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Creating jobs in low- and middle-income countries through demand-side policies[1]

Key points

- Since the 2008 crisis, the wider consensus about macroeconomic management for structural transformation has shifted, the emphasis on skills promotion has lessened, and increasing focus is placed on the demand side.
- Monetary policy acting alone is insufficient to counter stagnationary tendencies, fiscal policy has an important role, and weak demand can have permanent negative effects on growth and productivity and thus the creation of good jobs.
- In response to problems, such as climate change, stagnating productivity growth and rising geographical inequality, there is increasing acceptance of state involvement in investment; industrial policy is back on the agenda.
- Demand-side policies are interventions aimed at increasing one or more components of total expenditure. These policies include cheap money policies, active labour market policies, taxation policies, distributional policies, deficit financing, and increased government spending and investment.
- Reconsideration of the role of demand-led employment promotion policies in LMCs is overdue. Raising the demand for labour sustainably requires careful management of the interaction between the demand and supply sides of the macroeconomic system, and a focus that extends beyond the short run.
- However, creating jobs requires both supply and demand-side elements and a focus that extends beyond the short-run. Successful policy design needs to take into account the complementarities and linkages between public and private investment, productive capacity, finance, distribution and the external sector. Raising the rate of accumulation will generate both short-run increases in employment and long-run increases in capacity.

Introduction

Many low- and middle-income countries (LMCs) are characterized by high levels of overt and hidden unemployment and underemployment, and high rates of informality.[2] Progress on job creation has been limited in recent decades, as the focus of development policy shifted from structural transformation to microeconomic

[1] This brief was prepared by Adam Aboobaker, University of the Witwatersrand and SOAS University of London and Jo Michell, University of the West of England, based on an ILO report, Demand-side policies for employment promotion in low- and middle-income countries.

[2] Challenges relating to employment, especially in LMCs, are much broader than simply a problem of high formal unemployment, and include issues such as underemployment, informality, low incomes and working poverty, among others. Broader "relaxed" measures of unemployment recognise that traditional measures of formal unemployment which include an "actively sought work" stipulation are generally not appropriate in developing countries (ILO, 2015). We take the view that in LMCs the solution to problems of disguised and open unemployment will inevitably involve substantial growth of formal employment. We thus focus on the question of how to raise employment.

interventions, while the specific challenges of macroeconomic management for development were reduced to "getting the prices right" in the form of implementing inflation targeting regimes (Thorbecke 2019).

The downgrading of the role of demand management as part of a structural transformation strategy for LMCs contrasts with a significant shift in the consensus since the 2008 Global Financial Crisis on appropriate policy in advanced economies. It is increasingly accepted that, until the outbreak of post-pandemic inflation at least, advanced economies suffered from *secular stagnation* – persistent deficiency of aggregate demand alongside weak growth in capital investment and productivity – and from *hysteresis* – persistent negative labour market responses to weak demand (Summers 2015). These phenomena have led economists to call for active fiscal policy to raise demand. Although attention has been mostly confined to advanced economies, such demand-side issues and policies are also relevant when considering the problem of inadequate job creation in LMCs.

Alongside this policy shift, and in response to problems such as climate change, stagnating productivity growth and rising inequality between and within countries, there is increasing acceptance of state coordination of investment: industrial policy is back on the agenda (Rodrik 2008; Cherif and Hasanov 2019).[3] In contrast with traditional "supply side" policy – which emphasises letting market forces take the place of direct policy intervention – industrial policy advocates active state involvement in directing and facilitating investment and in guiding other macroeconomic variables. In the case of LMCs, structural transformation is a key aim. Although the intended outcomes are on the supply side – expansion of productive capacity and complexity – industrial strategy has important demand-side aspects. Increased capital investment will lead to short-run increases in the aggregate level of spending, as well as generating potential longer-run increases in productive capacity.

Managing the interplay between macroeconomic demand and supply side factors in both the short and long run is essential in any successful structural transformation strategy. In turn, structural transformation is essential for achieving sustainable increases in the demand for labour in LMCs, or in other words, for employment promotion.

This primer focuses on demand-side policies for promoting employment in LMCs. The shifting consensus on macroeconomic policy in advanced economies, alongside growing acceptance of industrial policy, provides an important opportunity for reconsideration of such policies.[4] The primer draws from a structured review of the literature covering key concepts relevant to formulating demand-side policies for employment promotion in LMCs (Aboobaker and Michell 2022). The aim is to lay the conceptual foundations for a policy debate on employment promotion in LMCs.

