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OKUN'S LAW IN MALTA: LESSONS LEARNT FROM A SECTORAL PERSPECTIVE

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Research Question

Okun's law is a statistical relationship suggesting that growth slowdowns – as measured by the Gross Domestic Product (GDP) - typically coincide with rising unemployment and vice versa. On the basis of this definition, this paper aims: (i) to verify the existence of this negative relationship between Malta's output and its unemployment rate in light of the surge of interest in the law since the start of the global financial crisis; and (ii) to gauge the sensitivity of the unemployment rate to developments in the output of the different sectors of the economy, specifically manufacturing and services.

Contribution to Existing Literature

This paper contributes to the existing literature by providing additional insight on the functioning of the Maltese labour market and by showing that over the past decade - and contrary to general perception - the unemployment rate has been more sensitive to developments in the services sector than to those in the manufacturing sector.

Main Results

Using data for the period between 1993 and 2012, this study shows that there exists a negative relationship between Malta's output and its unemployment rate. Specifically, our estimates suggest that a decrease of 1% in the country's total output is associated with an increase of 0.1 percentage points in the unemployment rate. This is equivalent to saying that a 1% decline in GDP is associated with an increase in the number of unemployed persons of around 180.¹

This estimate reveals that Malta's unemployment rate is less sensitive to aggregate demand conditions than that of other European countries. Indeed, in the average EU country, a 1% decline in aggregate output is associated with an increase in the unemployment rate of 0.3 percentage points - almost three times as sensitive as that of Malta. This is

¹This estimate is based on 2012 labour market data and according to our estimates could vary between 160 and 200 persons.

probably the result of a number of factors relating to labour market and wage flexibility. However, the more important reason leading to a low Okun coefficient is the hoarding of labour during recessionary periods which is locally known to be motivated by a number of factors, including the avoidance of additional costs that would have to be incurred if employers had to hire new workers when demand returns to normal conditions; the tradition of lifetime employment which makes employer-employee relationships so strong that employers are reluctant to fire workers; and financial support by the Maltese Government to retain workers during recessionary periods.

This labour hoarding phenomenon - which is predominantly known to be practiced in the manufacturing sector - is one of two main reasons underlying the most important result of this study: *the impact of the manufacturing sector's performance on the unemployment rate is significantly smaller than that of the services sector*. This runs contrary to the general perception that the unemployment rate is more sensitive to developments in the manufacturing sector which probably stems from a number of factors, including the more frequent firing observed in the manufacturing sector, the sector's challenging performance over the past two decades as well as Government policies intended to assist companies within the sector in times of economic distress. In part, the larger impact that developments in the services sector seem to have had on the unemployment rate is the result of the sector's larger share in the country's total output (which in 2012 amounted to around 80%). However, our estimates show that the unemployment rate has been more sensitive to developments in the services sector even after accounting for the size of the two sectors.

The very fact that labour hoarding has helped contain the impact of negative developments in the manufacturing sector on the unemployment rate suggests that Government's policies to safeguard jobs were somewhat successful. When one also considers the limited effectiveness that widespread expansionary fiscal policy would have on aggregate demand, it is easy to see why Government should continue offering such sector-specific firm-targeted financial support in times of economic distress, particularly because the manufacturing sector typically employs persons whose skills are not easily transferable to other sectors of the Maltese economy and would therefore risk becoming long-term unemployed.

The other reason underlying our main result relates to the services sector's crucial role in absorbing new entrants into the labour market. Although we do not observe many layoffs within this sector, it still contributes to increases in the unemployment rate during recessionary periods. Indeed, when the growth rate of the services sector slows down (as is typical during recessionary periods), a number of new entrants - who would have alternatively found employment in the services sector - might end up registering for employment. Thus, in addition to assisting companies within the manufacturing sector, Government may also combat rising unemployment by helping new entrants in the labour market to find employment *sooner*. For example, temporary support may be offered in the form of partial or full payment of salaries related to apprenticeship opportunities in the private sector.