

HOW SHOULD LABOR MARKET POLICY RESPOND TO THE FINANCIAL CRISIS?

HD and PREM Labor Market Teams, February 2009¹

The financial crisis has triggered a serious slowdown in economic growth which is now beginning to be felt as a reduction of aggregate demand for output and labor. The IMF projections for economic growth in 2008 were revised downward by one percentage point, from 4.8 percent in October 2007 to 2.5 percent in November 2008, a rate far lower than those seen in recent years. The downward adjustments affected all regions of the world except the Middle East and it was particularly severe in Sub-Saharan Africa. According to the ILO, after four consecutive years of decline, the global unemployment rate increased from 5.7 percent in 2007 to 6.0 in 2008 as nearly 11 million people join the rank of the unemployed, the largest increase since 1998 (ILO, 2009). The employment-to-population rate also fell slightly (0.2 percentage points) as companies around the world are cutting production and closing factories. The outlook for 2009 is even more pessimistic as economic growth around the world is expected to fall sharply, severely affecting labor markets in developing countries.

This note argues that an effective policy package should also include – besides macroeconomic policies and direct cash transfers – a combination of passive and active labor market programs.² In particular:

- Middle-income countries, with favorable fiscal space and some degree of institutional capacity, should consider expanding income support programs for the unemployed and active labor market programs, including boosting unemployment insurance benefits, introducing temporary payroll tax holidays or wage subsidies, expand training programs for the unemployed (possibly amending them with training stipends) and introduce youth employment programs.
- Low-income countries have fewer options, and must rely on administratively less demanding programs that contain an important self-targeting component – above all, on public works and targeted micro-credit schemes.

1. Potential Impact of the Financial Crisis on Labor Demand and Employment

The unfolding financial crisis is quickly spreading as an adverse external shock to developing countries. Global economic growth is now expected to slow from 2.5 percent in 2008 to 0.5 percent in 2009, the lowest level since WW II.³ This worsening will be driven by a deterioration of the performance of OECD economies, where growth is expected to slow to 1.4 percent in 2008 and contract by 0.4 percent in 2009 (OECD, 2008). Facing this adverse international environment, the World Bank has recently lowered its estimates for growth in

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² The HDN and PREM networks have produced comprehensive notes guiding countries in their labor market policy response to the current crisis (World Bank, 2008a, World Bank, 2008b). The World Bank has recently put out several other comprehensive guides on possible responses to the current crisis (see Development Research Group, 2008, Ravallion, 2008, Brahmabatt et al, 2008).

³ IMF, World Economic Outlook Update, January 28, 2009.

developing countries. Growth for this group is expected to fall more than 3.0 percentage points in 2009 – from 7.9 to 4.5 percent – as result of sharp reductions in export and FDI inflows (World Bank, 2008c). In Africa, nearly half of the countries (21 out of 48) are forecasting drops in total output growth. In addition, over three quarters of the 35 low-income African countries covered in a recent diagnostic survey are experiencing or forecasting a decrease in demand for their exported goods, which in 8 of them is expected to be severe. A drop in GDP growth is also expected by over 80 percent of the low-income EAP countries. However, the strongest impact so far has been felt in ECA where all countries interviewed reported an actual or forecasted drop in GDP growth and export demand.⁴

The financial crisis will tighten credit markets, restricting access to credit (included trade finance) in the cash-constrained developing economies This has an immediate impact on firms' in developing countries, especially among larger and formal firms that tend to rely on formal financing facilities. Firms with greater capital and labor complementarities will also be hit harder. Combined with the expected reduction in FDI, this could have important negative effect on the short-term viability of these firms.

The slowdown in GDP growth will reduce aggregate demand and will inevitably affect – albeit with a lag – employment and wages. The slowdown in external and internal demand for goods and services combined with reduced access to external sources of credit (including trade finance) will reduce labor demand in developing countries. The ILO predicts the unemployment rate to growth by as much as 1.9 percentage point sin East Asia and 1.6 percent in the Middle East. They also predict the number of working poor to rise by as much as 13.3 percent in South Asia and 15.1 percent in the Middle East.⁵