Demand-side policies and structural transformation

Demand-side policies are interventions that aim to increase one or more components of *total expenditure* with the intention of raising employment and output. *Total expenditure* refers to the national accounting definition which states that expenditure in the domestic economy comprises spending on household consumption, investment (capital formation), and government consumption, plus net exports less imports. Demand-side policies thus aim to increase either consumption, investment, or the trade balance. A key aim of such policies is to increase employment – either by increasing demand for domestically produced output and thus indirectly increasing the demand for labour (in the case of increased expenditure on privately produced domestic output) or to increase employment directly (for example, in public works programmes).

In a discussion of demand-side policies in LMCs, Dutt (1996) provides the following definition:

> *...[p]olicies that deal with problems of economies suffering low levels of output, employment and growth. ... Included are cheap money policies, deficit financing, increased government spending, government investment, and redistributive policies*

[3] The signing of the 'Inflation Reduction Act' in the US, which allocates over $350bn to reducing emissions and investment in renewables, shows the extent to which the policy consensus has shifted on industrial policy.

[4] The need for such a reconsideration was recognised by the ILO in a Resolution adopted at the Second Recurrent Discussion on Employment at the 103rd Session of the International Labour Conference in June 2014, governments, employers' and workers' organizations called upon ILO member States to promote comprehensive employment policy frameworks based on tripartite consultations, which would include as a main element "pro-employment macroeconomic policies that support aggregate demand, productive investment and structural transformation, promote sustainable enterprises, support business confidence, and address growing inequalities".

> *shifting the distribution of income towards poorer consumers with higher propensities to consume.*

Although Dutt discusses these policies in the context of LMCs, the list of policies applies equally to advanced economies. However, the nature of the problem of insufficient work in LMCs is often substantially different to the unemployment problem faced by policymakers in advanced countries. In many LMCs, large numbers of underemployed and unemployed persons are the visible symptom of underdevelopment and inadequate structural transformation. The proportion of the working-age population unable to find formal employment in LMCs often greatly exceeds levels seen in advanced economies. Demand-side policy aimed at overcoming the problem of insufficient employment therefore needs to consider the "dual" nature of labour markets in many LMCs, as emphasised in the classic development literature (Lewis 1954).

This requires us to consider the interactions between *structural transformation* and demand stimulus. The former refers to changes in the productive structure and capacity of the economy, including technological upgrading, skills acquisition and infrastructure upgrading. *Structural transformation* requires substantial capital investment and takes place over a medium-to-long term time frame. *Demand stimulus*, on the other hand, refers to policies that increase expenditure on either consumption or investment in the short-run (policies that aim to raise export demand are usually thought of as a somewhat separate category). There is overlap between structural transformation and demand stimulus because increased investment as part of a structural transformation strategy also constitutes demand stimulus. Structural transformation, thus, has both demand-side and supply-side elements. The initiation of an infrastructure project, for example, will raise employment, money wage income and thus consumption spending, as well as raising demand for inputs such as construction materials.

As well as *generating* demand, structural transformation also *requires* demand: there must be a market for newly available products as upgrading progresses: as capital investment raises the potential output of the manufacturing sector, for example, realising this potential requires demand for manufactured output, either domestic or external.

There is also important overlap between structural transformation and demand stimulus in that both aim to increase economic activity, incomes and jobs. The mechanisms and time scales differ substantially however: demand stimulus aims to increase activity within the current economic *structure*, while structural transformation aims to *alter the current economic structure*. Nonetheless, the process of altering the economic structure is likely to require either increased activity, a reallocation of activity, or (most frequently) both.

Successful demand-side policy design for LMCs requires an understanding of the limits of what can be achieved using demand stimulus in the absence of structural transformation, and how demand management and structural transformation interact over medium- and long-run time horizons in raising the demand for labour. This requires discussion of the nature of the problem of inadequate job creation in LMCs

The problem of underemployment and unemployment in low- and middle-income countries

As already noted, LMCs are often characterised by "dual" labour markets – an underdeveloped formal labour market coexists with substantial disguised and open unemployment, and in-work poverty, particularly in informal employment. Although *demand stimulus* may be effective, at least in the short run, in raising both economic activity and employment, the number of persons unable to find employment at current wage rates relative to the degree of unused capital means that demand stimulus strategies will not, in general, be effective in achieving full employment. This contrasts with the situation in advanced economies where, for much of the last thirty years, demand stimulus could plausibly have increased employment to the point of generalised labour shortages and upward pressure on nominal wages.

