marginal utilities; and the operation of the price mechanism clears all markets), and because it designates the growth objective as the key goal.

³ It was argued that this was caused by increased demand from fast-growing, emerging economies like the PRC, along with the rise in the price of ethanol, which gobbled up a big chunk of US land dedicated to the corn crop and diverted acreage from wheat. Although the PRC is a big importer of a few agricultural products, such as soybeans, it has been a net exporter of food for many years.

rates would affect food and energy inflation was not clear. What is more certain is that an increase in interest rates would attract capital inflows and push the value of currencies up, helping curb imported inflation (of food and energy products). However, stronger currencies may have a negative impact on exports. And what if growth slows down significantly? Will policy makers reduce interest rates? Will this, however, bring in inflation later?

Countries like India, Thailand, Malaysia, the Philippines, and the PRC resorted in early 2008 to price controls and government subsidies on a wide range of goods (e.g., energy, transport, water, meat, grain, eggs, and cooking oil). For example, in early 2008, to tame the increase in agricultural prices, the PRC government declared that reducing consumer price inflation was a political priority. The government said that it would expand agricultural commodity production, exert strict control on industrial grain use, establish an early-warning system to monitor supply and demand, and strengthen market oversight and price inspections. It also indicated that subsidies for the poor would increase, and that provincial governors and mayors would be held responsible for ensuring basic food supply. Certainly these are political measures that appeal to public concerns (especially low-income urban groups) and address popular discontent that might generate social unrest. However, holding down prices reduces the incentive for producers to increase supply, leading to shortages that can lead to increases in prices despite government measures. In the short run, most likely this measure will be beneficial, as the source of inflation is the increase in energy and food prices, rather than increases in aggregate demand. But in the long run, this is a measure that may hamper the economy. In Malaysia and Indonesia, fuel subsidies account for about 10% of total government spending. And apart from efficiency considerations, if fuel prices are not allowed to increase across Asia, demand will not decrease and will push global oil prices higher.⁴ By early 2009, it was clear that inflation was not a problem and that the world economy was spiraling into recession. The question then changed: for how long?

The book is divided into 17 chapters (plus conclusions), each with a question as the title, and each revolves around the central issues of inclu-

⁴ By December 2008, crude oil prices had declined significantly, to below \$50 a barrel. Inflation started taking on a secondary place in discussions (headline consumer prices seem to have peaked) when a number of central banks around the world decided to lower interest rates, acknowledging that a recession is the most serious problem the world faces. Given that in the span of 6 months the price of oil declined by about \$100, it is difficult not to think that there had been an important element of speculation during 2007 and first 6 months of 2008. Evidence that this was the case is provided by Wray (2008a).

sive growth, full employment, and structural change. It would have been much more difficult and challenging to organize the book by countries. Probably the PRC and India would have accounted for the bulk of it. Some readers may argue that I have omitted important topics, such as aging, global health risks, environment and climate change, energy, the informal economy, and ethics. No doubt these topics are important, but the book would have been excessively long. These topics deserve another book.⁵ I do not discuss either the financial turmoil that started in 2007, except for some quick references that I make in some parts of the book. The reason is that I do not know yet how the crisis will damage the world economy and the changes that it will bring.⁶ The standard argument is that this is a crisis that started in the US, the result of two decades of easy-money policies coupled with the development of innovative financial products that fueled the US's "ownership society" (based on the idea that every American family would own a home). Since the 1980s, Americans have consumed more than they produced. In retrospect, this is the "chronicle of a death foretold." Only time will disclose its full implications.⁷

Chapter 1 defines inclusive growth. I use throughout the book the term "inclusive growth" because it is making its way into policy makers' language despite the lack of a unanimously accepted definition. The key issues are (i) what should policy makers' objectives be? and (ii) what policies should they implement? I will argue strongly that the key to inclusive growth is full employment. My position is that governments should not simply provide a series of public goods, as many argue, but ensure the full employment of labor. This is a much more ambitious and serious role that does not imply a bigger government.