Evidence from past crises is informative on the likely impact on the labor market. First, unemployment is likely to substantially increase, especially in countries with more formalized labor markets. For example, during the East Asian crisis, the unemployment rate increased from 2.6 to 6.8 percent in Korea and from 2.2 to 5.2 percent in Thailand. Similarly, during Argentina's crisis in the late 1990s, unemployment increased from 11.7 percent to 15.9 percent (World Bank, 2003). Some countries, like Indonesia, had smaller increases in unemployment because individuals could reduce working hours (Beegle, Frankenberg, and Thomas, 1999). Second, the brunt of adjustment is likely to fall on wages. For example, during the East Asian crisis median wages in Indonesia declined by 20-30 percent, while in Mexico following the 1994 Tequila crisis real wages dropped by 21 percent. Such significant wage adjustments, however, were facilitated by large currency depreciations and high inflation. This time, with modest inflation and relatively stable exchange rates, real wage adjustment might be more difficult to accomplish and the pressure may be more on employment. Third, reduced labor demand in the dynamic sectors of the economy is likely to spur costly labor reallocation, including movements into informality and to subsistence activities/sectors – for example, during the 1997 Asian crisis some 30-40 percent of displaced urban workers moved back to agriculture.

⁴ Reduced aggregate demand is already affecting employment and wages in many developing countries. In Mongolia, for example, a major mining company, Ivanhoe, cut its workforce from 2,000 employees in 2008 to 300 currently. Armenia and Zambia have also lost jobs due to the decreased demand, as many copper mine and smelters have closed since September. Largely due to the decline in toy, shoe, and furniture manufacturing, an estimated 130,000 people leave Guangzhou, China every day and tens of thousands of migrant workers are reported to have left the area since the start of the crisis.

⁵ These estimates use the interim IMF estimated of GDP growth and are therefore likely to underestimate the overall impact.

The coping strategies adopted by poor households may have considerable negative impact of their welfare. Historically, when faced with a negative shock, poorest households have adopted strategies that could be particularly harmful in the long run. The evidence from the East Asian crisis is telling. The poorest households in the Philippines had to resort more frequently than the rich to changing their eating patterns, taking children out of school, working longer hours, and migrating to urban areas or other countries (Esguerra et al, 2001). Similarly, in response to the increase of poverty, Indonesian households reduced their investments in education, especially for the poor (Beegle, Frankenberg and Thomas, 1999). Moreover, the World Bank (2000) also shows that the ability of the poor to maintain their consumption in the face of crisis-induced income shocks is more limited than the ability of the non-poor. The risk to household welfare is increased by the fact that this crisis it is expected to manifest itself as a sharp decline in global demand for labor, reducing considerably the effectiveness of increasing labor supply and migration as a copy mechanisms. Indeed, the predicted reduction in remittances will increase household vulnerability during this crisis (according to Ratha et al, 2008, remittances to developing countries are expected to decline by 0.9 percent in 2009, while they increased by 6.7 percent in 2008).⁶

Which groups will be most affected by the crisis? Historical experience suggests that young, old, unskilled and female workers as well as migrants are particularly vulnerable to an economic downturn and are more likely to bear the brunt of rising unemployment:

- **Urban workers.** According to a survey of WB country economists important pockets of vulnerability emerge with respect to the financial crisis. In particular, urban workers in sectors experiencing a larger decline in demand (e.g., export-led sectors, construction) are reportedly the most hurt. Even though urban workers are not among the poorest segment in most countries, if displaced, they do face greater obstacle in re-entering the labor market. This problem is greater as workers get older.
- **Older workers face greater obstacles in re-entering the labor market.** Evidence from the early transition to a market economy in Slovenia showed that older workers did not face a greater risk of displacement (Orazem et al, 2005). However, they were much less likely to get a job after losing one and they also suffered much larger post-displacement wage losses once again re-employed (the wage loss of workers with 25 to 30 years of experience was 36 percent, compared to no wage loss of workers with below 10 years of experience). Similar results are found for other countries.⁷
- **Young people suffer disproportionately from economic downturns (World Bank 2007).** Reduced labor demand imply fewer job openings, and young people – new entrants, lacking skills and experience, are the first ones affected. Moreover, job closings are also likely to disproportionately affect the young workers, especially if the shock is expected to be short-lived, because young workers tend to work more frequently under temporary contracts.
- **The crisis will also more severely affect unskilled workers and women.** Employers are more prone to dismiss unskilled workers, as they tend to have more flexible work arrangements and are not covered by labor market regulations. Women, who tend to be disproportionately unskilled and have more flexible work arrangements, will also have more difficulties becoming reemployed, especially in stagnant labor markets and in economies with stricter labor regulations.
- **Finally, migrants – both internal and international – are likely to be disproportionately affected.** Immigrants are often among the first workers to be laid off because of their

⁶ On the added-worker effect, see, for example, Airola (2008) and Rodriguez and Tiongson (2001).

