BOX 1.3 Recent Developments in Emerging and Developing Country Labor Markets

The Great Recession had a relatively mild impact on the labor markets of developing countries. Since 2010 unemployment rates have generally been below pre-global financial crisis levels, and declining. This is in stark contrast to the steep rise, and sluggish decline, of unemployment rates in high-income economies. The resilience of developing-country labor markets reflects, in large part, stronger output growth during and after the crisis. As growth in developing economies slows from post-crisis peaks, labor markets may weaken. Since job creation plays a critical role in reducing poverty, and promoting shared prosperity, this risk heightens the importance of implementing reforms to support growth, and of removing structural constraints on labor markets.

The 2007–09 financial crisis had a sizeable impact on global labor markets, with social and human costs: a reduction of lifetime income, an increase in poverty, and the loss of human capital (Gourinchas and Kose 2013). Though global unemployment rates returned to pre-crisis levels by 2014, according to official statistics, labor markets of advanced and developing economies followed very different paths. The unemployment rate in advanced economies increased by nearly three percentage points during 2007–09; in contrast, official statistics show an increase of less than half a percentage point in the jobless rate in developing countries over the same period. In advanced countries, the unemployment rate remains about 1.5 percentage points above pre-crisis levels; in the developing world it is one-percentage point below them.

Formal unemployment statistics cover only part of the story in developing economies, because of problems in measurement related to high levels of informality and underemployment. The latter—low-income employment, under-utilization of skills, and lack of full-time job opportunities—are particularly evident (World Bank 2012). Understanding the evolution of labor market conditions in developing countries is of paramount importance, as labor is the main source of income for the poor. Unemployment or underemployment are often associated with extreme poverty. Employment and wage growth are therefore critical for achieving the World Bank's twin goals of reducing extreme poverty and promoting shared prosperity (World Bank 2013).

How resilient were labor markets in developing countries during the Great Recession?

The global average unemployment rate rose sharply from 2007 to 2010, reflecting steep increases in high-income economies (Figures B1.3.1 and B1.3.2). As one would expect, employment contracted especially sharply in the countries that experienced the sharpest declines in output.

In contrast, unemployment rates in developing countries, based on official statistics, show a modest one-half percentage point uptick in 2009, and a return to pre-crisis levels by 2011. The largest increases in unemployment rates and declines in employment growth were in the regions with the largest output losses: Europe and Central Asia (ECA); and Latin America and Caribbean (Figures B1.3.3 and B1.3.4). This reflected contractions of demand in the export markets of Western Europe and the United States. Participation rates show a more complex pattern, generally (but not uniformly) declining during the global recession, and rising afterwards (with the exception of East Asia (Figure B1.3.5). In other developing regions, unemployment rates increased more moderately and participation rates remained near pre-crisis levels. China's relatively strong growth during the peak of the Great Recession helped support developing country exports, particularly in East Asia.

The resilience of developing economy employment compared to high-income economies during the Great Recession can be attributed to three factors:

- **Less severe contractions.** The 2008–09 slowdown in developing countries was not particularly severe, relative to that of the advanced economies, or for that matter, relative to earlier recessions in developing countries,

Figure B1.3.1 Global unemployment rate

Global unemployment has receded towards pre-crisis levels.

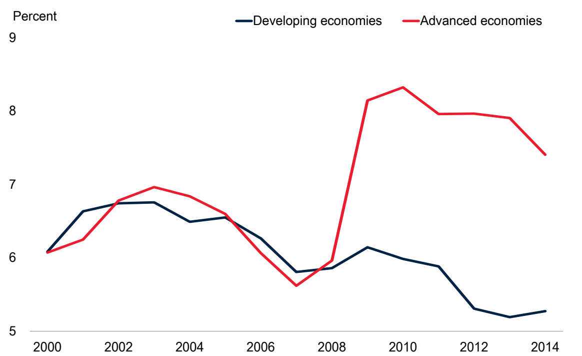
Sources: International Monetary Fund; International Labor Organization.
Note: Weighted by size of national labor force; 2014 value is projection from IMF's World Economic Outlook.