Chapter 2, on the main problem of developing countries, and chapter 3, on the concept of full employment, contain the foundation of my arguments. Chapter 4 contains a discussion of why growth tends to be unstable, based on the Harrod–Domar model. Starting in chapter 5, chap-

⁵ The interested reader can see the excellent essays in Quibria (1995) and Quibria and Dowling (1996). See in these volumes Dasgupta (1995) on the environment and Kapur (1996) on ethics and values.

⁶ By the end of 2008, it became clear that the financial crisis was affecting developing Asia. Initially, the region was well positioned to weather the global crisis. Economies across the region had learned the lessons of the 1997–1998 financial crisis and banks were well capitalized, highly liquid, and with low rates of nonperforming loans. Moreover, central banks had accumulated large amounts of reserves. But as the crisis deepened in the US and Europe, the effects began to be felt, especially through real-sector channels. Given Asia's dependence on exports, the rich world's recession hurts Asia.

⁷ Wray (2008b) is critical of the orthodox view of the causes of the current global financial crisis. He argues that US current account deficits and federal budget deficits are sustainable, so the US does not need to adopt austerity.

ters where I make policy proposals (in chapters 5, 6, 8, 12, 14) have been labeled “Full Employment I, II, III, IV, and V” respectively. Chapter 5 is on the role of agriculture, and chapter 6 on the role of investment. Chapter 7 is on the need to plan development. Chapter 8 discusses the role of industrial policy. Chapter 9 analyzes the record of structural transformation and industrialization in developing Asia. Chapter 10 presents a modern analysis of why economic diversification is important. Chapter 11 is on inflation. Chapter 12 discusses how fiscal and monetary policies can be consistent with inclusive growth. Chapter 13 discusses the technical problems in achieving and maintaining full employment in economies undergoing structural change. Chapter 14 discusses the role of the public sector as employer of last resort. Chapter 15 summarizes my views on globalization and competitiveness and their relationship with inclusive growth. In chapter 16, I review recent discussions about the need to shift from export-led growth to domestic demand-led growth and what this implies and entails. Chapter 17 offers a discussion of externalities, knowledge, and education. Finally, chapter 18 summarizes the main arguments.

Writing this book has been a most rewarding personal experience from which I have learned a lot. For this reason, I want to close this preface with the always pleasant task of thanking those who in many ways have contributed to the improvement of the original manuscript. I am deeply grateful to Luis Cañete, David Dole, Nimal Fernando, David Garrigos, Tun Lin, Saby Mitra, Safdar Parvez, Sukhumarn Phanachet, Raquel Rago, Sona Shrestha, Ramesh Subramaniam, Joey Tan, Alex Warren Rodríguez, and Juzhong Zhuang for useful discussions, comments, and suggestions about different chapters and versions of the original paper that led to this book, titled *Macroeconomic Implications of Inclusive Growth: What are the Questions?* This does not necessarily mean that they share all the views expressed. In fact, many of their comments (and, in particular, disagreements) were tremendously useful and helped me polish the arguments and make them more comprehensible. Joseph Lim and Gemma Estrada helped me with the data on structural change. Conversations and joint work with Ricardo Hausmann, Cesar Hidalgo, and Bailey Klinger were also very useful and aided me to fully grasp their recent path-breaking work on the implications of structural transformation, diversification, and upgrading using network theory. Michael Hobday provided me with the material on global value chains. Work with my colleague Norio Usui during the last 2 years, especially on growth diagnostics, public finance, and structural change, also helped me polish the arguments. Mathew Forstater, Warren Mosler, and especially Randall Wray and Bill Mitchell helped me understand the details of the public sector as employer of last resort as well as of the functional

finance approach, and the true meaning of budget deficits and surpluses. Conversations and discussions on growth during the last 15 years with my coauthor John McCombie, as well as with Tony Thirlwall, have helped me shape my views on many issues in growth and development. John's great generosity during all these years has made our collaboration a most rewarding experience for which I shall always be grateful. I am deeply indebted to all of them, although I am solely responsible for the content, in particular, for any remaining errors.

