Box 7

LABOUR MARKET ADJUSTMENT IN THE EURO AREA

This box looks at how the euro area labour market has adjusted since the onset of the financial crisis by examining the evolution of employment, unemployment and wages.[1] Normally, there is a relatively strong relationship between output growth and the labour market. However, the 2008-09 recession led to some divergence in this relationship in the euro area. At the beginning

1 For a more detailed analysis of the evolution of euro area labour markets up to the first quarter of 2010, see the article entitled "Labour market adjustments to the recession in the euro area", *Monthly Bulletin*, ECB, July 2010.

of the recession employment in most euro area countries proved rather resilient, notably as a result of the strong fall in hours worked and the implied labour hoarding. Nonetheless, the severity and persistence of the recession ultimately led to a fall in employment and a sharp rise in unemployment. During the subsequent recovery period there has been a moderate pick-up in employment growth, owing partly to labour hoarding, while unemployment has remained at high levels. Wages have adjusted somewhat, although this appears to be due to the stronger downward adjustment in the variable component of wages (i.e. bonuses, overtime payments, etc.) rather than to negotiated wages. Overall, the most recent labour market developments in the euro area seem to be back in line with the historical pattern. There is, however, a high degree of diversity in labour market adjustment across the euro area countries, largely reflecting differences in the degree of labour market flexibility and progress being made on structural reforms. Wage moderation and measures to enhance labour market flexibility are essential to support employment, particularly in those euro area countries experiencing high levels of unemployment.

Labour market typically adjusts to changes in GDP growth

If aggregate demand in the economy falls, companies usually adjust their production first, followed by the number of hours worked and, finally, the size of their workforce. There may be several reasons why companies do not immediately adjust the number of hours worked to the lower level of production. Initially they may perceive the fall in demand as temporary and, furthermore, it takes time to plan how to utilise the existing workforce in the new situation. Once it becomes evident that the downturn has set in, companies adjust the number of hours worked. This is usually done without adjusting the number of employees, so that only average working hours are reduced. Only as a last resort do companies cut the number of employees in response to the lower level of demand. In general, employment in the euro area normally adjusts to changes in production after one to two quarters, although labour hoarding can mean that it takes longer, depending on how employers perceive the nature and duration of the downturn, as well as the need to retain skilled labour.

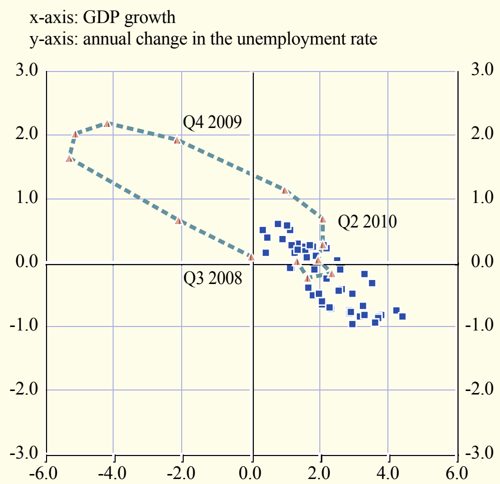
Labour market adjustment since the 2008-09 recession

At the beginning of the 2008-09 recession employment in most euro area countries proved rather resilient, notably as a result of the strong adjustment in hours worked.[2] However, the severity and persistence of the recession ultimately led to a fall in employment and a considerable rise in unemployment.[3] Charts A and B show the labour market adjustment in terms of unemployment and employment since 1996. From the very start of the recession, the relationship between labour market developments and economic activity appeared to diverge from its normal pattern.[4] In particular, GDP growth fell sharply, but unemployment (employment) did not increase (decrease) as much as would have been expected on the basis of historical regularities, suggesting that some labour hoarding occurred. Recently, however, the relationship seems to be back in line with normal historical experience.

2 Policy measures encouraging flexible working time arrangements, namely short-time working schemes, were used as a way of containing the impact of the recession on employment.
3 There was nevertheless considerable heterogeneity across the euro area countries. For example, in Germany, unemployment actually declined during the crisis, partly as a result of past labour market reforms, e.g. the Hartz reforms.
4 This was also discussed in the box entitled "Back to Okun's Law? Recent developments in euro area output and unemployment", *Monthly Bulletin*, ECB, June 2011.