The root of the problem in LMCs, in contrast to the situation in advanced economies, is the lack of *productive capacity.* The current capital stock, level of technological sophistication and knowledge, and infrastructure (we will refer to these collectively as the "capital stock" as a shorthand), impose a limit to the amount of new work that can be undertaken that will generate higher output.[5]

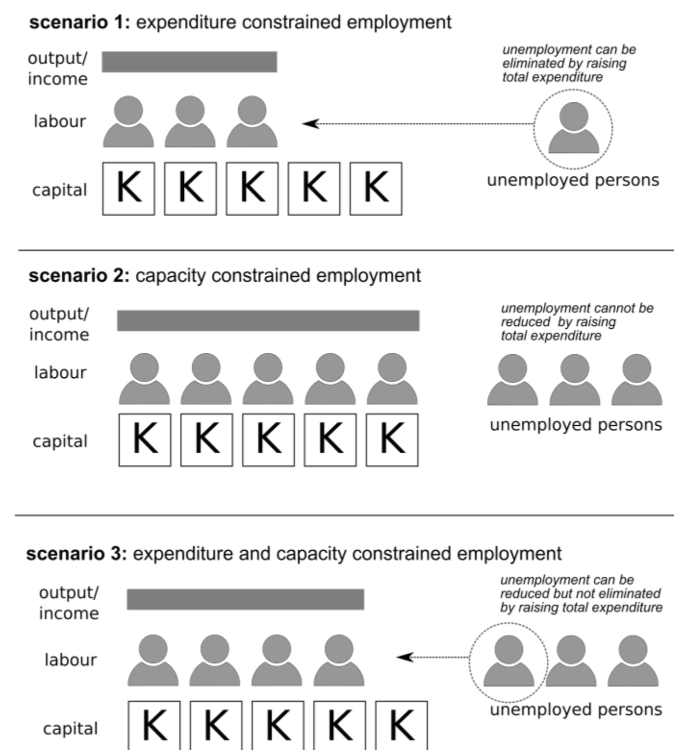
[5] In technical terms, beyond a certain level of employment (including informal activity) the marginal productivity of labour becomes zero.

When considering the problem of insufficient job creation in LMCs, and appropriate policy responses, it is therefore necessary to distinguish between situations of underutilised productive capacity and situations of *insufficient productive capacity*. A given capital stock imposes an upper limit to the level of economic output. *Demand stimulus* can increase employment and economic activity up to this limit, but beyond this limit, further increases in employment can generate regressive redistributions: with a fixed limit to output, further increases in employment require reallocation of that output if wages are to be paid to newly employed workers. An increase in total expenditure due to demand stimulus will only lead to an increase in production if *spare productive capacity* – machinery, tools, skills, and infrastructure – is available. If such spare capacity is not available, so that money incomes and expenditure increase *without* an increase in output, the result is likely to be inflationary pressure: increased demand in the face of fixed supply will lead to higher prices and thus lower real wages for those already employed.

Over the longer run, sustained increases in labour demand thus require *growth in capacity*: employment promotion beyond the short run requires capital accumulation and structural transformation.[6]

We can distinguish different limits to expansion of production and employment on this basis, as illustrated in stylised fashion in Figure 1. On the left-hand side of the figure, productive capacity is represented as several units of capital. When labour works with capital, output (and thus income) is produced. The level of the capital stock thus sets an upper limit on possible production, regardless of how much labour is available or employed ("capital stock" is synonymous with "productive capacity" in this stylised account). Above the capital stock on the left-hand side is an indication of the current level of employment. The right-hand side shows the number of unemployed and underemployed persons. It is assumed that people can be withdrawn from this group without causing a reduction in output (the marginal productivity of labour in this group is zero). The level of output is thus determined by the level of employment.

▶ Figure 1. Limits to expansion of employment and output



Three different scenarios are represented. The top row depicts the case where insufficient total expenditure leads to a level of employment insufficient to use all available capacity: there is spare capacity (unused units of labour) on the LHS sufficient to absorb all unemployed/ underemployed persons on the RHS. This row depicts a situation of expenditure-constrained employment. In this situation, demand stimulus which raises total expenditure can draw all unemployed/underemployed persons into productive employment without exhausting the available capital stock.