The main author of this box is Bryce Quillin.

BOX 1.3 *(continued)*

Figure B1.3.2 Unemployment rate in developing and advanced economies

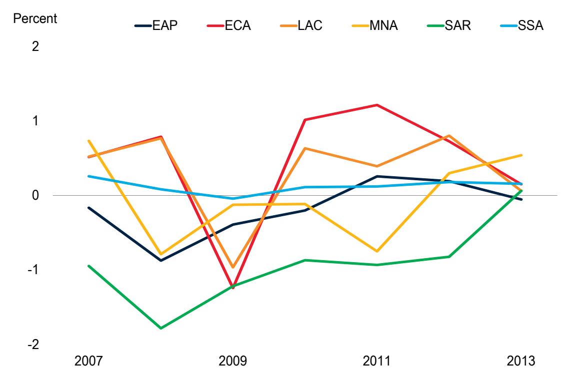
During the crisis, unemployment rose sharply in advanced countries, less so in developing countries.



Sources: International Monetary Fund; International Labor Organization.
Note: Aggregates weighted by size of national labor force. 2014 values are projections from WEO, IMF.

Figure B1.3.4 Change in employment to population ratio

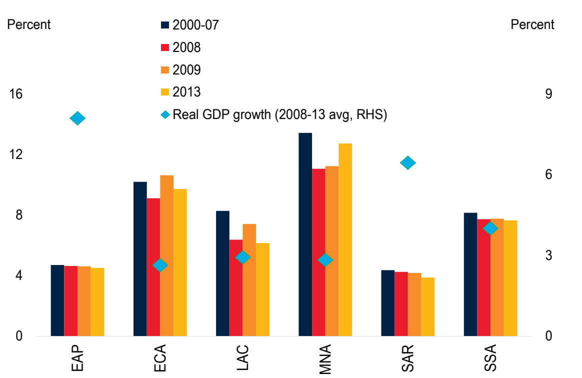
In LAC and ECA, employment rebounded strongly from employment losses in the crisis.



Source: International Labor Organization.

Figure B1.3.3 Regional unemployment rate

The increase in unemployment rates during the crisis was most pronounced in developing countries in LAC and ECA.



Source: International Labor Organization.
Note: EAP stands for East Asia and Pacific, ECA stands for Europe and Central Asia, LAC stands for Latin America and the Caribbean , MNA stands for Middle East and North Africa, SAR stands for South Asia, SSA stands for Sub-Saharan Africa.

and the recovery was somewhat quicker (Figure B1.3.6). As a result, in 2008–09, unemployment rates re-attained pre-recession levels faster than in earlier recessions. The linkage between growth and unemployment is also seen in divergences among developing regions. For example, ECA and LAC experienced the biggest drops in both output and employment growth.

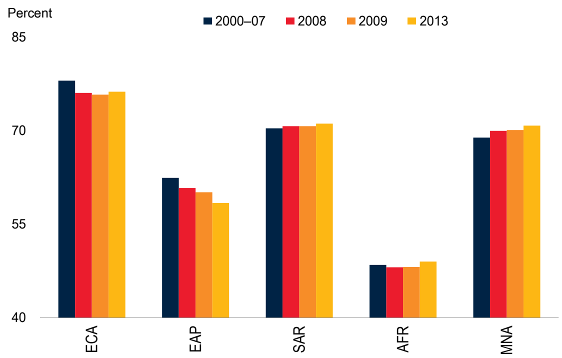
- **Less sensitivity of unemployment rates to growth.** Unemployment rates respond less to changes in economic activity in developing countries than in high-income countries. Historical estimates of "Okun's Law" suggest that a 1 percentage point increase in growth is associated with a smaller decline in unemployment in emerging than advanced economies; the estimated elasticity for frontier markets is about half that for advanced economies (Loungani 2014, Figures B1.3.7 and B1.3.8). However, these estimates vary widely over time, over countries, and over sectors (Cazes et al. 2012; Moosa 2012; Ball, Leigh and Loungani 2013).[1] For example, in Sub-Saharan Africa (SSA), LAC, and India, employment in manufacturing tends to be less responsive to growth than in agriculture, construction, or services (World Bank 2012).
- **Informality and measurement uncertainties.** Weaker Okun coefficients may reflect the high levels of informality and labor market segmentation in developing economies (UNCTAD 2012). In the absence of social safety nets, workers may be unable to afford periods of

[1]There are two versions of Okun's Law. The "gap" version relates that for every 1 percentage point increase in the unemployment rate, a country's GDP will be about 2 percentage points lower than its potential. The "differences" version (as originated in Okun, 1962) describes the relationship between quarterly changes in unemployment and GDP.

