Unemployment in the Great Recession

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Introductory remarks: Timings

• Great Recession started with a downturn in housing markets and financial failures, sometime in late 2007 or beginning of 2008

• Recession was at its most severe in late 2008 and early 2009. In the UK and US one can identify early 2008 to April 2009 as the downturn in the labour market
Objectives

• Unemployment increased in all countries affected by the recession.

• I will focus on impact of recession by comparing unemployment outcomes in 2009 and 2007.

• I will evaluate the impact of labour market institutions and policy on the response of unemployment to the recession.
Outline

• What happened to unemployment during and after the recession?

• Understanding unemployment

• Understanding country differences

• Developments since 2009: the European periphery
Overview of impact on unemployment
Unemployment rise 2007-09
Men suffered more unemployment than women
Youths suffered more unemployment than overall

![Bar chart showing unemployment rates for different countries and age groups]
Most job losses in industry

Job losses, 2007-2009

% population aged 16-64

EUROZONE  OECD

industry  construction  services  agriculture
But this ignores structural change

- Structural change in both OECD and Eurozone was destroying jobs in industry and agriculture and replacing them with jobs in services.

- If we predict where structural change would have taken employment levels (by extrapolating 2000-07 trends for two years) we get completely different story.

- Making this correction also implies that the recession caused a lot more job losses: aggregate employment was on an upward trend.
No job creation in services is the villain

Predicted job losses compared with employment levels if 2000-07 trends continued to 2009
Unemployment dynamics

- At the onset of recession, usually the cause of the rise in unemployment is an increase in new entry – average duration might even fall

- But as recession takes hold either new entry or duration could be behind unemployment rise (and persistence)
Cause of rise in unemployment, 2007-2010 (smaller sample)

- new entry
- change in duration
What happened next?

- The Great Recession of 2008-09 was succeeded by the Eurozone debt crisis
- Response of unemployment predictable
- Countries that followed fiscal austerity experienced further increases
Unemployment rise 2009-12
Understanding unemployment
Causes of recession

• Recession started in housing markets and caused disruption in financial markets (house price fall causing bad loans)

• Once housing wealth dropped and financial institutions saw their capital dissipate the whole economy went into recession
Aggregate and construction shocks

• How much of the rise in unemployment was due to the overall fall in aggregate demand and how much to the construction sector? How much remains unexplained?

• The remainder (or residual rise) shows how good or how bad is the labour market in absorbing shocks without undue impact on unemployment

• It’s a relative concept – compares labour market performance across counties
Decomposing the rise in unemployment

- I remove the impact of the fall in aggregate demand and the bias due to the size of the construction sector

- The remainder yields the graph that follows (because it is a relative concept the residuals add to zero)
Residual rise in unemployment
2007-09
Interesting cases to consider

• USA and Spain worse than average (controlling for their overall fall in demand and the size of their construction sectors)

• UK rise in unemployment explained by the overall fall in demand

• Germany better than average

• Italy, Ireland, Portugal, Spain, Greece (in that order) deteriorated badly in debt crisis years, after initial shock
Country differences
United States

• Initial impact of recession similar to earlier ones but experience soon deviated

• Compared with OECD average and controlling for the fall in GDP and the size of the construction sector, US experienced:
  – Bigger fall in employment and hours
  – More burden of adjustment on employment than on hours per person
  – Despite this, rise in unemployment due more to longer durations than to new entry – a new feature for the US
What does it mean?

• Typical response of economy with employment laws that impose no restrictions on firms and offering no incentives for labour hoarding

• But suffering from rigidities on the workers’ side that delay job acceptance

• Combination of employer-friendly flexibility with frictional rigidities in job search
Beveridge curves

• US relation between job vacancies and unemployment (the Beveridge curve) reminiscent of European labour markets in the 1980s recession

• Due to the increase in mismatch and job search frictions

• If US labour market showed the same flexibility in this recession as in 1980s recession, unemployment now would be at least 2 points lower
The US Beveridge curve, 2001-12

- Vacancies %employment vs. Unemployment %labour force
- Data points for different months:
  - 2001M1
  - 2008M1
  - 2012M8
  - 2009M4
Plausible causes

1. Structural change in recovery. Jobs created in different locations from the locations of those destroyed. Traditional response in US is labour mobility, mobility now down substantially (less than half) could be due to home ownership and depressed housing markets.