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Many of the ideas in this book started maturing during my years in the Economics and Research Department of ADB. Ifzal Ali, ADB's chief economist from 2002 through 2008, provided the department with an excellent environment to be creative and carry out independent work. His lack of dogmatism and his openness to different ideas made me respect him deeply. He retired from ADB in October 2008, after more than 20 years of service. I wholeheartedly wish him the best.

Discussions over many lunches, dinners, and coffee sessions with my colleague and friend Joao Farinha-Fernandes were instrumental in keeping my arguments judicious. Rana Hasan has also been a source of inspiration and friendship during many years. I have learned a lot from him on employment issues and development in general. Both are outstanding individuals who possess great human qualities that I admire. Living and working in developing Asia is a fascinating and most satisfying experience that we enjoy and share.

Finally, Juan Miranda (director general, Central and West Asia Department, ADB) and Xianbin Yao (director general, Regional and Sustainable Development Department, ADB) were always very supportive, and, since the inception, they encouraged me to develop the ideas in the book.

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To conform with ADB's rules and policies, I use "[Taipei, China]". This has affected the references to some work. My apologies to the authors.

My employer, ADB, has provided me with the opportunity to learn about developing Asia. I am very grateful. Nevertheless, the views expressed

in the book are solely mine and do not necessarily reflect the views or policies of ADB, its executive directors, or those of the countries that they represent.

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Executive Summary

This book discusses the implications for macroeconomic policy of the term inclusive growth, understood as growth with equal opportunities. This is a term that, in different ways (e.g., harmonious society, sufficient economy), is making its way into the policy discourse in many countries in Asia, and multilateral organizations such as the World Bank and the Asian Development Bank have also started using it. To achieve inclusive growth, Asian governments must commit efforts and resources to the pursuit of the full employment of labor to provide jobs to the 500 million unemployed and/or underemployed people in the region. The book discusses the different aspects of the link between inclusive growth and full employment, and offers a menu of policies that will have to be tailored to each country's circumstances.

A summary of the main arguments is as follows:

- (i) The most salient feature of developing Asia's labor markets is the considerable underutilization of labor, which manifests itself in unemployment and underemployment. Having a job that pays a decent salary is the most basic measure of a person's living standard. For this reason, Felipe and Hasan (2006, 2) argue that "improving labor market opportunities for workers is the key to reducing poverty and improving standards of living for the large majority of Asia's workers and their families. Poverty reduction requires helping people as workers." A high-employment economy is the best single tool for fighting poverty.
- (ii) The main cause of unemployment and underemployment in developing countries is lack of capital equipment and productive capacity. Therefore, the purpose of development must be to increase a country's productive capacity. Only sound policies geared toward full employment will create the foundation for inclusive growth.
- (iii) Unemployment and underemployment as the fundamental causes of lack of inclusiveness are unethical states of a malfunctioning economy. They ultimately are the result of a lack of collective will to make political choices that favor maintaining adequate levels of demand.
- (iv) The most important way in which a person can participate in society and contribute to its progress is through a productive and decent job.

- (v) Full employment means, ideally, zero involuntary unemployment as well as zero part-time employment.
- (vi) In developing countries, the objective of achieving full employment has to be complemented with the objectives of creating productive employment (i.e., employment that is not underutilized) and ensuring decent employment (i.e., employment that provides living wages—determined by local conditions, benefits, reasonable job security, and a healthy work environment).
- (vii) Full employment requires the government's commitment to attaining and maintaining it. Achievement of this objective must be the government's mandate and responsibility, and governments should be evaluated and held accountable. Ensuring full employment is the most direct way to achieving the ultimate objective of economic policy, to improve the long-run well-being of *all* the people in the country, especially the most disadvantaged. And maintaining the economy as close as possible to full employment will lower safety net expenditures.
- (viii) While the private sector is the generator of wealth in a market economy, it cannot be entrusted with the achievement of full employment, because it is not a component of its overall objective function. The private sector has neither the commitment nor the tools to achieve it. Full employment requires close coordination between private and public sectors.
- (ix) Achieving full employment will require the synchronization of different policies (agricultural, monetary and fiscal, exchange rate, trade, and industrial). Piecemeal approaches will not work because the policies directed at the achievement of full employment have to take into account a country's overall economic conditions. This means that one must think in a systemic and coordinated way: that is, policies that influence the achievement of inclusive growth cannot be devised independently. The policies discussed in this book are (a) the expansion of agricultural production (chapter 5); (b) a coherent public investment plan that determines not only the amount but also the composition of investment across sectors (chapter 6); (c) an industrial policy program for productive diversification (chapter 8); (d) fiscal, monetary, and exchange policies geared toward full employment (chapter 12); and (e) governments (the public sector) willing to act as employers of last resort when necessary (chapter 14).
- (x) In pursuing full employment, the government will have to set priorities and deal with constraints.