BOX 1.3 *(continued)*

Figure B1.3.5 Labor force participation rate

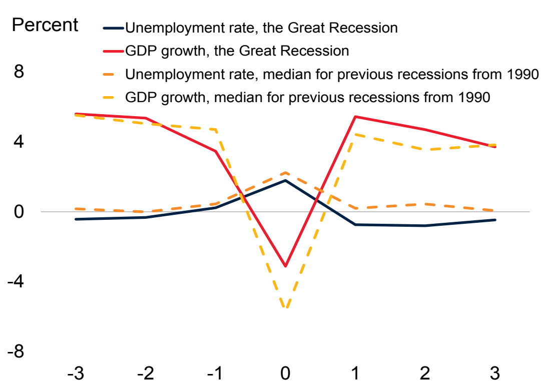
In the post-crisis rebound, labor force participation rates also rose in LAC and ECA.



Source: International Labor Organization.
Note: Modeled ILO estimate. EAP stands for East Asia and Pacific, ECA stands for Europe and Central Asia, LAC stands for Latin America and the Caribbean , MNA stands for Middle East and North Africa, SAR stands for South Asia, SSA stands for Sub-Saharan Africa. Labor force divided by working age population of ages 15-64.

Figure B1.3.6 Changes in unemployment rate and GDP growth in Great Recession vs. previous recessions in developing economies

During the 2009 recession, the unemployment rate in developing countries rose less than in earlier recessions.

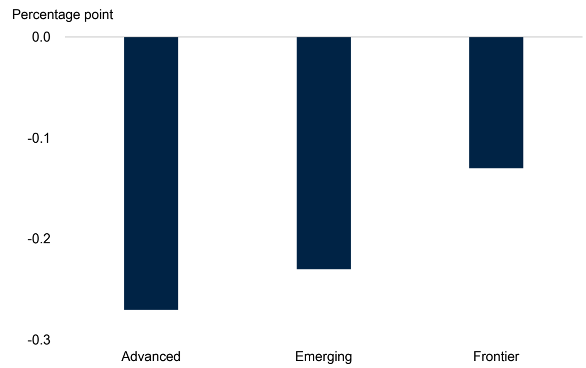


Source: International Labor Organization. World Bank calculations. Definition of recessions obtained from World Bank 2014a.
Note: The zero ("0") represents trough and the -3 to 3 values represent years before and after the trough. Sample comprises 11 emerging market economies.

unemployment and there may be a revolving door from formal to informal jobs that cushions the impact of slower economic growth on official unemployment rates. Informal employment can account for 70 percent of total employment in Asia and the Pacific, over 60 percent in Africa and LAC, and over 20 percent in ECA (ILO 2014; Figure

Figure B1.3.7 Estimates of Okun's Law coefficients for advanced, emerging, and frontier market economies

Additional growth is associated with a smaller reduction in the unemployment rate in emerging and frontier markets than in advanced markets.



Source: Furceri and Loungani (2014).
Note: Bar represents the impact of an extra percentage point of GDP growth on the unemployment rate.

B1.3.9). The very nature of informality makes it difficult to measure (note the wide range of the estimates in Figure B1.3.9). In addition, by blurring the distinction between employment and unemployment, it increases the margin for error in the unemployment data. Large-scale underemployment of workers, in low-paid, low-productivity occupations that under-utilize their skills, means that the measured unemployment rate in developing economies cannot be interpreted in the same way as that in advanced economies, either as a cyclical indicator, or as a gauge of economic welfare.