⁷ See, for example, evidence on US workers in Jacobson et al (1993) and Fairlie and Kletzer (2003), and OECD (1998) for OECD countries.

concentration in the most vulnerable sectors, such as construction or tourism, and because they frequently hold temporary jobs. As for international migration, the global nature of the crisis makes it difficult to predict its direction and intensity. While evidence from previous crises – the East Asian crisis in 1997-98 and the Mexican Peso Crisis in the 1990s – shows that both return migration and emigration increased significantly (Stalker 2000), the global nature of the current crisis speak against the option of migrants to return home.

2. How Should Labor Market Policy Respond?

Sound macroeconomic policies and a favorable investment climate are necessary, though not sufficient, to mitigate the impact of the crisis on earnings and employment.⁸ An effective policy package should also include (i) a combination of passive and active labor market programs designed to stabilize employment and earnings; and (ii) direct cash transfers – including Conditional Cash Transfers (CCTs) – designed to cushion the income and human capital investments of the working poor from the worst impacts of the crisis.

However, the fiscal implications of these interventions could be daunting, given the fiscal crunch developing countries are expected to face over the next budget cycle. However, the costs of these interventions can be contained via adequate design. Moreover, the cost of inaction, in terms of lost opportunities and human capital disinvestments, can be large and irreversible (for example, for school dropouts and malnutrition).⁹ For reasons of both fiscal sustainability and efficiency, interventions should be well-targeted, temporary and easily retracted in the aftermath of the crisis. In addition, in order to be effective, the policy package should also be tailored to reflect the institutional and implementation capacity of different countries. Thus, interventions could differ substantially between middle- and lower-income countries.

(a) Middle-income countries

Middle-income countries have available a number of possible instruments in order to mitigate the impact of the crisis. These can be broadly divided into two categories: (i) policies to support to employment and earnings, and (ii) income maintenance interventions. The former includes traditional active labor market policies as well as policies designed to reduce firms' vulnerability to cash-flow problems. Of particular importance amongst the latter are unemployment benefits and other cash transfers.

Policies to support employment and earnings

Countries may use temporary payroll tax holidays (including unemployment insurance contributions) or wage subsidies, which are targeted at dampening the pace of job destruction in the formal sector. By decreasing labor costs, without reducing (or indeed increasing) worker take-home pay, these measures may prevent short-term retrenchment of workers at a time of crisis (they can also be targeted to maximize protection for vulnerable subgroups, such as women, low-paid workers, old workers, and labor market entrants). They might also reduce the long-run persistence of unemployment by avoiding the skill depreciation of workers who would otherwise be laid off. For fiscal sustainability reasons, such measures are a viable option only when the crisis is expected to be short-lived.

⁸ The need for a multi-sector treatment to address employment issues is highlighted by the MILES approach that the Bank has developed (see Holzmann et al, 2008) – the approach that has gained even more importance during the current crisis.

⁹ See World Bank (2008d).

Enhancing access to credit may considerably reduce the threat of massive lay-offs associated with firm closure or shrinkage. This will help firms of all sizes to overcome a possible cash-flow problem associated with higher cost of borrowing and the drying up of opportunities for trade finance. During this crisis, access to finance has become very difficult while self employment could provide an alternative to formal and/or paid employment. As a result, programs that typically provide financial and advisory support for firm start up and/or support for the operational costs of micro firms could be useful. The advantage of this type of programs is that they help a subgroup of the population which is more prone to self employment and is facing additional constraints in this time of crisis. For example, during the recovery from the Argentinean crisis, these programs helped women with previous experience in the business (Almeida and Galasso, 2008). However, these programs are unlikely to be a viable solution for mass unemployment and displacements.

Countries should also consider introducing temporary youth employment programs. These programs – such as the *Joven* programs in Latin America and the Caribbean – provide a package of training, income support and re-employment services to deal with the multiple challenges faced by the young in times of crises. While targeting the poor youth (particularly school dropouts – they represent 50 percent of Chile’s *Joven* participants), these programs provide comprehensive training – from technical to life skills and from lectures to internships – and sound support services and course certifications that foster youth’s continuing participation.¹⁰ While costly, these programs have a proven track record. For example, a rigorous evaluation in the Dominican Republic shows that the program raised hourly earnings by 10 percent and would “pay for itself” if the impacts are maintained for two years (but the program did not improve chances for employment). An impact evaluation in Colombia finds even stronger effects, as the program increased salaries by 35 percent for women and 18 percent for men (the program had a rate of return of roughly 5 percent for men and 13.5 percent for women).

