Economics Internal Assessment 2

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Article 2:

The Mystery of Spain's Perpetual Jobs Problem

Peter Eavis, May 2, 2016

It was welcome news Friday when Europe's economies reported higher-than-expected growth. The region, after all, has had to deal with rolling debt crises, terrorist attacks an influx of refugees and migrants, and the possibility that Britain may vote to leave the European Union.

Then there is Spain. Across Europe, economic growth has helped bring the unemployment rate down. But in Spain, the rate is 20 percent, according to European Union surveys, and has been above that level for five years, even as the country's economy has been recovering.

You'd be forgiven for thinking that such a high level of joblessness, weighing on families for so long, would have caused the country to crack by now. The joblessness number is so much higher than the rate for other economic laggards like Italy (11 percent) and Portugal (12 percent).

Certainly, some of Spain's unemployment is overstated because some workers have off-the-hook jobs. And people may feel optimistic because unemployment has fallen in recent quarters, from 25 percent two years ago.

Still, Spanish officials recently said they did not expect the jobless rate to fall below 15 percent until 2019. And there's the matter of the country's youth unemployment (those under 25): an almost incomprehensible 45.5 percent.

A new government in Spain – once it is chosen after almost half a year of discord – may end up pursuing smarter and bolder policies that reduce joblessness to levels that exist elsewhere in Europe.

But the chances of that look slim.

Spain's unemployment is so high partly because of particular local forces that have existed for decades. Marcel Jansen, and expert on labour markers at the Universidad Autonoma de Madrid, notes that unemployment above 20 percent is not uncommon in Spain. In fact, it has been at that level in three periods since Spain's transition to democracy in the 1970s. And, ominously, from the previous unemployment rate peak in the 1990s, it took 14 years for it to decline to the wide European level, Mr Jansen notes.

One cause of the high rate became embedded in Spain's labour market over the last 40 years. A significant proportion of Spain's workers emerged from the dictatorship years with ironclad job security. Many of those protections remained, Mr Jansen said, but much of the new hiring in the democratic era took place through temporary employment contracts. Just before the 2008 financial crisis, around a third of Spain's workers on temporary contracts, far higher than the European average.

When the crisis hit, it was very easy to lay off the temporary workers. True, during the recent recovery, the high use of temporary contracts has most likely spurred Spanish firms to bolster their hiring. But the persistence of overly protective labor contracts alongside temporary ones with too few protections has probably also created inefficiencies within Spanish companies that have dampened economic growth.

Mr Jansen's preferred solution is to introduce a new contract that could increase protections for temporary workers and loosen them for many permanent workers. But he said Spain's politicians had shown little support for this idea.

Something else is making matters worse right now. Much of Spain's working-age population does not have education beyond high school. And many of those people have remained unemployed for multiple years after the financial crisis of 2008 (Nearly a fourth of the unemployed have been without work for four years or more.) Such workers are increasingly losing contact with the industries they worked in, and that will make it even harder for them to find jobs. And hiring in Spain's construction industry, a big employer before the crisis, is not likely to return to precrisis levels anytime soon. Mr Jansen says helping the long-term unemployed requires substantial overhaul of Spain's retraining programs. But this costs money, and Spain has one of the largest budget deficits in Europe.

This is where we bump into the big economic debate that looms over the Continent. On one side are those who insist that struggling countries must pursue policies that cut government spending and free up markets, to spur strong and sustainable growth. As we have learned, Spain's labor market could certainly do with some big changes. But as have also seen, these changes are far from imminent. These are expensive. They threaten entrenched interests. Spain's leaders are so divided that they can't form an administration that could attempt bold moves.

Economists on the other side of the debate emphasize the need for the European Union as a whole to come together to introduce big top-down actions. Such policies include debt forgiveness and far greater fiscal stimulus. Spain's sky-high unemployment has not moved Europe's leaders to take such steps by now. Then again, Europe can't count on Spain – or any country – to tolerate this high level of joblessness forever.

Commentary 2

This article illustrates the high unemployment (unemployment refers to those of working age who are without work, but who are available for work at current wage rates) levels in Spain due to the high levels of unskilled labour as much of the working population “does not have education beyond high school as well as the lack of aggregate demand (AD) as the Spanish “economy is slowly recovering”. This has led to cyclical and structural unemployment that can be addressed by using expansionary fiscal policy and supply side policies.