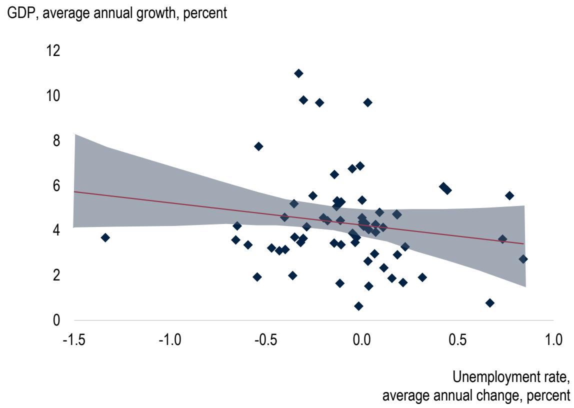
What are the prospects for developing country labor markets after the Great Recession?

Moderating growth in several large developing economies since 2010 has not yet had a large labor market impact, but some signs of weakness are emerging. Unemployment rates in all developing regions are around or below the pre-crisis average. Likewise, aggregate rates of employment growth remain solid, although there are exceptions, such as the marked declines in employment growth in ECA from 2011, and the softening in East Asia and Latin America in 2012. The International Labor Organization (ILO) projects that unemployment rates will rise in ECA, East Asia, and South Asia in 2014, with employment growth falling short of the growth of the working age population (ILO 2014). Global real wage

BOX 1.3 *(continued)*

Figure B1.3.8 Real GDP growth and change in unemployment rates in developing economies, 2000–14

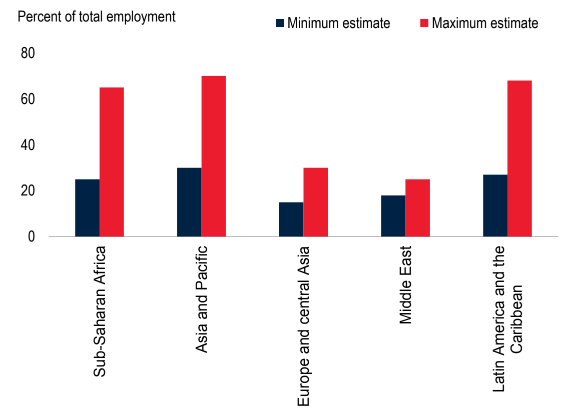
Higher growth was associated with falling unemployment rates.



Source: International Labor Organization; International Monetary Fund. World Bank staff calculations.
Note: Shaded area reflects 95 percent confidence interval. 2014 values are projections from WEO, IMF.

Figure B1.3.9 Estimated informal employment shares in selected countries, 2011

Informal sectors are large in developing countries.



Source: International Labor Organization.
Note: Calculations based on a sample of 49 countries.

growth declined in 2013 (Figure B1.3.10). Large emerging markets (China, India, South Africa) reflected this trend (Figure B1.3.11), although the wage increase in China, of more than 7 percent, held the global rate of increase close to 2 percent.

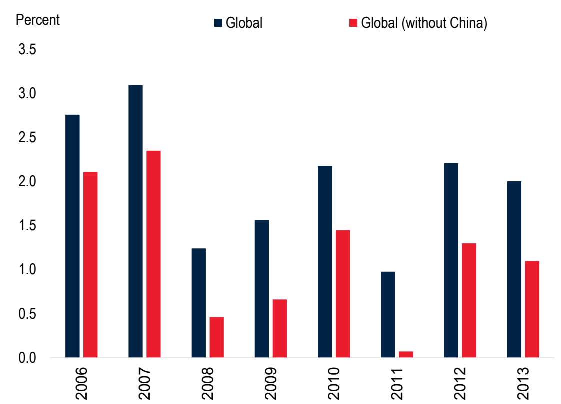
Aside from the signs of cyclical softening, labor markets in developing countries face macroeconomic and structural policy challenges that make them vulnerable to a global slowdown.

- **Reduced space for counter-cyclical fiscal policy.** Part of the relative resilience of emerging market economies during the Great Recession was due to the use of simulative fiscal policy to support domestic demand. Many countries, having used much of the available space, will be unable to respond as strongly in the event of another cyclical slowdown (World Bank 2015c).

