

# **The Employment Crisis in Spain<sup>1</sup>**

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## 1. Introduction

One of the features of the global crisis that has received much attention is the different impact on unemployment it has had among countries. In some countries (e.g. Germany) unemployment barely increased, and nowadays, after almost four years since the crisis started, it is more or less at the same level that it was in 2007. In other countries (most notably, Spain and Ireland) the unemployment rate skyrocketed and reached levels similar or even higher than those of the high unemployment period of the early 1980s.<sup>2</sup> Understanding the reasons why the crisis has had such differential labour market effects is crucial for designing employment policies that support employment creation and speed up the recovery.

In principle, there could be three possible reasons for cross-country differences in the (un)employment consequences of the crisis among countries. First, although the origins of the crisis are, to a large extent, similar in all the countries, it could be that the implications in terms of the fall of economic activity were much larger in some countries than in others. Secondly, the responses of employment policies to the crisis could have varied across countries, with some of them trying to avoid employment destruction through specific schemes favouring reduction in working hours and labour hoarding. Thirdly, faced with a similar negative shock, differences in labour market institutions across countries may also explain why in some countries the loss of employment was much larger than in others.

This paper is about the impact of the crisis on (un)employment in Spain. After a period (1995-2007) of very intense employment creation, where employment grew at an average annual rate of 4.1%, Spain is the European country with the largest increase in unemployment and employment destruction during the last four years: the unemployment rate went from 8.26% in 2007 to 21.29% in the first quarter of 2011, while employment losses had surpassed two million jobs (from 20.36 to 18.15 million during the same period).

To explain why the employment crisis in Spain has been of this magnitude, the rest of the paper will go over the three possible explanations sketched above. In Section 2, it is shown that the employment crisis is not created by a fall of GDP of a larger magnitude than that of other countries, and that, while it is true that Spain entered the crisis with a very large proportion of employment in very labour intensive industries (most notably, in the construction sector, the increase in unemployment, the fall of aggregate employment, and employment destruction in other sectors but construction, are far larger than in other countries. Section 3 focuses on employment policies in Spain as a response to the crisis, to conclude that, given the structural nature of the crisis in Spain, there was no much reason to

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<sup>2</sup> See IMF, *Economic Outlook*, April, 2010; OECD, *Employment Outlook*, 2010; and European Commission, *Employment in Europe*, 2010 for detailed accounts of cross-country differentials in the (un)employment impact of the crisis.

implement policies to foster labour hoarding, as done in other countries. Section 4 highlights two institutional features of the Spanish labour market (dual Employment Protection Legislation and the prevalence of sectoral collective bargaining) that has fuelled employment destruction and the increase in unemployment, and that constitute, to a large extent, the main reasons of the dismal performance of the Spanish labour market. Finally, Section 5 contains some concluding remarks that, departing from this diagnosis, signal to the kind of structural reforms needed to build a scenario of employment creation and sustainable economic recovery.

## 2. The crisis

Although originated in the financial sector, the global crisis has had different characteristics across countries. In most of them, the banking system was affected by the disruption of financial markets, which reduced credit supply and which increased the cost of financing. Also, in most countries, there were substantial losses of financial wealth, which translated into weaker consumption and investment demand. Additionally, in some countries the crisis revealed that the fundamentals of growth during the expansion period (credit, housing booms) were unsustainable, so that the recovery requires a significant sectoral reshuffling of production factors, and higher productivity growth. Spain is within this latter category.

