



## Editorial: Deficits in real convergence become evident

One of the main challenges of the single currency project was to create an economic space which was sufficiently harmonized to be able to maintain a common monetary policy, that is consistent with the country-specific economies. This was the objective of the nominal convergence criteria specified in the Maastricht Treaty which potential Euro area members had and still have to meet, before entering the currency union.

While the initial goal of nominal convergence has been met more or less over the years, the so called “real convergence” remained a major unsolved issue in the Euro area. The current crisis has given us a good example how wide the differences among member countries still are.

Indeed, comparing the current situation (third quarter 2009) with the values achieved before the crisis (first quarter 2008), the effects of the economic crisis have been significantly different in the individual member countries. The rates at which real GDP declined in the 16 members range from -1% in Greece to more than -9% in Ireland. These differences become particularly evident when we focus on the labor market, which was, as is well known, hit hard in most developed economies.

Labor market reactions have been even more divergent than those observed in GDP, both on the demand and the supply side. On the demand side, changes in employment lie within a range larger than 12 percentage points (even 20 points if we consider the 11% employment growth rate in Luxemburg). In Austria, employment increased by 2.6 %, in Ireland it declined by almost 10%. On the supply side, the working population increased by 4.2% in

Finland (even 11% in Luxembourg), and it decreased by 2.2% in Ireland.

As a result of these differential effects, unemployment rates have also show significant divergence among the Euro area members states. In Spain an increase by about eight percentage points was registered, whereas there even was a small decrease in Germany in the most recent months.

Obviously, these significant differences have their origins in different production structures on the one hand, and country-specific legislation on the other, causing different mechanisms to adjust to a decline in employment. Throughout this document the Spanish case will be discussed in more detail.

Now, considering that governments have to cover the cost of increasing unemployment, it becomes obvious that a lack of real convergence may also result in a fiscal divergence. Fiscal deficits are climbing everywhere, but in some countries more strongly than in others. This might endanger the stability of the system.

At this point, measures might be required that foster real convergence. More harmonized labor market regulations may be one approach. Supply side measures, such as immigration policies or changes in retirement ages, as well as demand side policies, e.g. a more flexible regulation of working time or the use of part-time work, might help in this context. Even a more harmonized settlement of rights and obligations of unemployed (social benefits) should not be excluded.

*Contact:*

*Julian Perez (Julian.perez@ceprede.es)*

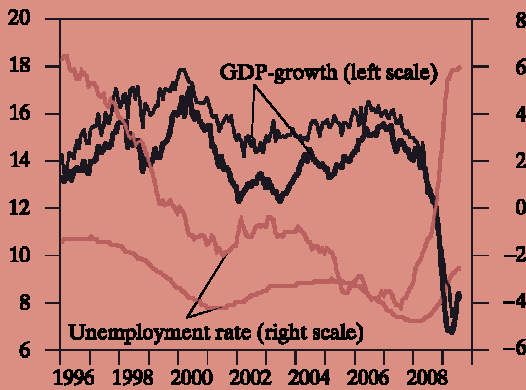


## Spanish labor market: Why is it so different?

One of the most visible effects of the current crisis is the deterioration of the labor market situation. Each country in the Euro area has experienced an increase of unemployment, but the Spanish economy has suffered most. Here the unemployment rate jumped from 8.6% in the fourth quarter of 2007 to nearly 18% in the second quarter of last year. On the other hand, almost half of all new jobs in the European Union were created in Spain during the past expansion. Indeed, unemployment rates as well as GDP growth are a bit more volatile in Spain compared to the Euro area, with a more pronounced reduction of unemployment in expansion periods followed by stronger increases during decelerations (graph 1).

Graph 1

**GDP Growth and Unemployment Rate In Spain and in the Euro Area 1996–2009**

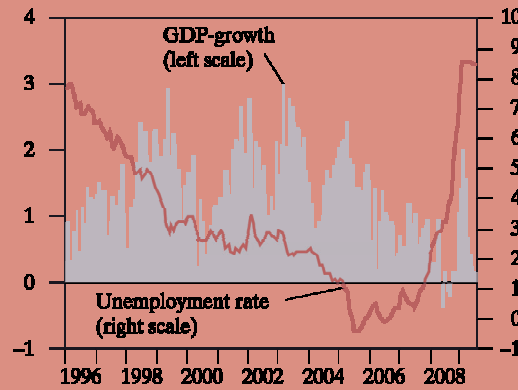


Source: Ceprede September 2009. Bold lines: Spain.