This contrasts with the middle row which depicts the situation of *capacity-constrained employment*: all available capital is already in use, yet unemployed/underemployed labour still remains on the RHS. Further job creation is not possible in this situation without redistribution of income/inflationary pressure. In this case, the root cause of underemployment/unemployment is *insufficient productive capacity* rather than insufficient expenditure. In this case, employment and output cannot be increased in the short run by demand stimulus: an increase in productive capacity is required. This scenario illustrates

[6] See Aboobaker and Ugurlu (2020) for detailed discussion of this issue and An et al. (2017) for discussion of the evidence on the relationship between growth and employment.

the importance of *structural transformation*, represented in stylised form here as the need to increase the size of the capital stock.

A more realistic characterisation of many economies is shown in the bottom row, which combines the features of the two previous cases. In this case there is under-utilisation of the capital stock, but even if demand stimulus raises employment to the level where all units of capital are in use, unemployment/underemployment *will not be eliminated*: the number of persons on the RHS exceeds the number of unused units of capital on the LHS. This scenario – a combination of expenditure-constrained and capacity-constrained employment – highlights the need for demand to keep pace with accumulation: as the capital stock expands, expenditures need to be sufficient to ensure a market for increased potential output. The scenario also illustrates the limits to demand stimulus without structural transformation.

When designing policies in LMCs that aim to raise the demand for labour sustainably, it is important to strike an appropriate balance between short-run adjustment of production and employment given *current* available capacity, and longer-run *increases* in capacity. If, for example, spare capacity exists in the manufacturing sector due to a cyclical drop in expenditure (a recession), demand stimulus which raises total expenditure on domestic manufactured goods will be effective in raising employment in the domestic manufacturing sector. Raising employment in manufacturing beyond these limits cannot, however, be achieved by demand stimulus – instead, expansion of manufacturing capacity is required in the form of investment in plant and machinery.

Linkages between sectors mean that reducing unused capacity in some sectors will also raise capacity use in other sectors. Increased demand for domestic manufactured goods, for example, will raise demand for labour in manufacturing. If this leads to higher employment, total wage income will rise and this will lead to lead to an increase in consumption expenditures. These consumption expenditures are likely to include expenditure on services and food, thus raising demand and capacity utilisation in other sectors.

Effective policy therefore requires correct diagnosis of the current situation and of the causes of unemployment and underemployment: how much spare capacity is available in various manufacturing sectors (high tech versus low tech, domestically oriented versus export oriented, etc.)? What linkages exist between sectors? How much capacity is there to expand agricultural output and/or employment? How much additional demand for agricultural output will result from increased output and employment in manufacturing? How large is the number of unemployed or underemployed persons in the agricultural and informal services sectors?

Demand-side policy design

With these definitions in place, we can return to the list of *demand-side policies* identified in the Dutt quote, above. This is a broad definition which includes policies which affect total expenditure within the current economic structure by raising consumption, and policies that affect *both* immediate expenditure *and* medium-term productive capacity by raising capital investment. The list includes policies deployed in examples of both successful structural transformation and in cases of failed structural transformation.

The common *demand-led* element is that these policies aim to generate a short-run expenditure-driven effect: the intention is to rapidly raise the level and/or growth rate of one or more components of total expenditure on the assumption that sufficient productive capacity and unemployed labour are available to accommodate a short-run increase in production. As already noted, the assumption of available spare capacity requires caution in the context of LMCs – the extent to which capacity is available to accommodate demand stimulus will be country and context specific. In the case that capacity is not available to raise investment, policymakers face a trade-off between consumption and investment: in order to raise investment, consumption may need to be constrained until capacity can be increased sufficiently.

We can therefore improve precision by distinguishing between *consumption-led employment* policies and *investment-led employment policies*. These terms provide more specificity than the more general term “demand-side policies”. Consumption-led employment policies aim to increase consumption expenditure by raising output within the current economic structure and level of productive capacity. Investment-led employment policies either directly or indirectly aim to raise the rate of capital investment, thus increasing output and employment in the short run and increasing the growth rate of the capital stock, and thus productive capacity, in the longer run. We can use these definitions to categorise and organise a range of demand-led policies.

Cheap money policies refer to interventions that aim to reduce the cost of funding for firms, households and/or government. This may lead to increased investment if lower funding costs stimulate firms to raise investment expenditure. Cheap money policies can also lead to consumption booms if consumer credit is used to finance consumption, or as a result of wealth effects if credit expansion leads to growth in the prices of houses and/or financial assets.