In the face of the inevitable reduction in private employment, middle-income countries may consider also **public works programs** (see below).

Income maintenance interventions

The main instrument to maintain the income of laid-off workers is unemployment benefit system. There are several options for boosting unemployment insurance benefits:¹¹

- *Potential benefit duration can be extended*, for example from 6 to 9 months (as is the case of the US), or selectively for some groups of workers (above certain age, for example).
- *Coverage can be extended to groups previously not covered* (for example, to workers with short prior employment, to those completing prolonged training courses or exiting from public works, and to workers in small enterprises – as did Korea during the 1997-98 crisis).

¹⁰ See evaluations of Aedo and Nuñez (2001), Aedo and Pizarro Valdivia (2004), de Moura Castro (1999), Elias and others (2004), Inter-American Development Bank (2005), and Santiago Consultores Asociados (1999).

¹¹ In adjusting their UI programs, countries can take advantage of the World Bank UISIM model. This is a new tool developed by HDNSP to assist client countries to make projections of unemployment insurance benefit costs, contributions, and trust fund balances under different economic scenarios. The model is user-friendly, it can be adjusted to fit the UI system of almost any country, and it is powerful enough to provide accurate estimates for numerous variables of interest. For more information, visit: http://siteresources.worldbank.org/INTLM/Resources/EPPNoteNo11_UISIM.pdf

- *Short-time compensation could be introduced.* To stimulate employers to keep their workers in times of weak demand, this option permits employers to reduce the number of work hours of workers, with the lost wages of affected workers being partially compensated using unemployment insurance benefits. Typically, workers that reduce their work hours receive unemployment insurance benefits pro-rated for the hours lost due to work-sharing, benefit duration is limited to 20–30 weeks, and there is a floor (and sometimes, a ceiling) for the percent of the workforce that reduces work hours (Abraham and Houseman 1993).

Comprehensive training programs can help the unemployed, including dislocated workers, to boost their chances to find a job and to increase their post-unemployment earnings – and they could be combined with a training stipend to provide income to the unemployed.

Recent evidence indicates that the most effective programs are the ones that combine class-room and workplace training. In comparison to classroom training alone, these programs were shown to increase the likelihood of positive labor market impact by 30 percentage points, and by up to 53 percentage points when combined with other services.¹² In addition, particularly if UI program is non-existent, countries could add a stipend to training participants. For example, the Mexican Job Training Program for Unemployed Workers (PROBECAT) successfully combined short-term training for unemployed with income support (at the minimum wage) and placement services from the local employment offices.

The above labor-market measures should be supplemented by direct cash transfers, when possible. These can help protect those who cannot work, such as children or the elderly, and also help cushion the human capital investments of the working poor (e.g. in schooling and health) from the worst impacts of the crisis. When already implemented, Conditional Cash Transfers (CCTs), can be particularly effective in channeling help to the most vulnerable while maintaining the investment in human capital.¹³

(b) Low-income countries

Low-income countries have fewer options, and must look towards less administratively-intensive approaches that contain an important self-targeting component:

The primary way to boost income of the most vulnerable workers is through public works that, according to a recent survey, exist in over 40% of low-income countries and have been shown to provide a flexible and fast response to shocks. Evaluations show that public works programs are typically well-targeted, can be flexibly implemented and withdrawn, and help alleviate short-term poverty. They also appear to be effective in reducing unemployment: the Argentinean *Jefas y Jefas* program, which employed 1.5 million workers at its peak, is estimated to have reduced unemployment by 2.5 percentage points. But these programs have downsides as well. Participants may be stigmatized, and there is little evidence that public-works programs impart useful labor-market skills.

In designing public works programs, policymakers should be guided by several “good practice” principles (see Ravallion 1999, 2008). First, forgone earnings should be minimized by attracting workers with low alternative earnings opportunities. This can be accomplished by

¹² The evidence is based on recent meta analysis of 345 studies of training programs from 90 countries around the world (Fares and Puerto 2008).