This as a starting point, one could think that GDP growth differentials can explain the specific movements of the Spanish unemployment rate. However, graph 2 shows that this argument is not very clear. Between 2001 and 2003, e.g., when Spanish GDP was growing about two points faster than the Euro area average, the unemployment spread stayed almost constant at about 3 points. Since mid 2007, when Spanish GDP was still showing a slightly positive growth differential, the unemployment spread rose by almost 10 percentage points.

Graph 2

**GDP growth and Unemployment Rate Differentials 1996–2009; Spain versus Euro area**



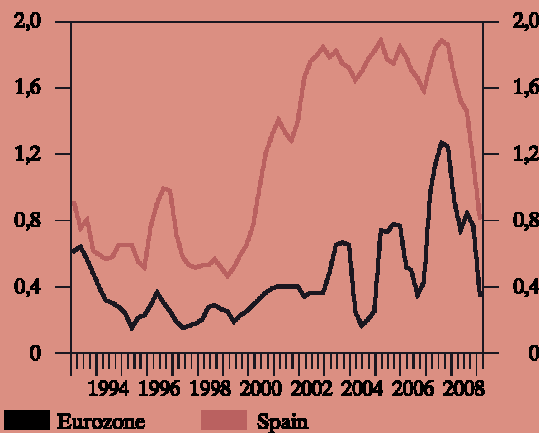
Source: Ceprede September 2009.

Looking at explanations for these differences, we should first focus on labor supply in terms of demographic trends as well as participation rates. Concerning demographic trends, growth of the working age population (between 15 and 54 years) was and still is, fuelled by immigration, significantly larger in Spain compared to other Euro area countries (graph 3).

Additionally, the Spanish participation rate has shown a strong convergence

Graph 3

**Population aged between 15 and 54 1993–2009, yoy growth**

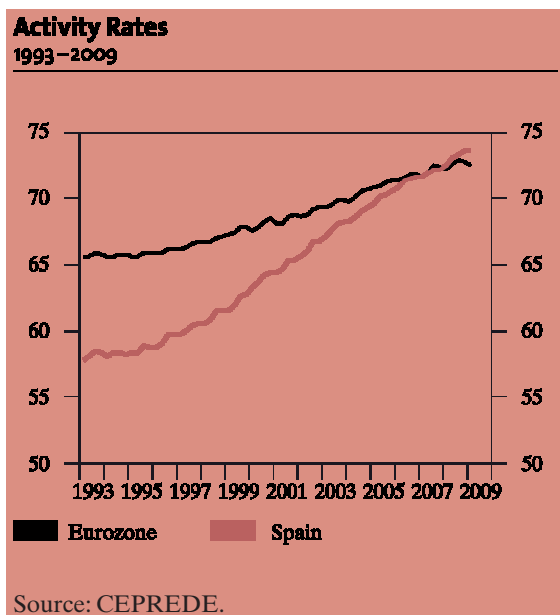


Source: CEPREDE.



towards the European average. At the beginning of the 1990s it was one of the lowest in the Euro area; in 2008 it even was slightly above average (graph 4). Other countries like Italy, which were in a similar situation, have shown less progress.

Graph 4



Both factors imply a growth rate of the economically active population which is significantly larger in Spain than the Euro area average. This means that Spanish employment must grow stronger than the Euro area average to keep unemployment constant. Therefore, labor supply can partially explain why the unemployment rate was not reduced further during the past expansion and why it increased so strongly during the current crisis.

However, to get a full picture, also the demand side must be taken into account. The elasticity of employment growth with respect to GDP growth was around 1.25 in Spain compared to 0.75 in the Euro area in the recent years, and it also is significantly larger than in the three big EU countries.

That higher elasticity means that during expansion cycles the Spanish economy generates relatively more employment than the Euro area average, while during contraction phases, like the current one, employment is destroyed at a faster pace. Two factors should be taken into account to explain these differences. Firstly, the higher elasticity may reflect differences in the production structure, and secondly in productivity levels.