- (xi) The key to growth is structural transformation aimed at upgrading production and export structures, industrializing, and diversifying. Structural transformation is policy induced and not the result of market forces. It requires the government and the private sector to be aware of the information and coordination problems that inhibit investment. They have to work together.
- (xii) Achieving inclusive growth-*cum*-full employment in a developing economy undergoing structural transformation, and where fighting inflation is often the central objective of policy making (and with the constraints imposed by globalization and competitiveness), is extremely difficult because of technical and political reasons, as argued by Karl Marx, Michal Kalecki, Milton Friedman, and Luigi Pasinetti. On the other hand, John Maynard Keynes, John Kenneth Galbraith, and William Vickrey thought that a market economy could achieve it, as the government has the tools and mechanisms to steer the economy in that direction.



1

What Is Inclusive Growth?

We need to make growth more inclusive—to expand access to opportunities so that all can participate, regardless of their individual circumstances.

—Haruhiko Kuroda, ADB’s President (2008)

During the last few years, terms such as “harmonious society” in the People’s Republic of China (PRC), “sufficient economy” in Thailand, and similar terms in other countries across Asia, have made their way into the discourse of policy makers. The message in all cases is similar: development is more than growth. The Commission on Growth and Development (2008) in its *Growth Report* also echoes the same sentiment. The Government of India, for example, boasts to have fostered “inclusive growth.” By this it means that the budget has increased allocations to school meals or rural road-building.¹ The high-growth policies implemented across the region since the 1960s were successful and led to increases in per capita income and dramatic reductions in poverty, contributing to closing the gap with the developed world. But today a feeling has spread that policies and objectives need to be revised as citizens across Asia demand more than growth. Inequality, productive and decent employment, the environment, health, and climate change are becoming increasingly important in the agendas of policy makers. Institutions such as the World Bank and the Asian Development Bank also acknowledge the issue and argue that growth and globalization have to be *inclusive*.²

What is inclusive growth? Although the term has not been formally defined, Ali and Zhuang (2007, 10) claim that a consensus is emerging as to what it means: “growth with equal opportunities.” In a related paper, Ali and Son (2007, 1–2) further argue that inclusive growth is “growth that not only creates new economic opportunities but also one that ensures equal access to the opportunities created for all segments

¹ *The Economist* 2008c.

² For example, World Bank President Robert Zoellick argued in October 2007 that the challenge of globalization is to make it inclusive.

of society. Growth is inclusive when it allows all members of a society to participate in, and contribute to, the growth process on an equal basis regardless of their individual circumstances” (Box 1.1 and Table 1.1 on the PRC).

In this book, I discuss the implications of inclusive growth for policy making in developing Asia. *If* the term inclusive growth is a useful concept, how should it be interpreted in developing policies? What sort of policies should be implemented to achieve it? What are the constraints and trade-offs? And finally, can it be achieved? The *central argument of the book* is that in order to achieve inclusive growth, governments must commit efforts and resources to the pursuit of full employment. The most significant way for a person to participate in society as a valuable member is through a productive and decent job. Moreover, maintaining the economy as close as possible to full employment will lower the need to dedicate resources to set up safety net expenditures. In the final analysis, full employment is the most direct way to improve the long-run well-being of *all* the people in the country. The questions into which the book is divided discuss different aspects of the link between inclusive growth and full employment and, in so doing, offer a menu of policies that will have to be tailored to each country’s circumstances (some proposals may not even apply to some Asian countries). All this implies that governments must set objectives and policies aimed at achieving inclusive growth (Stiglitz 1998).³ As modern economic theory and historical experience show, markets are the best way to organize the production of goods and services, but in some instances they fail to produce efficient outcomes (e.g., as a result of the existence of public goods, externalities, imperfect information, technology). But of all the market failures, none is perhaps more important for its social consequences than the failure of an economy to utilize its resources fully, especially employment. This is a key tenet of this book.