¹³ Guidelines for appropriate use of direct cash transfers and other basic safety net interventions to protect the poor during the crisis are synthesized in Grosh, Revenga, and Zaman (2008) and described more fully in Grosh et al. (2008).

setting wages below the market wage level, to trigger a self-selection mechanism that will attract only those in need. Low wages also encourage participants to search for regular jobs and contribute to high labor intensity of selected projects.¹⁴ Second, displacement effects should be avoided by carefully selecting the types of public works projects.¹⁵ Third, to maximize the “bang for the buck,” programs should avoid projects that require heavy nonlabor costs, particularly during crises (Maloney 2001). Fourth, public works programs should be more labor intensive than required by pure maximization of present value of the assets created. Labor intensity is determined by the selection of assets, the wage rate, and the ability of the implementing agency to account for nonwage costs.¹⁶ And finally, exit strategies to facilitate the transition out of welfare dependency should be formulated (they could include wage subsidies, combination of wage subsidies and skills training, and entrepreneurship schemes).

Some scope may also exist to introduce measures aimed at increasing the productivity of small-scale informal and self-employment activities such as via targeted micro-credit schemes. Micro-finance institutions (MFIs) have proven remarkably resilient to downturns in the economy. The East Asian crisis, for example, did not result in a reduction in MFI credit provision but the pro-poor impact of the programs was adversely affected by governments’ reluctance to extend rural credit guarantees).¹⁷ Still, there is a major gap in evaluating this measure rigorously.

A word of caution. Governments should resist pressures to rush and implement untargeted, ill-designed policies and programs. Amongst them:

- **Increasing public sector employment and wages** may be seen as a tempting way to bolster labor demand. But this is an expensive intervention with limited pro-poor impact as civil service workers are typically not poor and public sector wages typically constitute a large share of public expenditures. Once implemented, the increases are also difficult to reverse.
- Another often advocated measure is **to increase minimum wages**. Yet the effectiveness of this policy in protecting incomes is questionable, and the outcomes for employment likely to be more harmful than positive. Minimum wages have a greater impact on the distribution of earnings, than they do on the aggregate level of employment and wages. Empirical evidence suggests that they have a negative effect on the employment of less-skilled workers, women and youth.
- **Early retirement programs** have been used to facilitate withdrawal of redundant workers from the labor market. But such programs proved to be fiscally expensive while generally failing to promote the employment of young workers – contrary to their stated goals.

¹⁴Although Korea and Thailand implemented similar public works programs during the financial crisis of the 1990s, labor intensity rates were significantly different: 70 percent in Korea and below 20 percent in Thailand. High statutory minimum wage prevailing in Thailand reduced the labor intensity degree of the program.

¹⁵ A demand-driven approach in the choice of assets has proven to ensure relevance of the works and facilitate acquiring communities and local governments’ buy-in to the projects (e.g. Burundi). In addition, it is important to separate responsibilities for project selection from project implementation to ensure transparency and avoid conflicts of interest.

¹⁶ While road construction projects tend to yield a share of wage to total cost of 40-50 percent, road and drainage maintenance projects as well as soil conservation and reforestation projects have a share of 70-80 percent. In some well-known examples, such as the Maharashtra Employment Guarantee Scheme in India, the wage bill represented 60–70 percent of total cost. In Argentina’s Trabajar program it ranged from 30 to 70 percent.

¹⁷ See Patten, R., Rosengard, J. and Johnston, J. (2001), and McGuire, B. and Conroy, J. (1998)

3. Concluding Remarks

When selecting labor market programs to be applied in current global financial crisis, the assessment of these programs – typically obtained from non-crisis experience – needs to be “reexamined.” What works in normal times might not be the best option in the current climate. In addition to using best practice criteria, other aspects should be considered, above all (i) the speed and ease of program implementation, taking into account existing infrastructure and institutional capacity; and (ii) the ability to support groups most affected by the crisis.

While the crisis response must provide, above all, rapid support to those most in need, countries should use this opportunity to introduce reforms and programs that will help them during times of economic recovery. This applies, for example, to the introduction of comprehensive youth programs, to measures that help building the capacity of private training providers, and to improvements in labor market information systems. The atypical nature of crisis may also justify the introduction of new and innovative interventions on an experimental (and rigorous impact evaluation) basis.

And to monitor labor markets outcomes and to evaluate their programs, countries need to improve their information systems as well as their monitoring and evaluation capacity. In many countries, labor market information systems, including regular monitoring of trends on the labor market through labor force surveys, need further improvement. Moreover, conducting special surveys such as tracer surveys of displaced workers would also be very useful. Governments should also invest in improving their monitoring and evaluation capacity. Such actions will not only allow them to respond to the need of rapid reporting, but they will also contribute to the rigorous evaluation of crisis programs.