In fact, a few years ago, when the Spanish economy was generating almost 50% of the new jobs in the European Union, many economists argued that it was due to the strong growth in the real estate and construction activities, which have high direct and indirect employment multipliers.

Indeed, the share of the construction sector in GDP is by far larger in Spain (12.3%) than in the Euro area (6.4%). The primary sector also shows a somewhat larger share in Spain, albeit the differences are not as pronounced (2.9% vs. 1.9%).

In both sectors, agriculture and construction, productivity levels are rather low; gross value added per person is 25.000 and 40.000 , respectively. In other words, these sectors are more labor intensive than

Table 1

Effects of a shock of 100 Million in Gross Value Added (GVA) on Employment					
Mill.	Agriculture	Industry	Construction	Services	TOTAL
GVA sectoral distribution					
Germany	1	26	4	69	100
<b>Spain</b>	<b>3</b>	<b>17</b>	<b>12</b>	<b>67</b>	<b>100</b>
France	2	14	6	77	100
Italy	2	21	6	70	100
<b>Euro area</b>	<b>2</b>	<b>20</b>	<b>6</b>	<b>71</b>	<b>100</b>
Employment effects					
Germany	39	364	102	1 326	1 832
<b>Spain</b>	<b>98</b>	<b>342</b>	<b>288</b>	<b>1 462</b>	<b>2 190</b>
France	50	201	104	1 159	1 514
Italy	73	379	141	1 229	1 823
<b>Euro area</b>	<b>72</b>	<b>314</b>	<b>142</b>	<b>1 299</b>	<b>1 828</b>

Source: CEPREDE. September 2009.



others and they need more employment to produce the same value added.

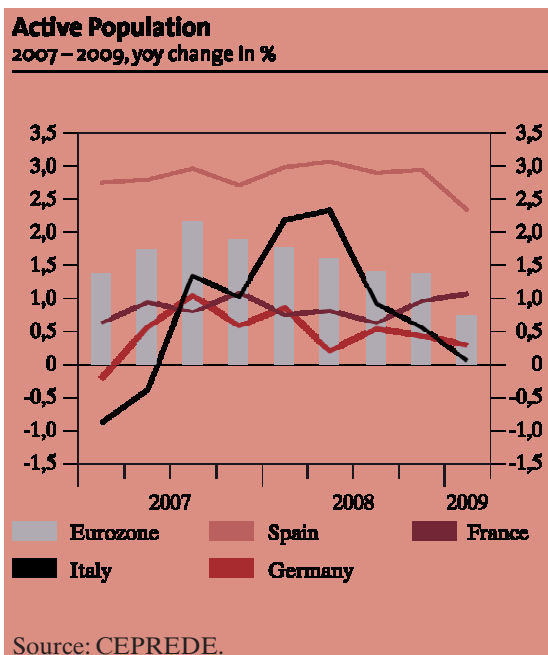
To illustrate the impact of these differences, a very simple exercise has been made. We have computed the effect on total employment that could be induced by an increase (or decrease) of total value added by 100 mill which is distributed among sectors according to the specific sectoral structures and applying country-specific productivities (table 1).

The upper half of the table shows the increase of sectoral GVA which would be caused by a homogeneous increase of GDP by 100 mill. . In the lower part of the table the number of jobs is shown that was necessary to generate the GVA. The hypothetical increase is almost 2.200 in Spain compared to just 1.820 on average in the Euro area. This simple exercise tells us that the structure of production, jointly with productivity levels, leads to an employment response to a GDP shock that is almost 20% higher in Spain than in the Euro area average, and even 40% higher than in France.

The employment shock could even be larger if we simulate a non-homogeneous GDP shock which is concentrated on the construction sector in Spain and on the industry sector in other countries, as it could be observed more or less during the recent crisis.

Table 2 shows the main results of this second simulation. It makes evident that the employment effect in Spain could be more than 2.300 jobs, while it is about 1.500

Graph 5



(65% of the Spanish effect) in the Euro area average.