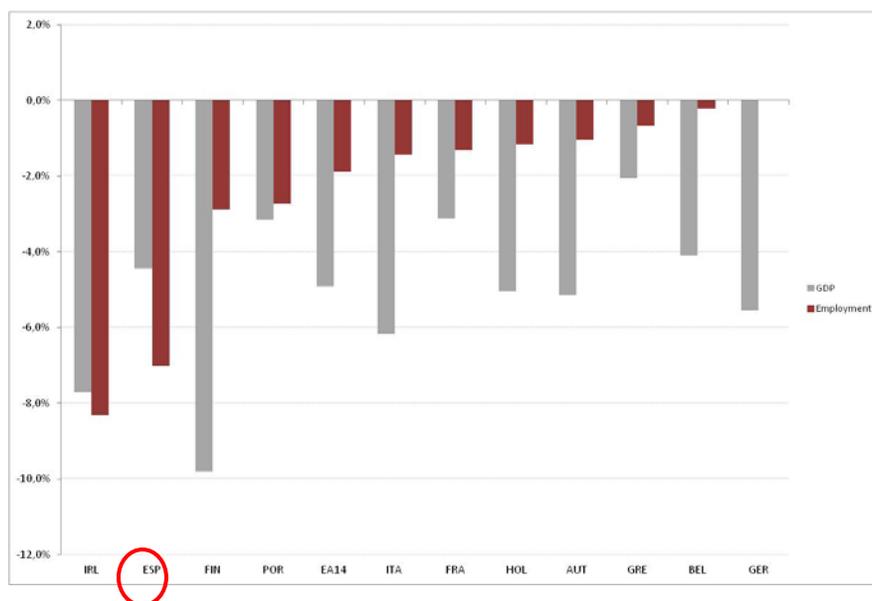
In Spain, there were two fundamental factors supporting growth during the pre-crisis expansionary phase:<sup>3</sup> i) a significant expansion of credit, which was induced by the fall in interest rates that followed Spain's adhesion to the EMU and, more broadly, by a pervasive relaxation in the conditions of access to credit, and ii) large immigration inflows that substantially modified the demographic structure of the Spanish population. With these driven forces, growth could not be permanently sustained. Since productivity growth was very low and important distortions in the domestic labour and product markets were not eliminated, competitiveness deteriorated significantly, which together with the sharp increase in private sector indebtedness, led to the Spanish economy being increasingly dependent of external financing, a situation especially vulnerable to a global financial crisis.

However, in terms of GDP, the impact of the financial crisis on in Spain was, at least initially, not larger than in other countries. As seen in Figure 1 the cumulative decline in GDP during the 2008q2-2009q2 was -4.4%, below the average of EU-14. In stark contrast, the cumulative employment loss during the same period was -7%, only surpassed by Ireland.

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<sup>3</sup>For an explanation of the characteristics of the Spanish economic expansion during the 1999-2007 period, see A. Estrada, J.F. Jimeno, and J.L. Malo de Molina, "The performance of the Spanish economy in EMU: The first ten years" in J.F. Jimeno, ed., *Spain and the euro. The first ten years*, Banco de España, 2010 ([http://www.bde.es/webbde/Secciones/Publicaciones/OtrasPublicaciones/Fich/Spain\\_and\\_the\\_euro.pdf](http://www.bde.es/webbde/Secciones/Publicaciones/OtrasPublicaciones/Fich/Spain_and_the_euro.pdf))

**Figure 1. Cumulative losses in GDP and employment, 2008q2-2009q2**

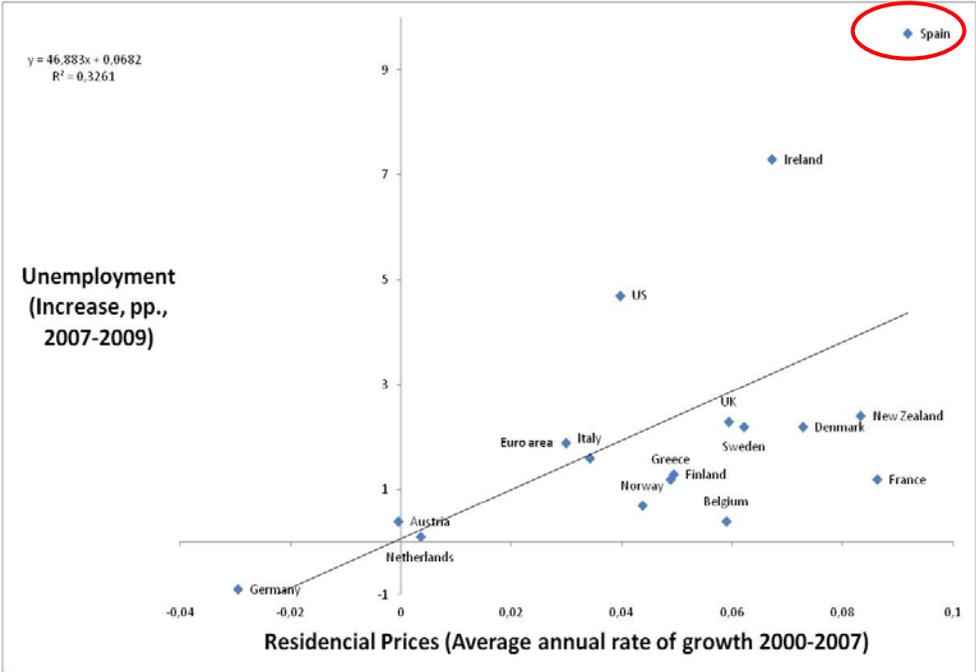


It is frequently argued that the main reason why such a fall in economic activity translated into a so large employment loss is that, after a very intense housing boom and a very high weight of employment in the construction sector, Spain suffered large employment losses in the construction sector. In a country in which the private sector is highly indebted, housing wealth is, by far, the most important component of household wealth, there is a high concentration of productive resources in the construction sector, as the housing boom is followed by a housing bust, there is a large negative demand shock, derived from the loss of wealth, and also a negative supply shock. In contrast, in countries in which housing prices did not grow that much, the sectoral allocation of resources was not distorted by credit conditions, and households were not much indebted, the main impact of the crisis is only a temporary fall of aggregate demand, stemming from a significant fall in exports that took place when, after the Lehman Brothers episode, the financial crisis became systemic and disrupted world trade during the last quarter of 2008 and the first quarter of 2009.

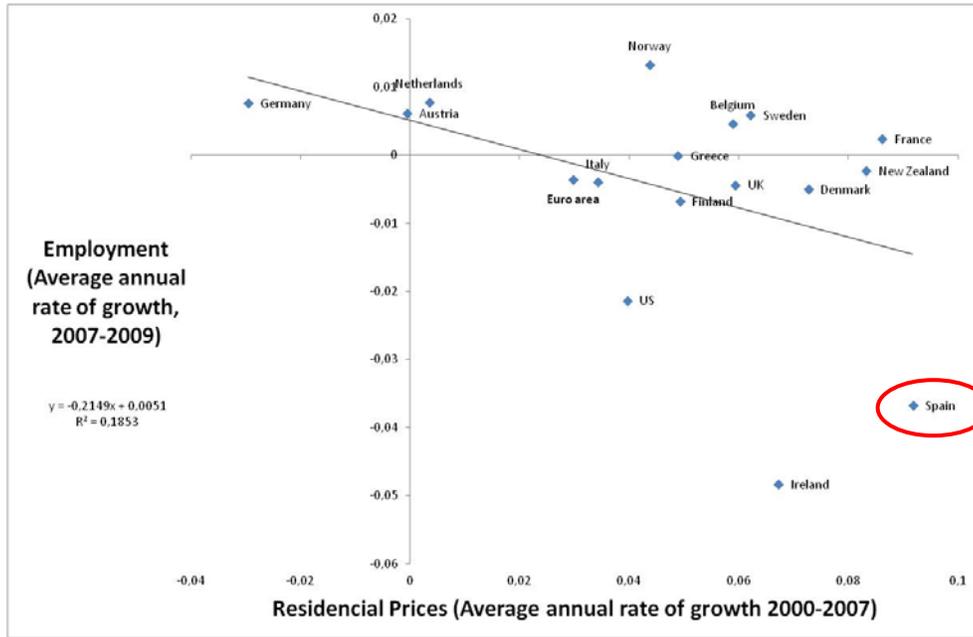
Figure 2 to 4 show some cross country variation in housing prices during the pre-crisis period and the rise in unemployment and fall in employment in the first two years of the crisis (2007-2009). Figure 2 shows that there is a positive association between housing price growth in 2000-2007 and unemployment increase in 2007-2009, which is more pronounced due to three observations (US, Ireland, and Spain). The same is true regarding the negative association between housing price growth in 2000-2007 and employment growth, both including and excluding the construction sector, in 2007-2009: it is less marked without US, Ireland, and Spain. This suggests that, while it is true that countries that had larger housing booms during the pre-crisis period experienced afterwards larger

unemployment increase and employment falls, the main reasons why the crisis had in Spain such a large impact on (un)employment have to be found elsewhere.

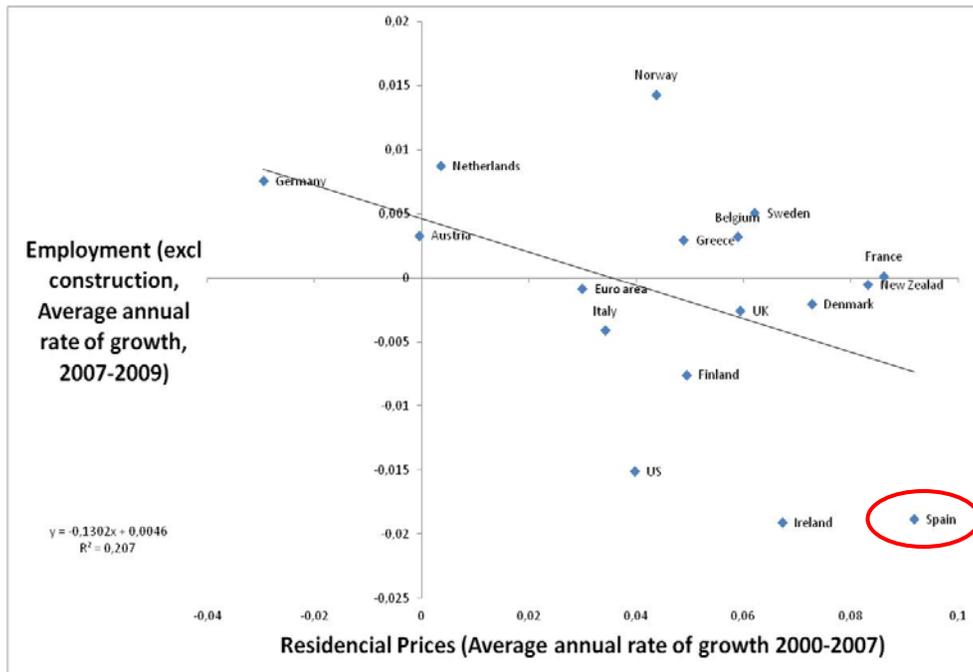
**Figure 2. Housing prices (2000-2007) and increase in unemployment (2007-2009)**



**Figure 3. Housing prices (2000-2007) and employment growth (2007-2009)**



**Figure 4. Housing prices (2000-2007) and employment growth, excluding the construction sector (2007-2009)**



### 3. The response of employment policies

Another explanation of why countries facing a similar shock and suffering similar losses in economic activity had different (un)employment responses is that the employment policies put in place to tackle the crisis could differ. An excellent summary of the employment policies responses to the crisis is provided by the OECD.<sup>4</sup> Table 1 summarises the information in this regard, which the OECD presents as following:

“All countries have implemented one or more changes to directly sustain labour demand, either through expanding job subsidy or public sector job creation programmes, lowering employer social contributions, establishing or expanding short-time work schemes, or some combination of the three. In the area of policies to improve the employment prospects of the unemployed, much of the focus is on expanding the capacity of public employment services, job search assistance and training programmes. Relatively few countries have formally altered activation or mutual obligation requirements in response to worsening labour market conditions, and where they have, requirements have been tightened in most cases. Around half of OECD countries have moved to increase the incomes of job losers by increasing the generosity of unemployment benefits or extending covering to those previously excluded. A number of countries have also provided new or expanded support for job losers through social assistance, training allowances, housing support or health insurance. While most of the policy responses have focused on those out of work as the result of the downturn, a number of countries have stepped up resources for training existing workers or apprentices to improve their labour market prospects or provide income support for low income earners through the tax system.”

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<sup>4</sup> See OECD, *Employment Outlook, 2009*, chapter 1. The European Commission has also offered a summary of employment policies during the crisis in its report *Employment in Europe 2010*.

**Table 1. Discretionary changes in labour market policy in response to the economic downturn**

	Labour demand			Measures to help unemployed find work				Income support for job losers and low-income earners			Other training measures		
	Job subsidies, recruitment incentives or public sector job creation	Reductions in non-wage labour costs	Short-time work schemes	Activation requirements	Job search assistance and matching	Job-finding and business start-up incentives	Work experience programmes	Training programmes	Generosity or coverage of unemployment benefits	Social assistance	Other payments or in-kind support	Fiscal measures for low earners	Training for existing workers
Australia	X			X	X		X	X	X	X	X	X	X
Austria			X		X		X				X	X	X
Belgium		X	X		X				X	X	X		
Canada	X	X	X		X		X	X	X	X	X	X	X
Czech Republic		X	X	X					X				
Denmark			X	X			X						X
Finland		X	X	X	X	X	X	X	X	X	X	X	X
France	X	X	X		X		X	X	X	X	X	X	X
Germany		X	X		X		X		X	X	X	X	X
Greece	X				X		X		X	X	X	X	
Hungary	X	X	X						X	X			
Ireland			X	X	X		X						X
Italy			X	X	X		X		X				
Japan	X	X	X		X	X	X	X	X	X			
Korea	X		X	X	X	X	X		X				
Luxembourg	X		X										
Mexico	X	X	X		X	X	X			X		X	
Netherlands			X		X		X					X	X
New Zealand		X	X		X		X	X		X	X		X
Norway			X		X		X	X					
Poland	X	X	X		X	X	X	X	X	X		X	
Portugal	X	X			X		X	X	X	X			
Slovak Republic	X	X	X			X					X	X	
Spain	X	X			X	X	X	X	X	X	X	X	X
Sweden	X	X			X		X	X	X	X	X	X	X
Switzerland			X										
Turkey		X	X		X		X		X				
United Kingdom	X				X	X	X	X		X	X	X	X
United States	X				X		X	X	X	X	X	X	X

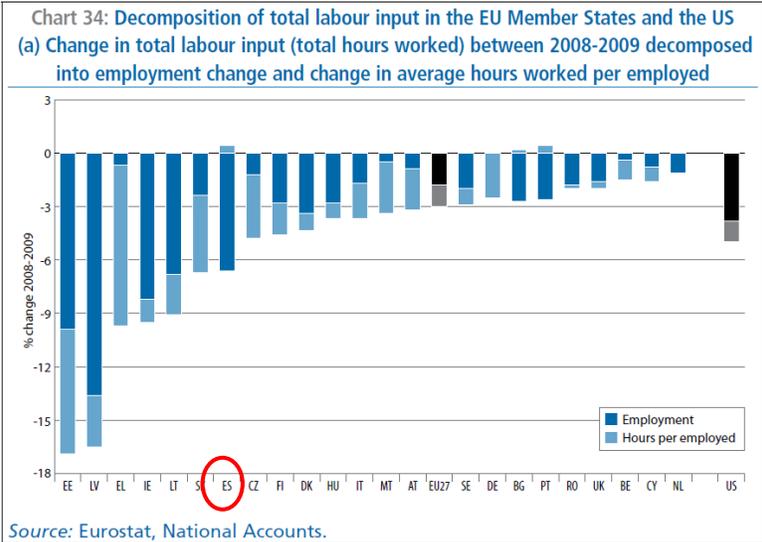
Note: Refers only to federal government initiatives. Additional measures undertaken at regional level are outlined in Annex "x" for some countries. In Denmark and Switzerland, active labour market expenditure increases automatically when the unemployment rate increases (or is expected to increase). Neither these automatic increases, nor increases in expenditure on unemployment benefits as a result of growing numbers of unemployed, are shown in the table.

Source: Responses to OECD/EC questionnaire.