Does this mean that growth is not important? No, certainly not. Growth is fundamental for developing countries. One of the main themes of this book is the relationship between growth and structural change. This is how

³ The fact that I link inclusive growth with full employment does not mean that I disregard other very important questions. For example, the role of investment in nutrition, health care, and basic education, all of them key to a more productive workforce in the future, must also be considered. One of the fundamental prerequisites for successful inclusive growth is investments in helping the people both create and take full advantage of the opportunities arising in development. These investments should be part of all government’s commitment to deliver inclusive growth, as malnutrition and diseases may have lifelong consequences, and affect the prospects of an entire generation. These types of investments are also necessary and valuable for social and political reasons, as they contribute to society’s quality of life (Galbraith 1997). Empirical evidence shows that feeding young children (up to 3 years old) with a high-energy, high-protein supplement leads to increased economic productivity in adulthood, and to about 40% higher wages on average (Hoddinott et al. 2008).

Box 1.1. The People's Republic of China's Harmonious Society: The 11th Five-Year Plan

In March 2006, the National People's Congress of the People's Republic of China endorsed the 11th Five-Year Program, 2006–2010, which builds on a gradual shift in the government's emphasis since 2003 toward policies aimed at achieving balanced, equitable, and sustainable development. This plan, officially called a "program," generally provides indicative targets, rather than fixed targets, and gives attention to standards of living and the environment as well as to the economy. Of 22 goals, only 2 relate to economic growth—total gross domestic product (GDP) and per capita GDP—and 4 to changes in economic structure—share of services in the economy and in employment, spending on research and development, and the urbanization rate. The other 16 relate to population growth, use of resources, the environment, and standards of living (Table 1.1). The primary economic target is an average GDP growth rate of 7.5% over the next 5 years (compared with actual average growth of 9.5% over the past 5). Key goals are to reduce both energy consumption and discharge of major pollutants.

There is a stronger emphasis on rural development. The government pledges to raise farmers' incomes and promote public services in the countryside. In addition to abolishing the agricultural tax at the start of 2006, it will eliminate all tuition fees for 9 years of compulsory education in rural areas in 2007, and trim local government bureaucracies. It will increase subsidies for farmers who grow grain, and will continue to set prices for grain purchases as a support measure.

For industry, the focus is on strengthening its structure rather than on increasing its size. In the environmental area, the authorities will push industries to upgrade equipment and technology and eliminate processes that waste energy, water, and raw materials. They will also make efforts to expand services. Recognizing a lack of technological innovation, the government will invest \$8.9 billion in 2006 to encourage innovation, up nearly 20% from 2005. In education, the government will expand the secondary vocational education system to about the same size as the general secondary education system; increase enrollment rates for senior secondary education and higher education to 80% and 25%, respectively; and extend the availability of 9 years of compulsory education to all regions.

Source: Asian Development Bank 2006a.

I understand the story of the successful developing Asian countries. Understanding the dynamics of structural change is essential for comprehending the difficulties in achieving full employment. However, the elasticity of employment with respect to output in many parts of Asia is not particularly high, and in some cases it has even decreased (Felipe and Hasan 2006, chapters 3 and 4). What does this mean? To cite Felipe and Hasan (2006, 113) in discussing the PRC's employment elasticity: "In the 1980s, it took a 3% growth rate of output to induce a 1% increase in employment. By the 1990s, however, it took more than twice as much growth—about 7.8%, to achieve the same result." In the same vein, the United Nations Conference on Trade and Development (UNCTAD) has also recently claimed that although "most developing economies have seen strong growth in employment or even succeeded in stabilizing or slightly reducing unemployment rates . . . open unemployment in developing countries is much less responsive to high growth rates than it is in developed countries. . . . The main reason for the low impact of growth on open unemployment in many developing countries and emerging market economies could be the huge reserves of labour that enter the formal economy only after a longer phase of rising demand for labour and increasing wages. As some emerging countries—including [the People's Republic of] China—show, the process of integrating such reserves of labour into more formal labour markets may take many years of fast growth" (2007, II). This is of utmost importance because, as Figure 1.1 shows, the labor forces of many Asian countries will increase significantly in the next two decades.