The differences could even be larger if the indirect effects for the rest of the economy were taken into account. They are typically higher in construction activities compared to the manufacturing sector. Considering that in the first stages of the current crisis its main effects in Spain were concentrated on the construction sector, the enormous impact on employment becomes evident.

In addition to these “structural” factors, the short-term reactions to the crisis differed, both on the supply side and on the demand side of the labor market. On the one hand, active population in Spain grew

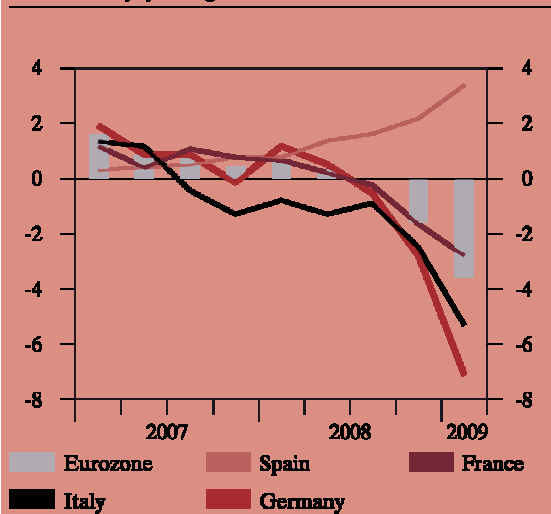
Table 2

Employment Effects of a sector specific shock of 100 Million					
Mill.	Agriculture	Industry	Construction	Services	TOTAL
GVA sectoral distribution					
Germany	0	100	0	0	100
<b>Spain</b>	<b>0</b>	<b>0</b>	<b>100</b>	<b>0</b>	<b>100</b>
France	0	100	0	0	100
Italy	0	100	0	0	100
<b>Euro area</b>	<b>0</b>	<b>100</b>	<b>0</b>	<b>0</b>	<b>100</b>
Employment effects					
Germany	0	1 383	0	0	1 383
<b>Spain</b>	<b>0</b>	<b>0</b>	<b>2 346</b>	<b>0</b>	<b>2 346</b>
France	0	1 427	0	0	1 427
Italy	0	1 770	0	0	1 770
<b>Euro area</b>	<b>0</b>	<b>1 540</b>	<b>0</b>	<b>0</b>	<b>1 540</b>

Source: CEPREDE. September 2009

Graph 6

### Labour Productivity per Person Employed 2007–2009, yoy change in %



Source: EUROSTAT.

at an unchanged rate during the first stage of the cyclical downturn, while in the rest of the Euro area a clear deceleration was registered (graph 5).

On the other hand, real productivity shows a pro-cyclical pattern in most European economies, i.e. it was reduced during the recession. In Spain, however, it showed a sharp counter-cyclical increase (graph 6).

Having in mind the prospects for GDP growth rates in the coming years it is quite clear that Spanish unemployment will stay significantly above the Euro area average for quite a number of years.

Contact:

Julian Perez ([Julian.perez@ceprede.es](mailto:Julian.perez@ceprede.es))





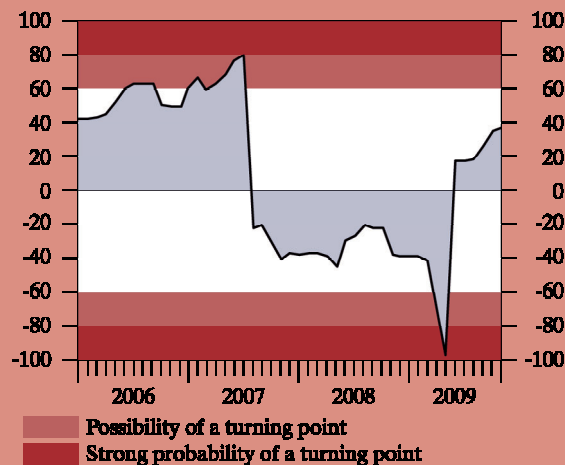
### Coe-Rexecode Leading Indicator for the Euro Area

It has become quite sure in the recent months that the Euro area is out of the recession since the summer 2009. The underlying growth, according to the Coe-Rexecode monthly growth indicator was above 3 % in November, which is significantly above the trend growth rate, confirming the exit of the low phase of the growth cycle. The trend growth rate has receded to an estimated 1%, which could be however biased downwards by end-point effects of the Christiano-Fitzgerald filter used to estimate it.