- **Structural policy weaknesses.** Structural constraints on the private sector and labor markets create risks for post-Great Recession employment prospects. The private sector is the main engine of job creation: during 1995–2005, the private sector accounted for over 90 percent of the jobs created in Brazil, the Philippines, and Turkey. Small- and medium-sized enterprises (SME) employed over 60 percent of formal sector workers in developing countries (IFC 2013, World Bank 2012). Firms, particularly SMEs, report that their growth and hiring is limited by infrastructure issues, access to financing, and competition from the informal sector caused by cumbersome labor regulations and

Figure B1.3.10 Global average annual real wage growth

Since the crisis, real wage growth has declined in developing countries.

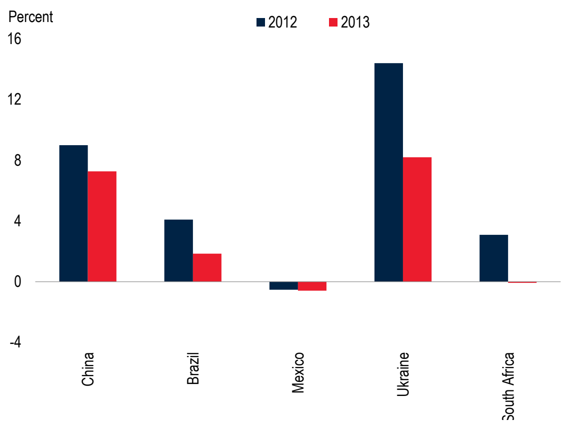


Source: International Labor Organization Global Wage Report 2014/15.
Note: Weighted average of y-o-y growth in average monthly real wages in 130 countries, covering 96% of all employees.

BOX 1.3 ***(continued)***

Figure B1.3.11 Real wage growth in selected developing economies

Real wage growth has been particularly weak in LAC.



Source: International Labor Organization Global Wage Report 2014/15.

poor enforcement (Figure B1.3.12, IFC 2013). Rigid labor regulations have been correlated with increases in urban poverty, fewer business start-ups, and lower productivity growth (Djankov and Ramalho 2009; Bassanini, Nunziata, and Venn 2014; Scarpetta 2014). The role and size of the state is also important. In MENA, which has the highest levels of unemployment, and the lowest labor force participation rates (particularly among women), the formal private sector employs no more than 20 percent of the labor force, with state employment exceeding 80 percent in some countries (World Bank 2013).

In addition to these policy-related risks to labor markets, demographic change is leading to rapid aging in many developing countries. Over the next 15 years, the growth in the working age population will slow from 2000–15 rates, in some cases sharply, in every developing region. Dependency ratios are already rising in Central and Eastern Europe and much of East Asia as a result of lower fertility and mortality rates (Galor 2012; Soares 2005; Acemoglu and Johnson 2007). Aging has broad-based policy implications, particularly for fiscal policy, and will impact labor markets by lowering labor supply and potentially lowering productivity and entrepreneurship (IMF 2004; World Bank forthcoming (a); World Bank forthcoming (b)). These demographic pressures exacerbate existing risks to labor markets and increase the need to pursue policies that promote formality.

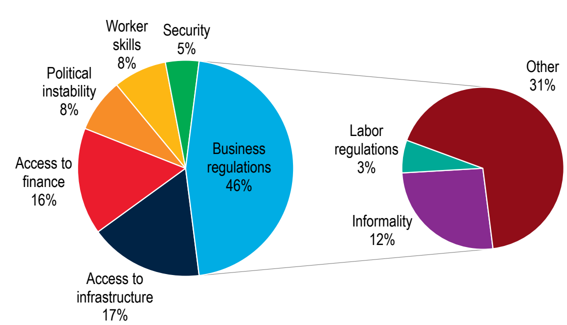
What policies could help address structural problems?

The nature of the policy challenges varies with the level of development, institutional strength, and endowments. However, promoting growth and addressing structural rigidities in labor and product markets will be parts of the solution. The reform agenda can be described along four themes (World Bank 2012).

