

# Keynesian vs Classical Theory of Unemployment

An approach to the Spanish labor market.

## Introduction

In the last decade the unemployment skyrocketed defining a dramatic landscape for the Spanish economy. In order to understand the root causes, I have revisited two theories widely extended in labor economics: The **Classical Theory of Unemployment and the Keynesian Theory of Unemployment**. Despite both conceptions are well known is still unclear what theory better adjust to reality.

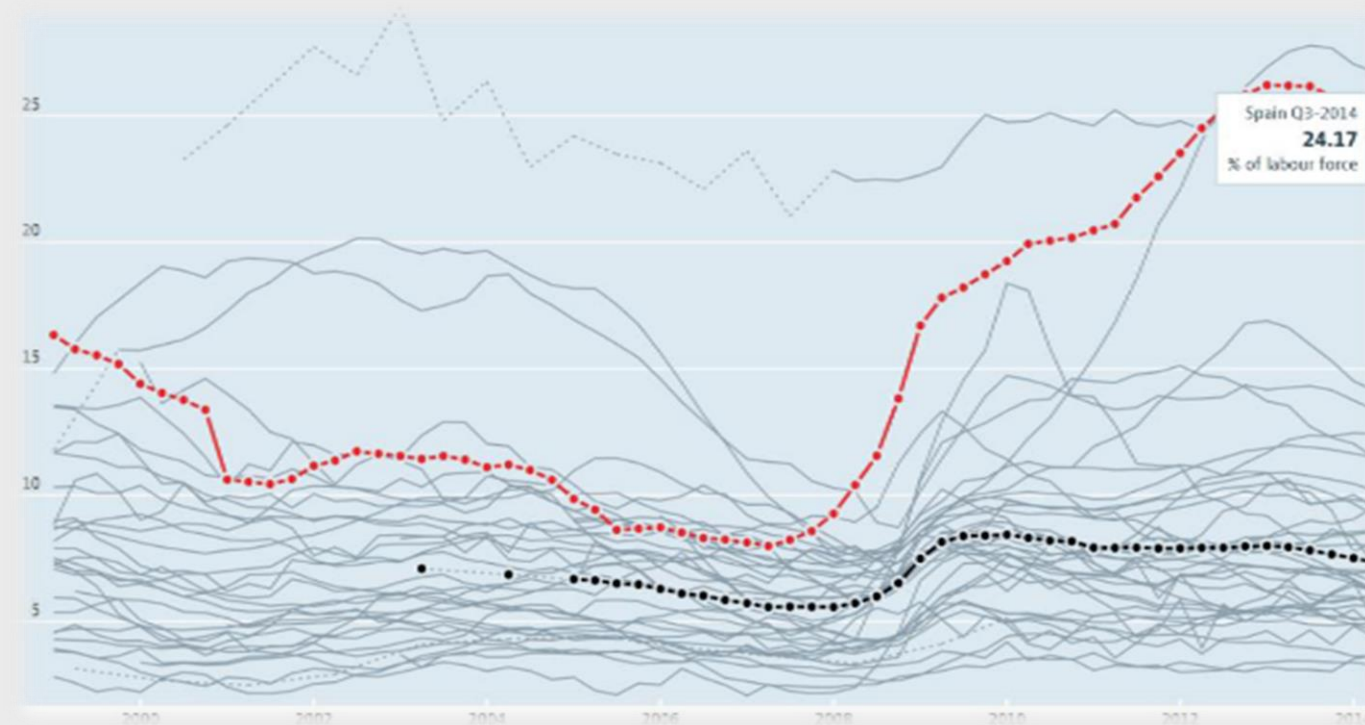
## Objectives & Methodology

My goal is to obtain evidences to identify the **best choice** for Spain. Only if we detect the root causes of the problem we will be ready to carry out the right economic policies.

In order to achieve this goal, I firstly introduced the **theories**, the **ingredients**, the graphical representation and the main differences between them. I followed with an extension of **advanced models** to shed some light on the next steps. Later on I focused on a brief study of the Spanish labor market and compared both models to explain graphically the potential cures. At last, is in the **final analysis** where the main results emerge after having tested all the different scenarios.

## Spanish Labor market

- The Spanish labor market has a chronic disease with **unemployment** since the democratic era.
- Real wage has increased incredibly before 2008. After it, started to stabilize.
- Negative features:  
Duality, Productivity, Temporality, Education, Bureaucracy