2. Extension of unemployment benefit: creating more disincentives than higher replacement rates of limited durations.

3. (Gordon) Executive compensation in shares, CEOs fired workers to cut costs and avoid loss of shares value.
Comparisons with Britain, 2001-2012
Comments

- Britain reformed its economy in 1980s and 1990s and the structure of the labour market is now very similar to US.

- But reaction to recession very different: Britain exhibiting features of conventional depressed labour market, US features of a labour market with structural problems.

- British story: booming 2001-08, sudden deterioration 04/08-04/09, stationary in recession since then.
Lessons

- In Britain, not much can be done with labour market policy to improve labour market – institutions seem to function well, problem is macro environment

- In US, evidence that extending UI in recession without an active component dangerous for duration of unemployment

- Returning labour market to traditional US-style flexibility requires fixing the housing market
Comparing with Germany:
GDP and total labour input

Percentage changes, 2007-09

United States	Britain	Germany

GDP	total hours
Split of labour input between hours and persons

Percentage changes, 2007-09

United States  Britain  Germany

employment  hours per worker
Striking facts

• Fall in GDP very similar, fall in overall hours dissimilar: US much bigger fall than Germany

• Fall in hours per person similar in US and Britain, a little more in Germany

• Striking difference is in employment adjustment: much more in US than Germany, Britain in the middle

• As a result, German unemployment not affected badly by recession
Productivity as the shock absorber

• Main adjustment that counterbalances labour changes is productivity, not differences in final output

• US had big increase in both hourly and per person productivity, especially in services, Germany big fall in both, Britain small fall
Reasons

• Germany liberalised labour markets in 2000s, similar reforms to Britain two decades earlier (the Hartz I-IV reforms)

• Economy becomes more business-friendly, less restricted by labour regulation and with lower duration of benefits to unemployed, increased active spending and benefit receipt conditional on strict search and work criteria

• Crucially: Germany had in place generous system of wage subsidies and other active labour market policies
German policy successes

• Active policies in the form of
  – Training, short term (e.g., how to apply for jobs and present oneself to employers) and longer term (skill acquisition)
  – Targeted wage subsidies
  – Start-up subsidies (support for 9 months, UI benefits plus some more)
  – Job creation schemes in public sector

• Targeted wage subsidies
  – Given to employers
  – Cover 50% of wage for 12 months with another 12 months “protection period”
  – Tailored to unemployed and disadvantaged groups
Germany 2005-2010: impact of reforms on Beveridge curve

- Recovery 2005-2006, following reforms (Hartz)
- Fast recovery 2007-2008M9 (up to Lehman collapse)
- Recession 2008M9-2010 but response of unemployment small
- Example of economy becoming more flexible in 2007
Evaluation

• Unrestricted labour markets like the US and UK can give rise to big increases in unemployment in recession

• Long-term unemployment builds up, especially if benefits are of long duration

• German example shows that wage and start-up subsidies can mitigate the impact of recession on employment
To be recommended?

- German policy good because it checks the growth of structural unemployment – keeps people in work, even if it is at reduced hours and pay
- But productivity falls
- Is this bad for recession years? Would you give up productivity gains for less unemployment
Spanish labour market

- Spain is an outlier in the other direction from Germany’s: massive fall in employment and rise in unemployment, no fall in hours per person, with big productivity gains

- All countries with very minor exceptions managed to keep unemployment rise below GDP fall

- In Spain unemployment increased by much more than GDP fall
Is the construction sector to blame?