Preferential credit policies are one particular form of *cheap money policies* which have played an important role in many examples of successful industrial policy and structural transformation. Ensuring the provision of credit, sometimes at preferential rates, to strategically important sectors, firms and enterprises can play a vital role in ensuring that finance is available for investment and production. Financial markets in many LMCs are underdeveloped, so that access to finance is an important barrier to investment, particularly for micro, small and medium enterprises (MSMEs).

Government spending provides a direct demand stimulus by raising total expenditure directly, either on consumption or capital investment. Government consumption expenditure is typically a substantial proportion of GDP, while public investment tends to be low. Government consumption expenditure includes both purchases of goods and services from the private sector, which stimulates production and employment, and direct employment of public sector workers.

In the case of public investment, quality of spending matters – well-designed and targeted government investment in infrastructure and research and development can have substantial positive effects on productive capacity in addition to the short-run stimulus to output and employment, while badly designed projects may generate short-run increases in employment but fail to generate an increase in productive capacity – or may fail even to generate increased employment in the short run.

Taxation and subsidies affect the levels of and distribution of disposable incomes. In general, a higher share of tax in national income will reduce total expenditure if not offset by other measures. However, if taxation is levied on those with a low propensity to consume, and matched by increases in government spending, the overall effect will be to increase total expenditure, an effect known as the *balanced budget multiplier*. Increases in marginal tax rates, if calibrated effectively, may serve to constrain the consumption of those on higher incomes, thus freeing productive capacity to be used for investment. As noted by Parisotto and Ray (2017), “Progressive taxation and measures to assist firms in their transition to formality, as called for in the SDG target 8.3, could provide an avenue to expand the tax base, providing that the fiscal system can assure fairness, transparency and efficiency." Fiscal transfers for the purposes of social protection such as unemployment benefits will tend to raise consumption expenditures.

The term *Active Labour Market Policies (ALMP)* covers a broad range of possible labour market interventions, from supply-side measures such as training and assistance and incentives related to searching for work, to demand-side measures such as public works programmes and wage/hiring subsidies. Supply-side ALMP measures are unlikely to be effective in the absence of a broader process of structural transformation – the problems of skills mismatch or insufficient training are only one part of the much larger problem of inadequate job creation in LMCs. Demand-side measures such as public works programmes may have a role to play as a form of consumption-led demand stimulus in limited situations of short-run inadequate expenditure but cannot substitute for effective policy to promote structural transformation. In some cases, by raising consumption expenditure without substantially raising output, large-scale public employment programmes may serve as an impediment to structural transformation by reducing available productive capacity for capital investment. Public employment programmes may therefore be useful for short-run alleviation of the welfare costs of high unemployment, but do not in themselves constitute a long-run strategy to promote structural transformation (Aboobaker and Ugurlu 2020).

Deficit financing refers to the situation where government spending exceeds taxation. Since taxation tends to reduce expenditure while government spending raises expenditure, higher deficits resulting from policy decisions to raise spending relative to taxation will raise total expenditure. It can be useful to distinguish deficits generated as a result of consumption-led policies from those *resulting from investment-led policies*. Public investment which successfully raises the growth of output and job creation is less likely to lead to unsustainable growth in public debt than expansion of consumption spending because tax revenues will increase as the economy grows. Expansion of public debt can lead to significant shares of government income being directed to

interest payments. This is problem is particularly acute for countries lower down international monetary hierarchies which are dependent on foreign exchange for imports and borrow in foreign currencies.

Care must be taken in inferring that higher reported public deficit necessarily imply active demand stimulus because deficits can also increase as a result of falls in private sector expenditure: deficits generally rise during recessions because tax revenues fall and social security payments rise. This is referred to as *automatic stabilisers* because lower taxation and higher transfer payments act as a (consumption-led) demand stimulus. This may not be sufficient to offset the fall in private expenditure, however.

Consumption-led distributional policies aim to raise consumption expenditure by shifting the distribution of income away from those on high incomes to those on lower incomes. Such policies include taxation, subsidies, and transfer payments, as well as regulatory interventions into wage bargaining through minimum wages. Since those on lower incomes tend to spend a greater share of their income on consumption, redistribution in favour of this group will raise consumption expenditure. Objections to such policies on the basis that those on high incomes are more likely to engage in investment spending are often overstated, however the potential for changes in profitability to influence investment decisions should be kept in mind when designing such policies.