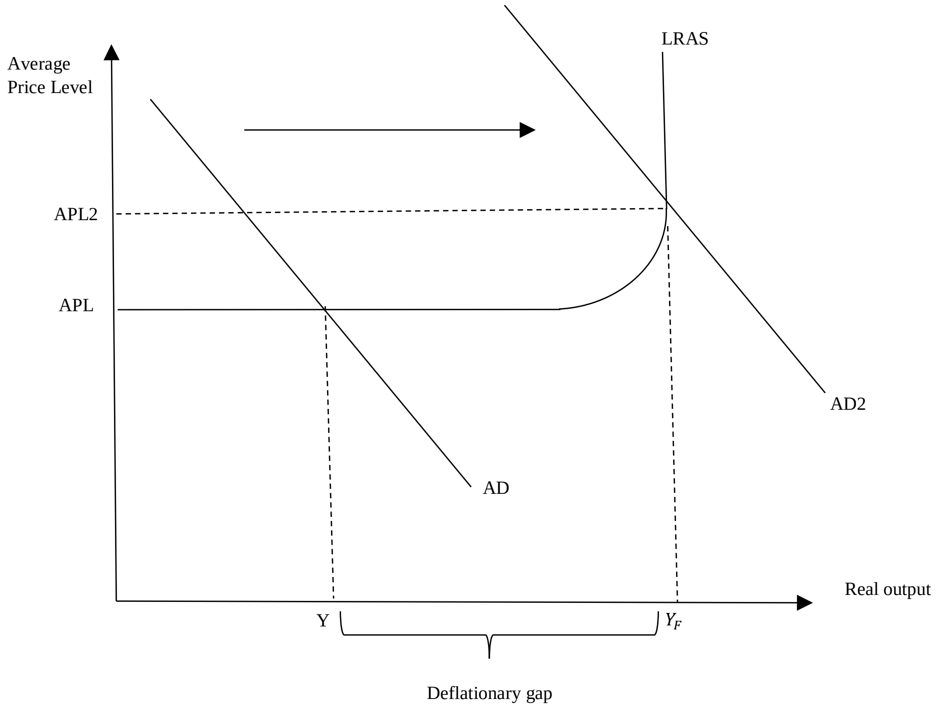

Figure 1: Cyclical unemployment in Spain

Figure 1 illustrates the cyclical unemployment (caused by the business cycle where the slowdown in economic activity with falling aggregate demand is the cause of unemployment) and structural unemployment (occurs when there is a change in the demand for skills as the structure of economy changes, so there is a mismatch between qualifications, skills and characteristics of the unemployed and the available jobs) in Spain. The high unemployment is illustrated by the deflationary gap in the Spanish economy in figure 1 as the resources in the economy are not fully utilised and is indicated by Y to Y_F. Hence, the government should use demand side (DD-side) policies to increase aggregate demand (AD) such that AD shifts to the right to AD2 to increase overall economic activity to create jobs and reduce unemployment. The DD-side policies that could be used are expansionary fiscal policy (fiscal policy is carried out by the government to influence aggregate demand using taxation rates) and monetary policy (monetary policy is carried out by the central bank to influence aggregate demand using interest rates and money supply).

When the government reduces income tax, it increases the disposable income of consumers and hence encourages consumption (C). It also allows companies to retain more profits and thus encouraging investment, (I). The government can also increase expenditure (G) on schools and roads. Thus, an increase in C, I and G will increase AD will shift to the right to AD2 in figure 1 because $AD = C + I + G + X(exports) - M(imports)$. Demand for labour will increase as a result and cyclical unemployment will be reduced.

However, the Spanish government already has "a large budget deficit" and therefore employing fiscal policy to reduce unemployment would be unsuitable because lower tax rates will reduce government revenue and increasing government expenditure will only worsen the deficit. Furthermore, the increase in disposable income may not yield a proportionate increase in consumption. Thus expansionary fiscal policy may not be suitable in the case of Spain.

Instead, they should employ expansionary monetary policy to induce higher AD. Expansionary monetary policy involves lowering interest rates to discourage savings and encourage borrowing and spending. Thus it will increase C and I, causing an increase in AD, thus reducing the deflationary gap and cyclical unemployment in figure 2.

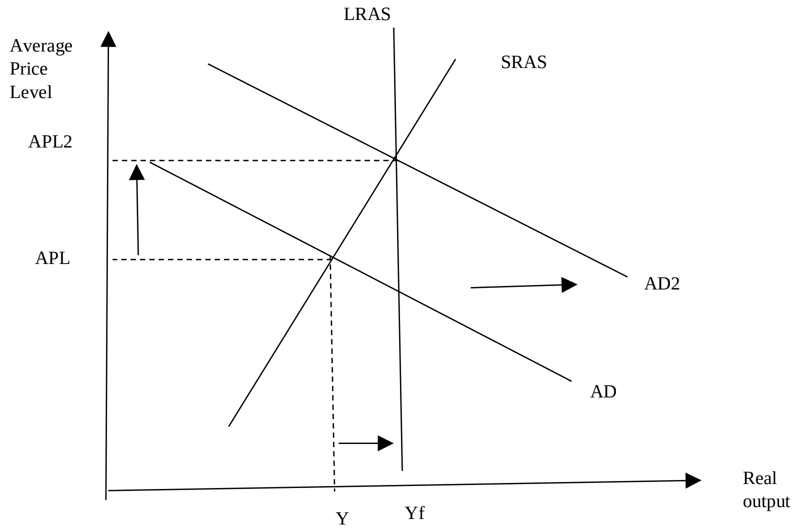

Figure 2: Expansionary monetary and fiscal policies

To counter the structural unemployment that is present because a significant portion of Spain's labour force does not have more than high school education, supply side policies such as retraining should be considered. When workers acquire new skills through retraining programmes, they can find jobs easily and hence reduces structural unemployment. However, given the budget deficit that the Spanish government has, it is unlikely that they will be able to fund retraining. Instead the government should consider investing and emphasizing in higher education in the long run to improve the efficiency of its labour force. The Spanish government may also want to consider deregulation to reduce the power of "particular local forces" and reduce labour market rigidity. However this may not be a possible option depending on the political climate.

In conclusion, Spain should employ a combination of demand and supply side policies to counter the high unemployment, including expansionary monetary policy to reduce the cyclical unemployment levels in the economy and investing in education to counter the structural unemployment. In the short run, unemployment may not reduce significantly because the effects of the supply-side policies may not be visible. However, a short term shortage of labour caused by the increase in AD will encourage Spanish workers to upgrade their skills and come out of unemployment in the long run. In the long run, the country may experience economic growth as the increase in AD as seen in figure 1 will result in higher real output. However the Spanish government will need to manage the costs of economic growth well in order to maintain or reduce the rate of unemployment as it may conflict with the goal of reducing unemployment.