We are now looking for the next peak of the current growth cycle. The leading indicator must overpass in turn the 60 and the 80 thresholds to send a strong signal of an imminent economic reversal of the present rebound. In November 2009, the indicator stands at 36.5, far below the 60 threshold which should be over passed to send a first signal of a possible peak in the nine coming months.

Contact:

Jacques Anas ([janas@coe-rexecode.fr](mailto:janas@coe-rexecode.fr))



### Forecast of the EUREN/CEPREDE High Frequency Model

Last update: December 17, 2009

	08Q3	08Q4	2008	09Q1	09Q2	09Q3	09Q4	2009	10Q1	10Q2	2010
Oct-08	0.8 ; 0.0	0.7 ; 0.2	1.3	0.5 ; 0.5				0.5			
Nov-08	0.8 ; 0.0	0.4 ; 0.0	1.2	-0.2 ; 0.1				0.0			
Dec-08	0.7 ; -0.1	0.0 ; -0.4	1.1	-0.6 ; 0.1				-0.5			
Jan-09	<b>[0.6 ; -0.2]</b>	-0.7 ; -1.0	0.9	-1.8 ; -0.4	-2.0 ; -0.4			-2.0			
Feb-09		-0.9 ; -1.2	0.8	-2.4 ; -0.8	-2.7 ; -0.5	-2.9 ; -0.4	-2.7 ; -0.5	-2.7			
Mar-09	<b>[0.6 ; -0.2]</b>	<b>[-1.3 ; -1.5]</b>	<b>[0.7]</b>	-2.7 ; -0.8	-3.5 ; -1.1	-3.6 ; -0.3	-2.6 ; -0.5	-3.1			-0.9
Apr-09			<b>[0.7]</b>	<b>[-2.7 ; -0.7]</b>	-3.2 ; -0.8	-3.1 ; -0.1	-2.0 ; -0.4	-2.7			-0.5
May-09			<b>[0.7]</b>	<b>[-3.8 ; -1.7]</b>	-3.0 ; 0.6	-2.5 ; 0.3	-1.2 ; -0.4	-2.6			0.5
Jun-09	<b>[0.6 ; -0.2]</b>	<b>[-1.4 ; -1.6]</b>	<b>[0.7]</b>	<b>[-4.7 ; -2.6]</b>	-3.9 ; 0.6	-2.9 ; 0.8	-1.0 ; 0.3	-3.1			1.1
Jul-09			<b>[0.7]</b>		-3.7 ; 0.8	-2.3 ; 1.2	-0.2 ; 0.5	-2.7			1.1
Sep-09	<b>[0.5 ; -0.2]</b>	<b>[-1.7 ; -1.6]</b>	<b>[0.6]</b>	<b>[-4.9 ; -2.6]</b>	<b>[-4.7 ; 0.8]</b>	-3.1 ; 1.3	-0.7 ; 0.7	-3.3			1.4
Oct-09			<b>[0.6]</b>			-3.2 ; 1.2	-0.7 ; 0.8	-3.3			1.4
Nov-09			<b>[0.6]</b>			-3.3 ; 1.1	-0.7 ; 0.8	-3.4			1.4
Dec-09	<b>[0.4 ; -0.4]</b>	<b>[-1.9 ; -1.9]</b>	<b>[0.5]</b>	<b>[-5.0 ; -2.4]</b>	<b>[-4.8 ; -0.2]</b>	<b>[-4.1 ; 0.4]</b>	-1.6 ; 0.6	-3.9	0.9 ; 0.0	1.2 ; 0.2	0.8

In brackets; GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

In Q3 2009, expansion was slower than the High Frequency Model forecasted. The annual rate for 2009 is now estimated -3.9% instead of the formerly published -3.1%. For the last quarter of 2009 a somewhat stronger growth is projected. In the first half of 2010, however, only moderate rates are foreseen.

Contact: Julián Pérez ([julian.perez@uam.es](mailto:julian.perez@uam.es))

### Impressum

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