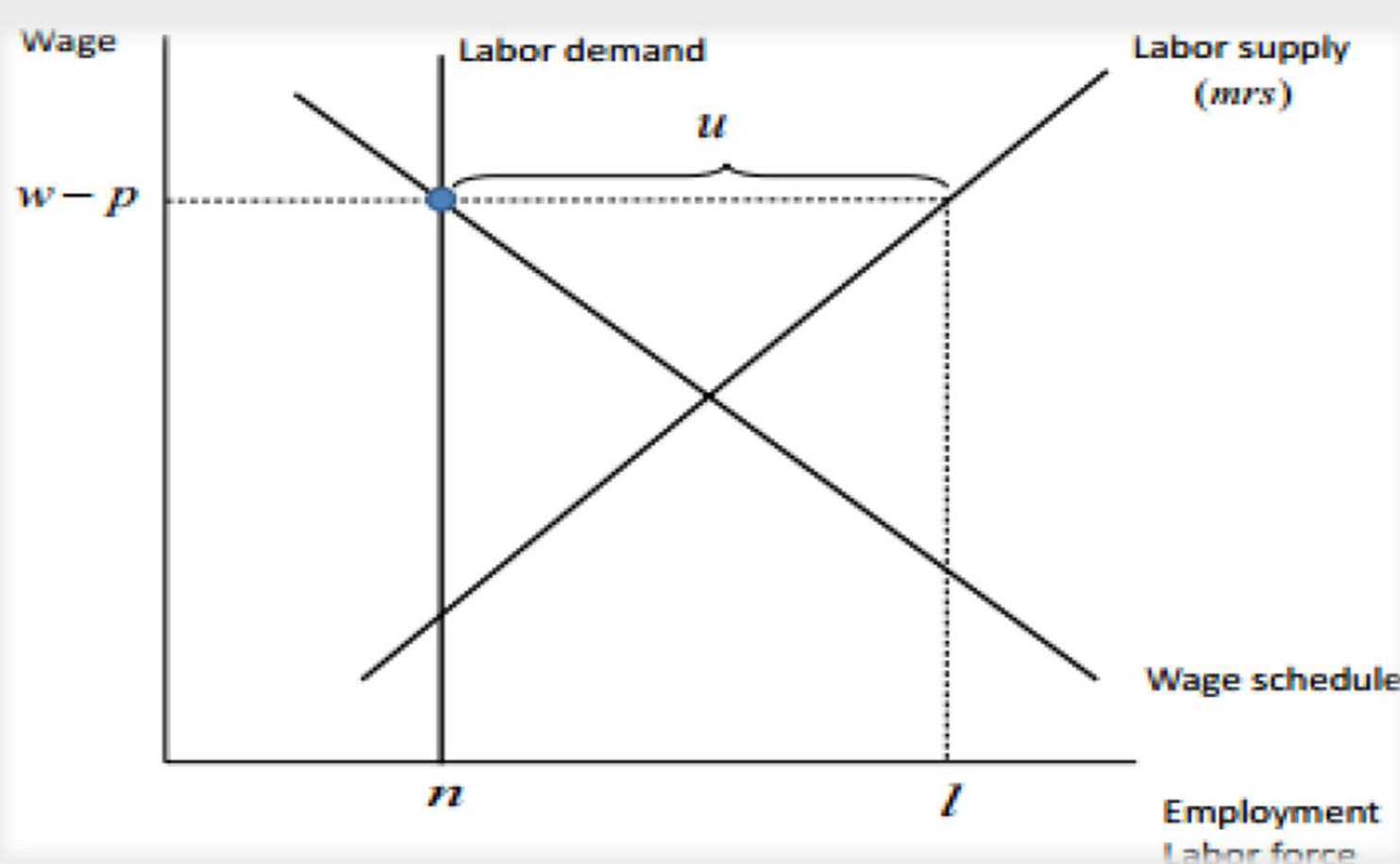


- Spain has responded differently to the financial crisis in contrast with the OCDE and northern countries in euro zone.
- Correlation between real wages and unemployment shows a positive trend.
- **Inflation** has increased in the last decades constantly.