Indeed, the expectation that labor could be released from agriculture and rapidly absorbed by industry has largely not been realized during the last 15 years. While the share of employment in agriculture has declined in much of developing Asia, labor has found new employment in the service sector (formal or informal) in relatively low-productivity occupations, mostly in trade and personal services. In other words, today, a high-growth economy does not necessarily generate the level and quality of employment that many Asian countries need. And without creation of employment, reduction of poverty will be very difficult. If growth is inclusive, it has to lead to a decrease in poverty; in particular, a faster decline in poverty should be observed for a given growth rate. The empirical evidence, however, indicates that, with the exception of East Asia, the degree of inclusiveness of Asian growth is relatively low (Pasha 2007). This is especially true in South Asia.

A preliminary conclusion is that policy makers should, perhaps, reverse the causality between growth and employment, and start thinking that a full-employment economy has a lot of virtues, and that full employment is what will lead to high growth, rather than the other way around.

I close this first chapter with the question of whether or not we need the adjective "inclusive." Many may argue that, one way or another, growth

Table 1.1. People's Republic of China: Key Indicators of Economic and Social Development, 2005–2010

Item	Indicators	2005	2010	Target	Type of target
Economic growth	GDP (CNY trillion)	18.2	26.1	7.5%	Indicative
	Per capita GDP (CNY)	13,985	19,270	6.6%	Indicative
Economic structure	Share of services sector value-added in GDP (%)	40.3	43.3	[3 pp]	Indicative
	Share of employment in services sector (%)	31.3	35.3	[4 pp]	Indicative
	Share of research and development spending in total GDP (%)	1.3	2.0	[0.7 pp]	Indicative
	Urbanization rate (%)	43	47	[4 pp]	Indicative
Population, resources, and environment	Population (billions)	1,308	1,360	<0.8%	Maximum Reduction
	Energy consumption per unit of GDP	–	–	[20%]	Reduction
	Water consumption per unit of industrial value-added	–	–	[30%]	Reduction
	Coefficient of effective use of water for irrigation	0.45	0.50	[0.05]	Indicative
	Rate of use of solid industrial waste (%)	55.8	60.0	[4.2 pp]	Indicative
	Total area of cultivated land (100 million hectares)	1.22	1.20	(0.3)	Minimum
	Total discharge of major pollutants	–	–	[10%]	Reduction
	Forest coverage (%)	18.2	20.0	[1.8 pp]	Minimum
Public services and standards of living	Years of education per capita	8.5	9.0	[0.5]	Indicative
	Coverage of urban basic old-age pension (100 million)	1.74	2.23	5.1	Minimum
	Coverage of rural cooperative medical care system (%)	23.5	>80.0	>[56.5]	Minimum
	New jobs created for urban residents (10,000)	–	–	[4,500]	Indicative
	Number of rural laborers transferred to nonagriculture sectors (10,000)	–	–	[4,500]	Indicative
	Urban registered unemployment rate (%)	4.2	50.0	–	Indicative
	Per capita disposable income of urban residents (CNY)	10,493	13,390	5%	Indicative
	Per capita net income of rural residents (CNY)	3,255	4,150	5%	Indicative

– = data not available, CNY = yuan, GDP = gross domestic product, pp = percentage points.

Note: (i) GDP, per capita disposable income of urban residents, and per capita net income of rural residents are at 2005 prices; (ii) changes in [] refer to cumulative figures for 2006–2010; (iii) major pollutants refer to sulfur dioxide and chemical oxygen demand.

Source: Asian Development Bank 2006a.