Low-carbon energy production, *pollution reduction and other environmental investments* (whether private or public) may not immediately increase productive capacity. However, such investment will generate jobs in the short run, and over the longer run will contribute to mitigating the major negative supply-side impacts of climate change and environmental degradation.

Industrial policy has returned to favour after a period on the periphery of policy debates. In the case of LMCs, this refers to policy aimed at transforming the structure of the economy. Such policy includes state direction and planning of investment, identification of strategically important sectors and potential routes to technological upgrading, provision of fiscal incentives and subsidies, policies to ensure access to credit at affordable rates, and policies that alter the composition of imports such as tariffs. While there is potential for badly designed policy to lead to negative outcomes, criticism and dismissal of industrial policy from the development policy toolkit in recent decades went too far (Cherif and Hasanov 2019). Rodrik (2008) notes the inconsistency in standard criticisms which argue that industrial policy is targeted at loosely-defined and hard to observe imperfections by incapable bureaucrats prone to malfeasance. These criticisms apply equally – although they are made less frequently – to other areas of government intervention, including education and health policies, social insurance, and macro stabilisation. These areas also feature hard to observe market failures and the policy response is presided over by bureaucrats with large degrees of autonomy, who are subject to political influence. In contrast to the debate on industrial policy, however, the debate on these areas rightly emphasises how rather than whether government should intervene.

Successful investment-led policies will produce both a short-run effect on output and employment and a longer-run increase in capacity. Consumption-led and investment-led are not absolute categories, and most policies will involve elements of both. Furthermore, investment and consumption expenditures are not independent: in the short run, increased investment is likely to lead to increased consumption as a result of higher employment in the production of capital goods and thus an increase in total wage income and consumption. It is also plausible that investment will respond to consumption demand: if consumption-good firms see increased demand they may respond by raising capacity. Thus, investment-led policies will raise consumption, while consumption-led policies may stimulate investment.

▶ Box 1. Social infrastructure

Social infrastructure investments in the “care economy” (in health and social work and in education) do not neatly fit the consumption-led/investment-led distinction. While the output of the care sector is categorised as consumption of services in national accounting conventions, investments in a well-functioning care sector are a crucial form of social “infrastructure” investment (Heintz 2018; UN Women & ILO 2021). Well-functioning care services raise output today but also output tomorrow, as they contribute to the creation of human capabilities, including in supporting the development of the future workforce. Expanding care service provision has positive externalities that are difficult to measure (like lowering absenteeism or allowing for greater women’s labour force participation) that are associated to higher productivity levels.

Challenges in implementing demand-side policy

The issue of demand-led employment promotion policies in LMCs has received insufficient attention in recent decades. The experiences of some Latin American countries with recurrent inflation and exchange rate and financial instability have led some to dismiss strategies of demand-led structural transformation policy as "macroeconomic populism" (Dornbusch and Edwards 1990). While LMCs face important constraints to the use of demand management tools, the experiences of Asian economies demonstrate that successful policy is feasible.

It is likely that size matters for successful demand-led policy. Historical evidence suggests that sustained growth in aggregate demand played a role in Indian and Chinese development. Strategies that were effective in such large economic units may not be effective for smaller units, particularly small individual countries. Regional cooperation and coordination are likely to be required for successful policy. It is also noteworthy that the Indian and Chinese cases involved substantial investment spending: public investment as a share of GDP increased substantially in India. In China, while investment during the high growth period is not officially recorded as public investment, state involvement – via state-owned enterprises and banking – was substantial.[7]

As already emphasized, demand-side policies – policies that increase total expenditure – require either spare productive capacity or reallocation of current capacity and incomes. Policy that raises income and consumption spending without generating sustained increases in productive capacity is unlikely to succeed. Estimates of available spare capacity should therefore be attempted when calibrating policy. This is not a straightforward task: statistics are not readily available and may be misleading. Even if there is apparent spare capacity overall, or in some sectors, linkages between sectors and potential bottlenecks due to intermediate inputs, agricultural production or imports may constrict expansion. The use of input-output statistics and industry-level production indicators may provide some guidance, along with careful monitoring of relevant price indices for inflationary pressure. Policymakers should also attempt to identify likely resolution mechanisms in the case that quantity constraints bind: how will price increases in one sector be transmitted to other sectors, for example?