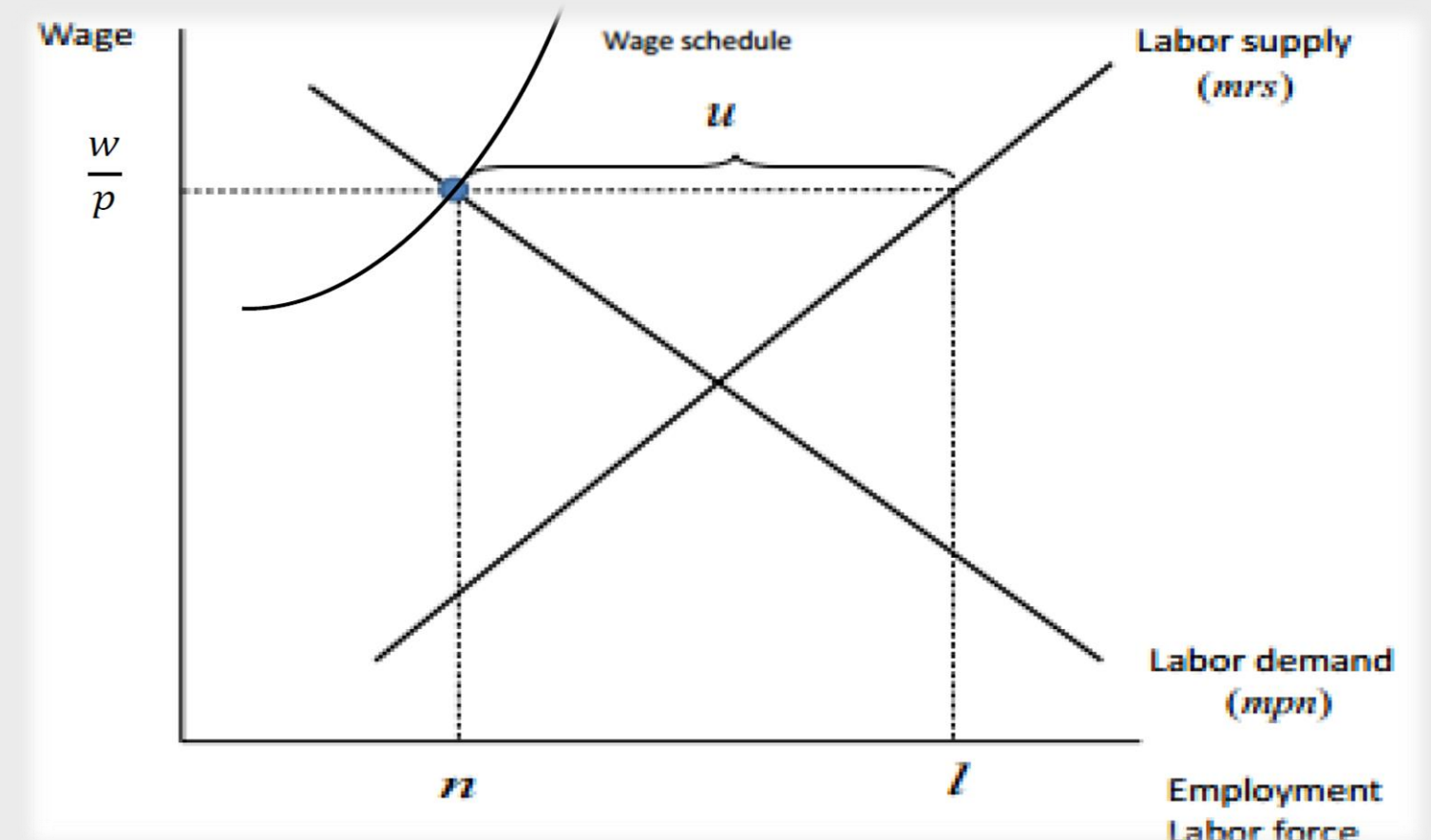
## Keynesian Theory of Unemployment

Keynesians and New-Keynesianism declare employment and **aggregate demand** is what determines the real wage. Consequently, real wage cannot be considered as a mechanism to adjust employment anymore but **labor demand** does.

Elements	
Labor Demand	Vertical
Labor Supply	Positive
Wage equation	Negative
Prices	Constant
Key Measures	Lower Interest Rate, increase aggregate demand



## Classical Theory of Unemployment



Elements	
Labor Demand	Negative
Labor Supply	Positive
Wage equation	Positive
Prices	Variable
Key Measures	Real wage moderation, lower subsidies and pay-roll taxes.

Classical theory of unemployment affirms unemployment depends on the level of **real wages**. It occurs when real wages are fixed over the equilibrium level because of **rigidities** provoked by minimum-wage policies, union bargaining or effective salaries.

## Analysis

- Econometrical Analysis

I have built an **econometric model** composed by an employment equation and a wage equation compiling data through temporal series from the last fifty-five years of the Spanish economy using the software Gretl.

Employment equation	coefficients
Const	2.95
Log_Employment t-1	0.66
Log_Var-employment t-1	0.056
Log_Capital	0.21
Log_l/t interest rate	<b>-0.012</b>
Log_s/t interest rate	<b>0.0055</b>
Log_Real Wage	<b>-0.29</b>
Log_GDP	0.015

Wage equation	coefficients
Const	-0.61
Log_Real wage t-1	0.70
Log_Productivity	<b>0.39</b>
Log_Subsidy	0.0034
Log_Employment	0.016
Log_Var-employment	-0.054

- Additional Evidences

Wage-employment correlation, price stickiness, subsidies and pay-roll taxes effect.

## Conclusions

I found elements in favor and against each theory. For instance, New-Keynesians advocate for the stickiness of prices in the short run and effectively, there are many evidences supporting this fact. However, other authors point that pay-roll taxes and subsidies have implications on employment, which contradicts this time the Keynesian view in favor of the other theory.

However, the output of the econometric test removes all doubt. Real wage has a negative correlation respect to employment while interest rate has a minimum effect on it.

It puts me in a position to affirm the best option to explain the behavior of the Spanish labor market is the **Classical Theory of Unemployment**.

For future, a deep inquiry on **real state bubble** could be a good path of research to continue the work done so far in this thesis.