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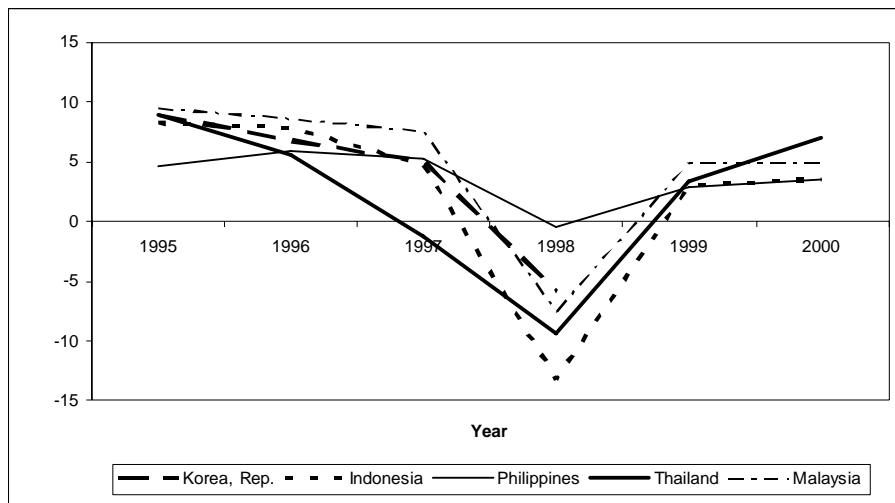
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Appendix 1: How East Asian Countries Reacted to 1997-98 Financial Crisis

The shock and the labor market impact. The precipitous decline in economic growth during the East Asian financial crisis (figure A1) increased unemployment and reduced wages. Interestingly, while employment decreased in some countries, it increased in Indonesia and the Philippines (the so-called added worker effect). In the worst-affected countries of Indonesia, the Republic of Korea, and Thailand, the unemployment pool increased by about a million workers in each country. Between 1997 and 1998, the unemployment rate soared from 2.6 to 6.8 percent in the Republic of Korea and from 2.2 to 5.2 percent in Thailand, while Indonesia and the Philippines showed small increases. The effects of the crisis on marginal groups were severe – survey evidence showed that the poor in the Philippines reacted by taking their children out of school, working longer hours, and migrating to urban areas or other countries. Similarly, in Indonesia, poor households reduced the share of consumption on education.

Beegle, Frankenberg, and Thomas (1999) report in detail about labor market adjustments in Indonesia. Wages took the brunt of the adjustment, with median wages falling 20–30 percent between 1997 and 1998, with even larger declines for men and urban workers. While men’s employment remained unchanged, women’s employment rose, primarily because more women worked as unpaid family workers. Fewer men, but not women, held secondary jobs in addition to their primary job, and average working hours for both men and women increased. Younger workers had better access to jobs than older workers, and men in rural areas had better access than men in urban areas. Younger, better-educated, and urban residents were also more likely to have moved between 1997 and 1998.

Figure A1: Annual GDP Growth Rates in Selected East Asian Countries, 1995-2000 (percent)



Labor market policy response. The response to the crisis was similar across the worst-hit countries, with governments resorting to both employment-generation and income-maintenance programs (Betcherman et al, 2001). Most countries adopted large-scale, labor-intensive public works programs as emergency measures. These programs involved 2.2 percent of the labor force in Indonesia, 2.6 percent in the Republic of Korea, and 5.2 percent in Thailand. Other programs were also introduced. Indonesia provided subsidized credit to small-scale firms and cooperatives. The Republic of Korea introduced job preservation and hiring subsidies to assist firms in dire circumstances. Indonesia, the Republic of Korea, and Thailand all created programs to promote self-employment.

Some changes were made in job security legislation to help displaced workers. In both the Republic of Korea and Malaysia, laws were amended to entitle workers who quit voluntarily to severance pay. But failure to remit severance pay was a problem. In Malaysia employers disbursed only 83 percent of the claims of laid-off workers in 1998 (Mansor and others 2001). Compliance was also low in Thailand, particularly among small employers (Mahmood and Aryah 2001). To address the problem, the Republic of Korea and Thailand introduced guarantee funds, which financed unmet claims from workers whose enterprises went bankrupt. Other legislative changes to extend income protection in Korea included widening public unemployment insurance coverage to smaller firms (those employing five workers or more). The Philippines introduced the Emergency Loan Facility for Displaced Workers, which lets workers borrow based on their previous payments of social security contributions. The program resembles UISA programs in Latin American countries.