- **Strong macroeconomic fundamentals.** Given the universal importance of sustained economic growth to the creation of permanent work, an overarching priority is a macroeconomic policy mix that supports steady growth.
- **Structural policies encouraging SME development.** In particular, policies should support SME development, given their contribution to employment. SMEs in developing countries are much less successful in growing into larger firms than in advanced economies: a study by IFC found that 35-year-old companies in India were typically born large, and shrunk by one fourth over their lifetimes; in Mexico they doubled in size. Yet in the United States they grew by a factor of 10 (IFC 2013). Reforms to broad-based infrastructure and financial-sector policies may be required to improve SME access to electricity and finance. Obstacles in these two areas pose binding on constraints firms in low-income and lower-middle income country (IFC 2013).
- **Labor market reforms.** A key priority is to eliminate government-created incentives for informal employment. Poorly designed regulation of formal employment often results in excessive red tape on hiring, and

Figure B1.3.12 Enterprise Survey results on key business constraints, 2013

Enterprises consider labor regulations and informality key constraints to business.



Source: Enterprise Surveys, World Bank. IFC (2013).

BOX 1.3 ***(continued)***

high penalties on firing. In turn, these encourage informality, or poor enforcement. Simulations of labor market models suggest that policy changes should be carefully sequenced, as increasing enforcement may reduce informality yet cause higher unemployment and lower welfare. Policies that first reduce costs in the formal sector would help avoid this outcome (Ulyssea 2010).

- **Country specifics.** Relevant country idiosyncrasies include economic institutions, natural resource dependency, and demographics. In some regions, states are embroiled in conflict, or post-conflict, situations that have large economic repercussions (World Bank 2012).
  - For agrarian countries, improving transportation to cities will be a high priority, as will be improving productivity in agriculture.
  - Aging economies, with growing dependency ratios, need to focus on policies that encourage health. Doing so will support labor force participation ratios by promoting longer working lives. There would also be fiscal savings, including on health care. Revised immigration policies may be needed to increase the size of the work force, particularly for non-traded services.
  - Countries with growing populations may be at risk of a "youth bulge" that increases competition for jobs, and dampens wage growth. Education programs can assist skills development, while business environment reforms may enhance business entry and market access. Large public sector employment, on the other hand, may crowd out private sector opportunities and lead to an inefficient allocation of human capital (World Bank 2013).
  - Resource-rich economies may need to focus on improving human capital and institutions. Excessive hiring by the public sector, or a loss of export competitiveness due to an appreciation of real exchange rates during periods of high commodity prices, may crowd out private sector job creation (World Bank 2014).
  - In conflict-affected countries, the availability of jobs that provide life-long skills for ex-combatants, or for youths who may be drawn into violence, is particularly important. Without decent employment opportunities, the risk is high that such people will become permanently disaffected. Productive infrastructure investments can provide such employment, and help build social cohesion.

labor (Callen et al. 2014). This non-tradables sector is typically characterized by low productivity growth relative to the tradables sector, in particular manufacturing (Cherif and Hasanov 2014). Reforms to provide market incentives for a transfer of resources towards the non-resource-based tradables sector may be helpful in some commodity-exporting countries.

- *Encouraging export diversification.* Export diversification is associated with higher growth (Lederman and Maloney 2007). Public policy can support export diversification and sophistication by fostering vertical diversification in oil, gas, and petrochemical sectors (i.e., increased processing of the raw materials), and horizontal diversification beyond these sectors (Cherif and Hasanov 2014).

- *Building human capital.* Government investment, including in human capital, would be an effective complement to efforts to accelerate productivity growth in the tradables sector (Cherif and Hasanov 2012). In developing countries, social returns to education have been shown to be significant, and potentially higher than returns to physical capital (OECD 2012; Psacharopoulos and Patrinos 2004).

Measurable effects of reforms, in terms of growth and productivity, can take a long time to materialize. Even in the short-term, however, reforms can have a considerable effect on activity. Policies could be implemented to ease the short-term transition cost, for example by assisting workers to move to new jobs and speeding up the repair of the capital bases of lending institutions. Some of the possible effects on activity are as follows: