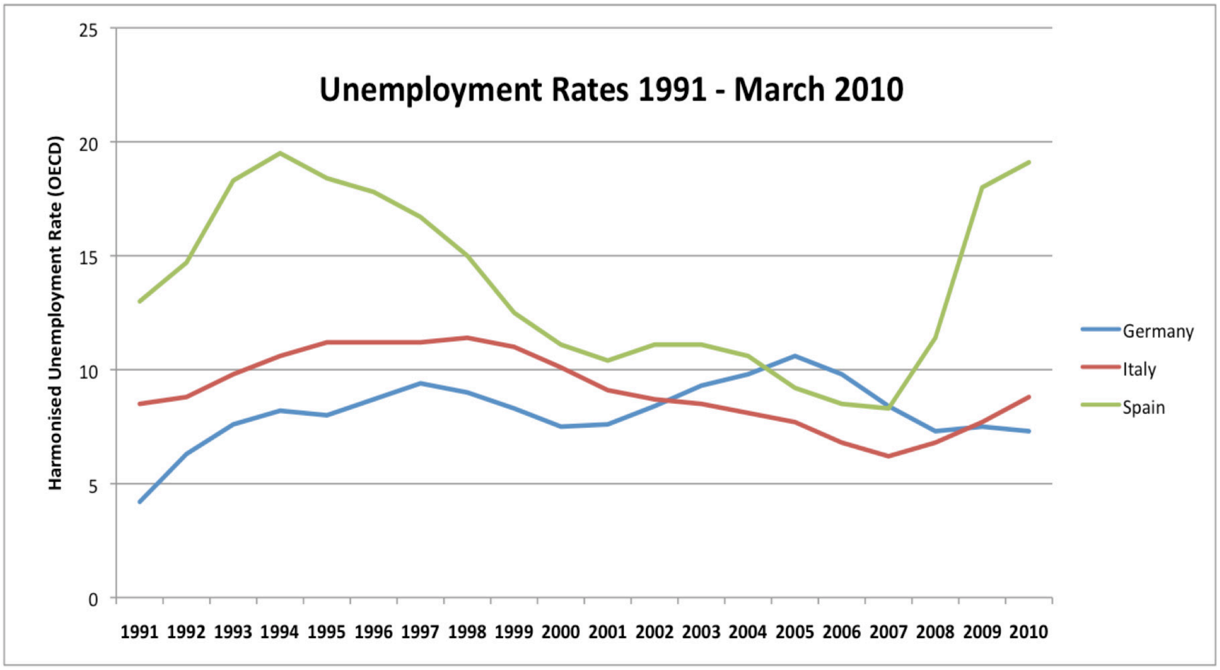
Worksheet 19.2

When Spain's Unemployment Problem gets Ugly

Watch this video about Spain's unemployment.

With more than four million Spanish people out of work in 2009, the eighth largest economy in the world found itself in a perilous position. Throughout the year the number of unemployed people in Spain doubled. Spain had as many unemployed people as France and Italy combined, and the unemployment rate was nearing the historic highs of 1993.

From the graph below we can see that unemployment in Spain has been high for at least the last 20 years, compared to other countries within the European Union.

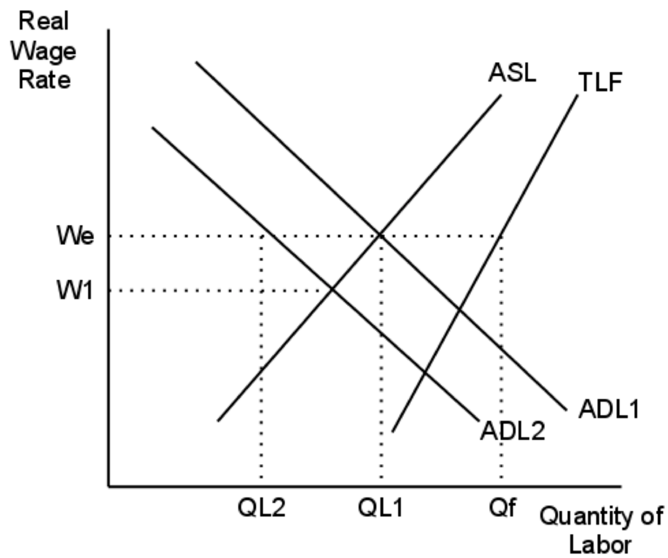


Source: OECD Factbook 2009: Economic, Environmental and Scoial Statistics

The cause of growing Spanish unemployment from 2008 to 2010 is related to the collapse of the domestic building boom and the wider global recession. In 2006, Spain enjoyed low interest rates and therefore cheap loans, this allowed developers to build new apartment blocks, houses and commercial buildings with a relatively low cost of borrowing. Spanish people could afford mortgages at low interest rates and therefore purchased houses contributing to the building boom. However, when the flow of 'cheap money' ran out in mid 2008 the building stopped and the flow on effects of spending dried up. Falling tourism receipts and less foreign investment also exacerbated the issue leading to unemployment doubling between 2008 – 2010.

We can classify the form of unemployment, illustrated in the Spanish example as demand-deficient unemployment. It is related to a downturn in the economic cycle. This concept is explained below.

Demand Deficient (Cyclical) Unemployment



This is associated with cyclical downturns in the economy. Aggregate demand falls, therefore the aggregate demand for labor will fall.

The aggregate supply of labor remains constant as households would like the jobs at the equilibrium wage rate (We). Since wages are sticky, however, firms will not be willing to hire the number of workers wishing to work.

The ADL falls, but wage remains high, so there is involuntary unemployment (cyclical) in the economy equal to QL1-QL2.

In the long run, wages will fall to W1 and the cyclical unemployment will be eliminated as firms hire more workers and some workers leave the job search due to the lower wage rate.

Effects and Solutions

The social and economic impacts of 20.7% unemployment are obvious, but the solutions are less so. Climbing unemployment creates two evils: falling tax revenue as workers no longer earn wages and the increased burden of paying benefits to the four million unemployed citizens. In addition, a series of social problems are often intertwined with high unemployment, these include depression; loss of skills, poverty and higher crime rates.

Some of the suggested fixes for the unemployment problem in Spain have included:

- **Use fiscal stimulus to boost consumer and government spending, thereby increasing the demand for jobs.** Spain could plan for a budget deficit (expansionary fiscal policy) and fund spending increases though increased government borrowing. Spain's current level of public debt is around 70% of GDP, which is well below Greece at 124%. However, Spain must borrow money from international bond markets, which are skeptical about Spain's ability to pay back this debt. This is despite assurances and favourable rates offered from the European Union. Increasing government debt in a period of European financial crisis is a risky option.

- **Use loose monetary policy (lowering central bank interest rates) to encourage Spanish people to increase their consumer spending through increased borrowing.** If you understand the complexities of the European Union, you understand that all 21-member countries use the same currency and follow the lead of one central bank. Despite one country wishing to lower interest rates, other countries may think differently. Europe can be compared to a train rolling along on a set of rails, with 21 separate carriages. Each European country must follow behind the big engine, there is no room to deviate from the European Central Bank's interest rates and all of the countries must move together. Many people have wondered how long the European train would run, before one of the carriages derailed.
- **Force Spanish firms to employ more people.** Firms have no requirement to hire more people. They may choose to employ more people but will logically offer everyone lower wages to maintain profitability.
- **Enact policies to bring greater efficiencies to firms though increased on the job training and worker education.** This is a long-term solution, which will require large structural adjustments, how Spain produces goods and services and exactly what is does produce. A startling statistic is that the average Spanish university graduate will find their first job at the age of 27, long after they have graduated.

Questions:

1. Of the policies suggested above, which would be considered demand-side policies? Which would be considered supply-side policies? Could any of them be considered both demand-side and supply-side?
2. Explain the causes of the historically high levels of unemployment in Spain.
3. Why is expansionary fiscal policy increasingly difficult for a government to enact in the middle of a 'debt crisis' such as that experienced in Europe in 2010 and 2011?