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Catastrophic job Destruction during the Portuguese Economic Crisis

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ABSTRACT

In this article we study the resilience of the Portuguese labor market, in terms of job flows, employment and wage developments, in the context of the current recession. We single out the huge contribution of job destruction, especially due to the closing of existing firms, to the dramatic decline of total employment and increase of the unemployment rate. We also document the very large increase in the incidence of minimum wage earners and nominal wage freezes. We explore three different channels that may have amplified the employment response to the great recession: the credit channel, the wage rigidity channel, and the labor market segmentation channel. We uncover what we believe is convincing evidence that the severity of credit constraints played a significant role in the current job destruction process. Wage rigidity is seen to be associated with lower net job creation and higher failure rates of firms. Finally, labor market segmentation seems to have favored a stronger job destruction that was facilitated by an increasing number of temporary workers.

1. Introduction

In Economics, resilience is typically defined as the rate at which an economic system responds to an exogenous shock. It is greater when the response preserves or minimizes changes to the pre-existing status quo. Hence, resilience may be quantified as the cumulative loss in some variable of interest and/or documented with the depth of structural reforms triggered by the shock.[2] Given its implications for aggregate welfare, labor market resilience – defined as 'the extent to which labor markets weather economic downturns with limited social costs' (OECD, 2012: 57) – is of special interest.

The depth of the 2008–2009 economic crisis put the resilience of labor markets across the globe to the test and provided us with the ideal setting for studying how labor markets respond to shocks. In its 2012 Employment Outlook Report, the OECD concluded that labor market institutions crucially shaped the response to the global crisis with coordinated bargaining increasing resilience and the spread of temporary employment reducing it (OECD, 2012: 55). As the global crisis kicked in, substantial differences across countries both in terms of labor market institutions and economic fundamentals were already apparent. It is clear that some economies were better-equipped to deal with the consequences of the recession than others.

In this paper, we focus on the case of Portugal which is of interest for two major reasons. First, despite all the regulatory changes implemented since 2002, the Portuguese labor market is, according to the OECD index of employment protection

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[2] One of the definitions of resilience used in Ecology focuses on the magnitude of a disturbance that can be absorbed before the system changes its structure, the greater that magnitude is the more resilient the system is.

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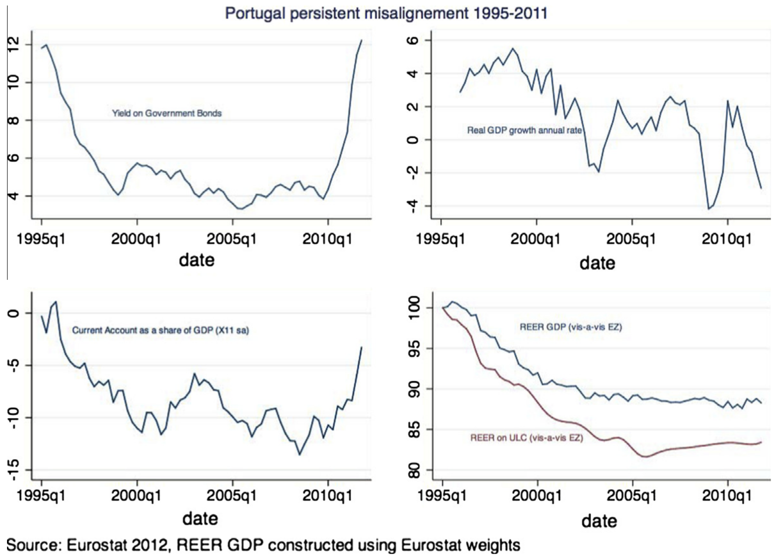

Fig. 1. Portuguese macroeconomic imbalances. *Source*: Franco (2013).

legislation strictness, an extreme case of labor market regulation. Second, even before the recession set in, the Portuguese economy was already facing severe macroeconomic imbalances that amplified the domestic impact of the international recession. Portugal clearly stands out as one of the OECD countries most ill-equipped to weather the effects of the current recession.

Our aim is to analyze how the Portuguese labor market responded to the recession, focusing on the employment and wage response to the great recession and considering three different channels that may have amplified the employment response: the credit channel, the wage rigidity channel, and the labor market segmentation channel.[3] In the empirical part of the article we use microdata from the Personnel Records database (*Quadros de Pessoal*), henceforth *QP*, that are available for the years 1985 to 2010. These data are linked employer-employee data. They do not have information on financial variables. For that reason, to analyze the importance of the credit channel we use data from the Simplified Business Information database (*Informação Empresarial Simplificada*), henceforce *IES*, available for the years 2005–2011.[4]

The article is organized as follows. Section 2 gives an overview of the evolution of the Portuguese economy and the Portuguese labor market over the last 20 years. In Section 3 the role that each transmission channel played during the current recession is analyzed. Section 4 concludes.

2. Background information on the Portuguese case

2.1. The macroeconomy

When the 2008–2009 recession hit Portugal, the Portuguese economy was already facing severe macroeconomic imbalances. Blanchard (2007) offers a very precise diagnosis of the country's economic problems at the onset of the recession: *'Portugal is in serious trouble. Productivity growth is anemic. Growth is very low. The budget deficit is large. The current account deficit is very large. In the absence of policy changes, the most likely scenario is one of competitive disinflation, a period of sustained high unemployment until competitiveness has been reestablished'.*

The diagnosis proved accurate (Fig. 1): the large decrease in nominal interest rate (1995–2001) opened the way to an increase in debt-funded private expenditure that originated an increase in labor demand and a 6% annual average increase of nominal wages and an inflation rate of 4%. Competitiveness *vis-à-vis* the eurozone countries rapidly and significantly deteriorated (see Franco, 2013).

In such a context the government's immediate response to the international financial crisis was driven by two objectives: to maintain the stability of the Portuguese financial sector, and to smooth the domestic effects of the crisis. The combined effects of the increased public spending and reduced public revenue (due to the activation of automatic stabilizers) made

[3] Other mechanisms are, surely, at work. The role of fiscal multipliers (Blanchard and Leigh, 2013), the consequences of the combination of generous unemployment benefits with strict employment protection (the unemployment time-bomb suggested in Ljungqvist and Sargent (1998), or the persistence of unemployment generated by hysteresis (Blanchard and Summers, 1986) certainly deserve a deep analysis. With the current available microdata, however, this is beyond the scope of this study.

[4] For a description of the data, see Appendix A.1. Whenever appropriate we also use data from a random sample extracted from Social Security records.