

Economic Research Note

Slack in the Spanish economy

- The Commission’s assessment of the supply side and unemployment in Spain is very bleak
- In our view, the supply-side deterioration in Spain has been less dramatic than the Commission suggests
- However, appropriate policy action is needed to avoid the crystallization of high structural unemployment

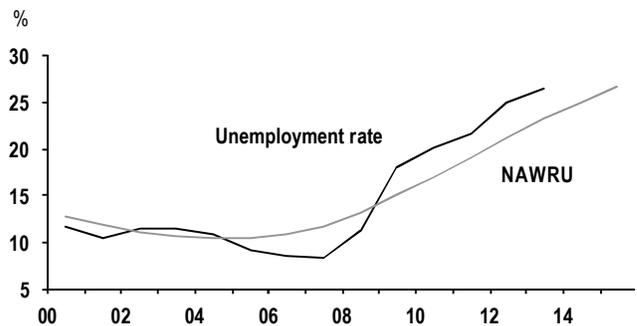
According to the European Commission, the natural rate of unemployment in Spain has risen from 10.9% in 2006 to 23.2% in 2013 (the Commission calls the natural rate the non-accelerating wage rate of unemployment, or NAWRU). The Commission expects the NAWRU to rise further, to reach 26.6% in 2015. This judgment about a sharp rise in the NAWRU has a huge impact on the Commission’s assessment of Spanish growth potential, because it represents a major negative shock to labor supply. Over the period 2009-2015, the Commission estimates that growth potential in Spain will average -0.5%oya, and for this year and next the Commission estimates that the average will be -1.2%oya.

This rather apocalyptic view of the Spanish supply side has a number of consequences. It leaves the output gap looking very small: the Commission estimates that the output gap will be -0.7% in 2015, even though it projects the level of GDP as still being 4.6% below the last cyclical peak and the level of unemployment at 25.3%. Strikingly enough, the Commission’s forecast of the unemployment rate for 2015 is already below its own forecast of structural unemployment. A negative view of the supply side puts more pressure on the government for fiscal austerity, by attributing less of the deficit to cyclical forces. It also makes the Commission forecast look sanguine on deflation risks in Spain: consumer price inflation is projected to be 0.9%oya this year compared to the latest January reading of 0.3%.

Perspectives on the supply side

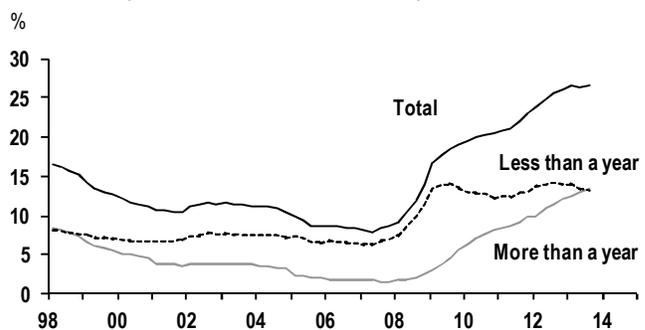
Our inclination is to think that the supply-side deterioration in Spain has been less dramatic than the Commission suggests. While it is very difficult to gauge the state of the supply side in real time, we would put the Spanish natural rate of unemployment at closer to 17% and the output gap at 9%. This would suggest that Spain is already not far from a balanced structural position—so that only moderate further austerity is required (of the order of 2% of GDP to reach the structural deficit target of 0.5% of GDP). Likewise, it suggests that that deflation risks in Spain are substantial, even though the economy is growing again.

Spanish unemployment and European Commission estimate of NAWRU



Source: Eurostat and European Commission

Spanish long-term and short-term unemployment



Source: Eurostat

Spain skill shortages in manufacturing and unemployment



Source: Eurostat and European Commission

There are a number of reasons why the European Commission has such a downbeat view of the supply side in Spain: long-term unemployment has risen sharply; skill shortages look elevated relative to unemployment; vacancies look elevated relative to unemployment; and inflation has not fallen as much as might have been expected.

It is true that long-term unemployment has risen, but we do not believe that it is appropriate to assume that the majority of the long-term unemployed are necessarily structurally unemployed. From 1998 to 2008, the long-term unemployment rate fell from 9.9% to 1.6%, with only moderate pressure on wages. Moreover, currently the short-term unemployment rate is 13.1%, and has been close to that level since the start of 2009. This does indicate that the entire rise in overall unemployment since the start of 2009 reflects

an increase in duration. But, it also suggests that there is a considerable amount of churning in the labor market whereby newly unemployed individuals are moving back into employment—albeit this appears to be largely a side product of the prevalence of temporary contracts for new hires, whose sequential use is constrained by law. This challenges the European Commission’s implicit judgment that the NAWRU for the short-term unemployed is as high as 10.2% (this assumes that in the Commission’s estimate of the overall NAWRU all of the long-term unemployed are structurally unemployed).

During the first recession in 2008-9, skill shortages in manufacturing and services moved broadly in line with developments in unemployment. There is no suggestion here of a structural deterioration in the labor market. However, in the second recession in 2011-13, a disconnect emerges between skill shortages and unemployment, which may point to a rise in the natural rate of unemployment. However, this may be more apparent than real. When firms are responding to the EC survey, the proportion reporting labor as a constraint on production cannot go below zero. For Spain, this survey hit the lower bound after the first recession so the relationship between skill shortages and unemployment since 2011 is not a good guide to the structural state of the labor market.

The Beveridge curve—the relationship between unemployment and vacancies—is less well defined in Spain than the relationship between unemployment and skill shortages. Nevertheless, a similar pattern is evident. In the first recession in 2008-9, vacancies fell as unemployment rose. But, in the second recession in 2011-13, unemployment rose further while vacancies moved sideways. While this might at first blush point to a structural deterioration in the labor market, there is also a zero lower bound to the vacancy data: the vacancy rate cannot go below zero. It looks to us like the Spanish vacancy rate reached the lower bound after the first recession and could not decline further in the second recession. This means that the Beveridge curve is not a good guide to the structural state of the labor market.

Another way to look at slack in the Spanish labor market is to consider the Eurostat data on underutilization. The unemployed are available and looking for work by definition. The key question is whether they are in the right place with the right skills. The participation rate has been broadly stable in Spain over the recent years, reflecting similar sized moves in employment and unemployment. However, there has been an increase in underutilization in addition to the move up in unemployment. Since 2008 there has been an increase of 800,000 individuals who are working part time but would like to work more hours (worth 3.5% of the labor force). In

Spain vacancy rate and unemployment



Source: Eurostat

Spanish employment, unemployment, underemployment and inactivity

Level millions and % of labor force, age 15-74

| | 3Q08 | 3Q13 | Change (millions) |
|---|--------------|--------------|-------------------|
| Full-time employed + part-time employed not seeking additional work (1) | 19.6 (85.3) | 15.4 (67.6) | -4.2 |
| Underemployed part-time workers (2) | 0.8 (3.4) | 1.5 (6.4) | 0.8 |
| Employed persons (1+2) | 20.3 (88.7) | 16.8 (74.0) | -3.5 |
| Unemployed persons (3) | 2.6 (11.3) | 5.9 (26.0) | 3.3 |
| Active persons (1+2+3) | 22.9 (100.0) | 22.7 (100.0) | -0.2 |
| Persons seeking work but not immediately available (4) | 0.3 (1.1) | 0.2 (1.0) | -0.1 |
| Persons available to work but not seeking work (5) | 0.8 (3.5) | 1.2 (5.1) | 0.4 |
| Potential additional labor force (4+5) | 1.1 (4.6) | 1.4 (6.2) | 0.3 |
| Other inactive (6) | 11.1 (48.6) | 10.4 (46.0) | -0.7 |
| Inactive (4+5+6) | 12.2 (53.3) | 11.8 (52.1) | -0.4 |
| Total population (1+2+3+4+5+6) | 35.1 (153.3) | 34.6 (152.1) | -0.5 |

Source: Eurostat

addition, since 2008 there has been an increase of 300,000 individuals who are classified as economically inactive but are either seeking work but not immediately available or who are available to work but not seeking (worth 1.3% of the labor force).

Reform effort should not wane

While we believe that the supply-side picture is not as bleak as depicted by the Commission, we acknowledge that appropriate policy action is needed to avoid the crystallization of very high structural unemployment. In the context of protracted salary moderation, the 2012 reform goes in the right direction to facilitate the creation of new jobs. But it only partly mitigates labor market segmentation. In our view, introducing an encompassing open-ended contract, with the level of employment protection increasing smoothly with seniority, would be the best course of action. In parallel, well designed active labor market policies should target the share of poorly educated low skill unemployed (mostly as a result of the real estate boom-bust), to reduce the likelihood of their permanent exit from the labor market.

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