The distributional effects of demand stimulus should be considered. Possible inflationary pressure resulting from increased expenditure can lead to redistribution between wage income, retained earnings and rents; between businesses in different sectors (e.g., primary production versus manufacturing or tradeables versus non-tradeables); between geographic regions; and between demographic groups. Inflationary pressure can itself weigh on demand: falling real incomes because of higher prices can lead, with some lag, to weaker consumption and recession.

Redistribution will have political implications as well as macroeconomic effects. Taxation and wage-bargaining institutions have an important role to play in providing an equitable distribution of income and consumption while ensuring sufficient capacity for accumulation and structural change.

One possible way to free up spare capacity is to use taxation to constrain the consumption of those on higher incomes. Domestic productive capacity can then be re-allocated towards higher priority areas of spending (Skott 2019). This kind of reallocation will not be possible in the case that consumption goods are imported but reducing imports of some kinds of consumption goods (e.g., luxuries) will free up available foreign exchange to be spent on essential consumption goods or capital goods.

Demand-side employment policies will affect the external position. Demand stimulus may affect the relative prices of tradeables versus non-tradeables, the balance of payments, net income flows, the exchange rate, and cross-border financial flows. The effect of increased output on total imports and the composition of imports should be considered, and the implications for the balance of trade. Many LMCs operate "intermediate" exchange rate regimes – managed floats or adjustable pegs of some kind – which make them particularly vulnerable to deterioration of the external balance and/or the willingness of external investors to provide credit. Rapid and disorderly exchange rate devaluation can lead to internal redistribution of income, compression of real wages and consumption, and increased foreign currency debt burdens.

[7] See Aboobaker and Ugurlu (2020) for detailed discussion of this issue and An et al. (2017) for discussion of the evidence on the relationship between growth and employment.

Financial constraints to increased expenditure, particularly debt-financed public expenditure, are substantial for LMCs. LMCs face structurally high interest rates due to inadequate domestic financial systems, short-term bias among investors – particularly foreign investors – and the subordinate position of LMCs in global monetary and financial hierarchies. Many of these problems do not have short-term solutions – reorienting financial systems toward patient investment, a domestic investor base and local-currency debt issuance is a long-term project. Many LMCs have substantial outstanding government debt and foreign currency liabilities, reducing room for further expansion. Growing debt stocks will, unless interest rates fall, lead to increasing interest payments. In the case of government debt, if rising shares of tax revenue are required to cover interest payments, resulting reductions in spending in the long run may outweigh short run gains from deficit-financed expansion.

Much of the problem of financial subordination is outside the control of domestic policy makers: better global credit allocation and risk sharing mechanisms are required. Climate finance initiatives may in some cases serve to lessen external financial constraints, but the potential for transformative change is likely overstated and such initiatives may in some cases lead to new forms of financial dependence (Dafermos, Gabor, and Michell 2021). Policy space can potentially be created by introducing restrictions on cross-border financial flows, particularly short-run speculative movements. This may increase the scope for central banks to influence domestic liquidity conditions and interest rates. While the strategic use of public debt monetisation can reduce the costs of government borrowing, it should not be seen as a plausible long-run strategy for job creation in LMCs.

These challenges are made more acute by the current situation of global inflationary pressure driven by supply shocks, and policy tightening by the central banks in response. The environment of tightening liquidity, higher policy rates and acute shortages of food and energy place tighter constraints on LMC policymakers with already limited room for manoeuvre. The prospect of ongoing supply disruption as a result of climate change highlights the importance of raising investment in climate adaptation and mitigation as part of structural transformation strategies.

Highlighting these issues does not constitute an argument against the use of demand-side policies. On the contrary, in many situations there is likely to be an important role for higher government spending, particularly on investment, the use of public deficits to supplement private expenditure, and redistribution towards those on lower incomes. Identifying likely negative outcomes or side-effects increases the chance that these can be avoided or mitigated.

Conclusion

Reconsideration of the role of demand-led employment promotion policies in LMCs is overdue. Raising the demand for labour sustainably requires careful management of the interaction between the demand and supply sides of the macroeconomic system, and a focus that extends beyond the short run. Successful policy design needs to take into account the complementarities and linkages between public and private investment, productive capacity, finance, distribution and the external sector. Raising the rate of accumulation will generate both short-run increases in employment and long-run increases in capacity.

Where we have highlighted obstacles to structural transformation, demand stimulus and job creation, removing these obstacles is likely to be a problem of political economy as much as an economics problem requiring a technical solution.

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