Employment in the construction sector

Per cent of working age pop.

Spain
Eurozone
Clear message

• Large construction sector only partially to blame

• Clear message is that in Spain there is an institutional structure in the labour market that leads to excess employment volatility

• It affects women more than men

• Young workers even more
Employment protection

• At the onset of recession Spain was the most regulated labour market in Europe

• Regulation was not only in legislation but also in trade union agreements

• It applied to permanent employees but also various other forms of regulation applied to temporary contracts
Employment contracts

- Spain still has dual structure of contracts: older male workers have too much protection at high wages
- Employers too cautious about offering this type of contract to new employees
- Could cause a lot of volatility in times of uncertainty. Employers rotate employees to avoid getting tied in to long-term contracts
- Security of permanent contracts encourages unions to negotiate high wages, and apply them to all workers
Spanish reforms 2010-11

• Worker dismissals for economic reasons made easier, with 15-day notice

• New more comprehensive employment-promotion permanent contract introduced, with express dismissal procedure (33 days’ wages paid as compensation for each year of service)

• Temporary contracts’ dismissal costs gradually raised from 8 to 12 days’ wages for each year of service
Prospect of success

- Reforms in the right direction but two key problems remain
- The dualism in the Spanish labour market is retained, permanent contracts have more benefits than others
- Collective bargaining still applies to all workers in the industry
- Unions need to be socially motivated for this system to succeed; No evidence for this, real wages sticky even in the crisis
Developments since 2009
The Eurozone (EZ) periphery

• Since 2009 the countries that deteriorated most in their unemployment performance are the ones suffering from sovereign debt crises

• In ascending order Italy, Ireland, Portugal, Spain Greece
Why crises?

• These countries had large borrowing requirements, either because of large government debts (e.g., Greece, Italy) or because they had to rescue their banks (Ireland, Spain)

• Interest rates became prohibitively high because of the risks of repayment

• They asked for help from the troika (IMF, EC, ECB)

• Troika imposed fiscal austerity measures that caused bigger recessions and unemployment
Structural reforms

- For the Eurozone to work labour markets of members need to be flexible
- Even with flexibility, there will be need for fiscal transfers
- Without flexibility there will be much more need of transfers
- Wealthy countries in EZ not happy committing to paying forever for the debts of less well-off members
- They are asking for reforms to make their labour markets more flexible and fiscal savings leading up to them
Lags in effect

• This combination is bad for employment

• Structural reforms will eventually be good for the labour market, but they need up to 4-5 years to have an impact

• Fiscal austerity has an immediate negative impact

• So expect an immediate deterioration in the labour market that might undermine the whole reform process
Previous examples

- Britain in 1980s tried it: unemployment went up from 5 to 12% from 1980 to 1986. Reforms had their positive impact after 1986, fiscal austerity had its impact immediately.

- German reforms in 2003-05: had their positive impact after 2007.

- Spanish reforms 2010-11, Greek reforms 2011-12, no positive impact visible yet.
Britain too

• British coalition government policy follows similar approach

• Wanted to revive private sector job creation and cut down public sector spending

• Claimed that cutting down on public sector will do the trick

• But it did not: it sank country into second recession

• Only just beginning to show some response. Eventually it will work out but initial cuts unnecessarily deep
Is there an alternative?

• Troika should be softer on fiscal austerity

• Fund investment projects from structural funds and enforce fiscal cuts gradually, as the economy recovers

• Otherwise unemployment will become chronic and will put at risk the recovery within the Eurozone

• Accelerate structural reforms under these conditions
Conclusions

- Countries with poor institutional structure in the labour market suffered bigger increases in unemployment

- Especially after 2009, when the recession led to the debt crisis

- Countries that performed best are either ones without debt problems but flexible structures, or ones that supported the unemployed with active policy measures (which are not possible with the fiscal austerity of the Eurozone)
Thank you!