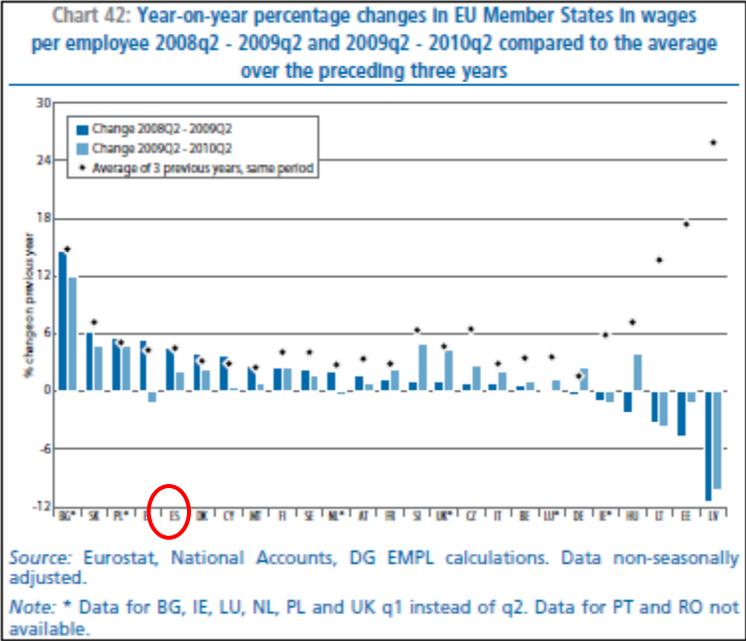
In the case of Spain, there were no substantial changes in the design of employment policies. Many of the measures in support of labour demand were already in place before the crisis and there were no new schemes fostering short-time work. The same applies for measures targeted to help unemployed find work and training programs. The only innovation in this regard refers to income support for job-losers, with an extension of unemployment benefits. Hence, contrary to other countries in which the impact of the crisis was perceived as transitory and, consequently, short-time work schemes were promoted as a way of tackling the employment effects of the crisis (eg. Germany), in Spain there had been no much adjustment through reduction of working hours per employee (see Figure 5).

Insofar as some institutional peculiarities of the collective bargaining system precluded any adjustment through wages (see Figure 6), most of the adjustment to the fall in demand came through employment destruction.

**Figure 5**



**Figure 6**



#### 4. A dysfunctional labour market

Labour market regulation is one of the main factors determining the response of wages and employment to economic developments. At the end of the day, firms' decisions about how to react to shocks are very much conditioned by Employment Protection Legislation, which set the conditions for hiring and firings, and collective bargaining agreements, which set wages and other employment conditions.<sup>5</sup>

As far as labour market institutions in Spain are concerned, there are two that are crucial for understanding the high employment impact of the crisis. One is the dual nature of Employment Protection Legislation, with a stark distinction between open-ended and temporary employment contracts. The second one is the prevalence of sectoral collective bargaining agreements, which set binding wages and employment conditions for all firms and workers within the scope of the agreement, without real effective possibilities of opting-out.<sup>6</sup>

Spain had more than 30% of employees under temporary contracts in the pre-crisis period (see Figure 7). Many times dual labour markets are conceived as some kind of combination of “rigid” and “flexible” labour markets. However, the way that hiring and firing takes place in this context has implications beyond that implied by average firing costs in the two segments of the labour market. One of them is that the volatility of employment is much increased, with many more hirings during expansions and many more firings during recessions, with respect to labour markets where temporary contracts are not so widespread. The intuition behind this result is the following: with high firing costs new jobs must have relatively high productivity (to compensate the firm for possible future firing payments), while to be destroyed jobs have to have low productivity (so that firms are willing to pay the firing costs on the spot). As for temporary jobs, which entail much lower firing costs than permanent jobs, firms are instead willing to hire workers with productivity arbitrarily close to the level which determines the firing margin. Hence, when temporary contracts are widely used to hire new workers, some job matches are already in a fragile situation at the time of hiring, and are thus vulnerable to separation whenever the aggregate state of the economy declines.<sup>7</sup> Thus, a dual labour market generates much higher turnover rates. This

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<sup>5</sup>Recently, a research network organised by the European Central Bank, the Wage Dynamic Network, has produced much empirical evidence, both at the macroeconomic and the microeconomic levels, on this issue, and, in particular, on how labour market institutions are conditioning the adjustment to the crisis. More information on the Wage Dynamics Network is available at:

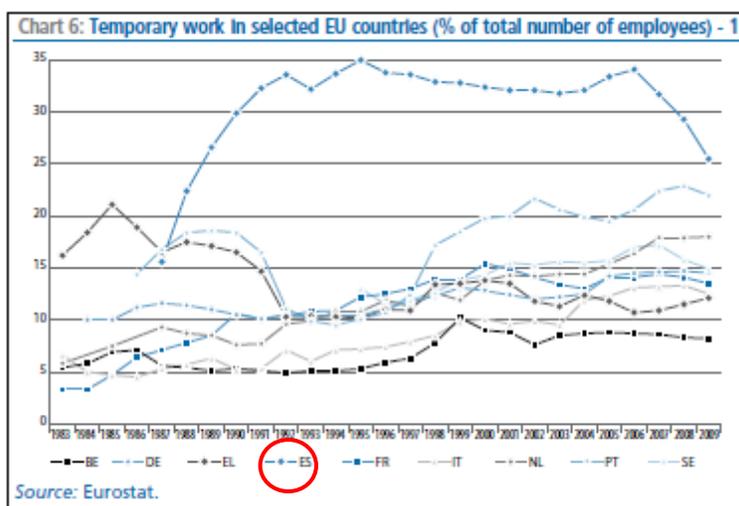
[http://www.ecb.int/home/html/researcher\\_wdn.en.html](http://www.ecb.int/home/html/researcher_wdn.en.html)

<sup>6</sup> In September 2010 there was a reform of the Employment Protection Legislation that is well short of what is needed to eliminate the inefficiency and inequality generated by the current dual system. As for collective bargaining, since January 2011 trade unions and employer associations have been engaged in negotiations to propose reforms that the government committed to endorse.

<sup>7</sup>For a technical exposition of this argument, see J. Costain, J.F. Jimeno and C. Thomas (2010): “Employment fluctuations in a dual labour market”, Bancode España, working paper 2013 (available at

has also some consequences for productivity growth. First, in dual labour market low-productivity jobs under permanent contracts are not destroyed, while new jobs with higher productivity under temporary contracts are destroyed, which has a negative impact on productivity. Secondly, because of the very high turnover rates, in dual labour markets returns to labour market experience and incentives to invest in human capital are lower, and, hence, productivity growth is also lower.

**Figure 7.**



Regarding collective bargaining, there are two characteristics of the Spanish system that create some wage inertia and lack of firm internal flexibility, two outcomes that are especially costly in the context of a crisis as abrupt and intense as the current one. These two characteristics are the prevalence of sectoral collective bargaining agreements, which cover all firms and workers under their scope, and the high degree of wage indexation, that is, wage-setting rules that link wages increases to inflation. Besides the consequences for wage adjustments in the aftermath of adverse shocks, sectoral collective bargaining also limits to some extent the reorganization of labour within firms needed to exploit the potential productivity gains of the introduction of new technologies. Moreover, sectoral collective agreements, not allowing for firms to adjust wages in response to productivity shocks, lead to higher steady state unemployment.<sup>8</sup>

<http://www.bde.es/webbde/SES/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosTrabajo/10/Fic/dt1013e.pdf>

<sup>8</sup> See J.F. Jimeno and C. Thomas (2011): “Collective bargaining, firm heterogeneity, and unemployment”, mimeo.

## 5. **Concluding remarks: Looking ahead**

Currently the Spanish economy is in a very slow recovery path, with GDP growth of 0.7%. With such a low growth rate, employment is unlikely to grow significantly and the unemployment rate could remain at very high levels for a long time. Private indebtedness and fiscal consolidation are restraining internal demand. Cumulated losses of competitiveness during the pre-crisis period restrain external demand. Macroeconomic policies, fiscal and monetary, cannot and will not provide the fuel for a demand expansion, given the financial conditions and the aggregate economic situation of the euro-zone.

Thus, in order to foster employment growth the only possible strategy is to focus on productivity-enhancing structural reforms. With a higher rate of productivity growth, competitiveness could be gained more rapidly, households and firms would be more likely to increase consumption and investment, and public debt could be stabilized without large expenditures cuts or increases in taxes. It is only through supply reforms that the Spanish economy can again reach a sustainable growth path, in which unemployment comes down to one-digit figures. Reforms that should be urgently undertaken should aim at increasing the efficiency of the educational and training system, further increase competition in product markets, and improve the functioning of the labour market by eliminating the current segmentation between temporary and permanent employment and introducing regulation that makes collective bargaining more inclined to provide internal flexibility and wage adjustments, rather than employment destruction, as the main instruments for firms to cope with negative shocks.