Chart A GDP growth and unemployment

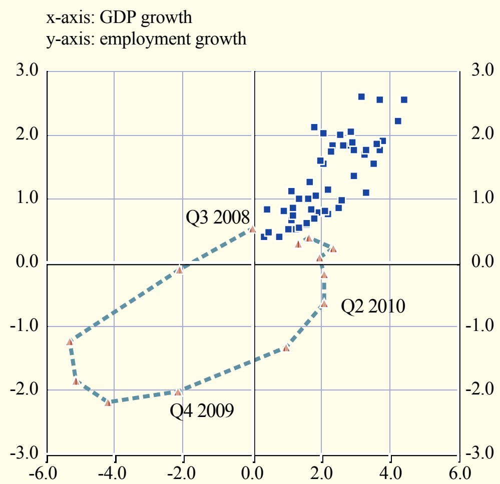
(year-on-year growth; percentage points)



Sources: Eurostat and ECB calculations.
Note: Data refer to the period from the first quarter of 1996 to the third quarter of 2011.

Chart B GDP growth and employment

(year-on-year growth)



Sources: Eurostat and ECB calculations.
Note: Data refer to the period from the first quarter of 1996 to the third quarter of 2011.

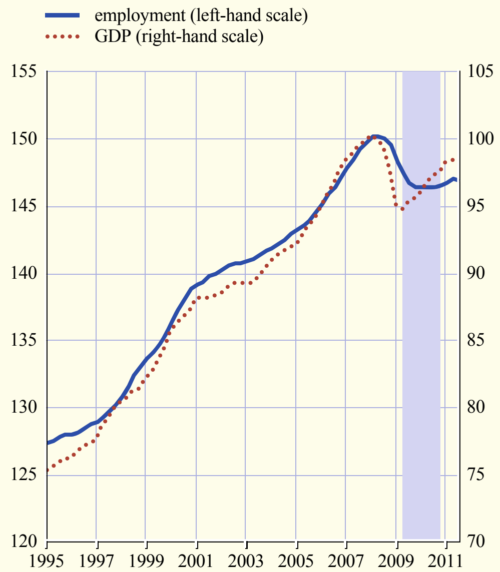
Periods of labour hoarding, such as that seen in the recent recession, may be followed by a period of economic growth without an increase in employment. This phenomenon is often referred to as "jobless growth" or a "jobless recovery". A company's decision to wait to recruit new staff may be explained by the fact that it has underutilised resources that it can use when demand increases again. A certain degree of labour hoarding and jobless growth is thus normal over a business cycle. This may partly explain recent developments in the euro area, which has experienced a somewhat muted recovery in employment, despite the reversal of the negative trend in GDP (see Chart C).

Wage developments in the euro area

In response to the 2008-09 recession, euro area wage growth slowed. Owing to the severity of the recession and associated rise in unemployment, there was a marked downward impact on compensation per employee in 2009, which declined from a sample high to

Chart C Employment and GDP

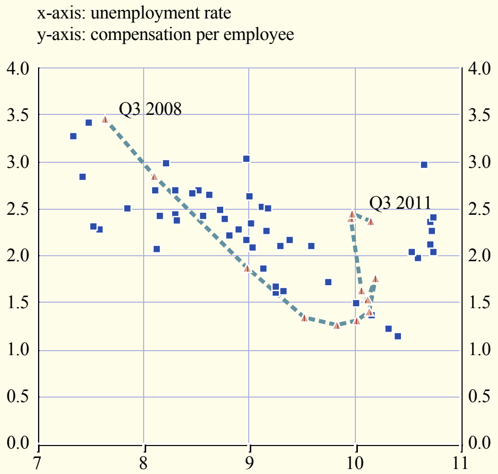
(millions of persons; index Q2 2008 = 100)



Sources: Eurostat and ECB calculations.
Notes: Latest observations refer to the third quarter of 2011. The shaded area indicates the period in which GDP growth increased and employment fell (i.e. "jobless growth").

Chart D Compensation per employee and unemployment

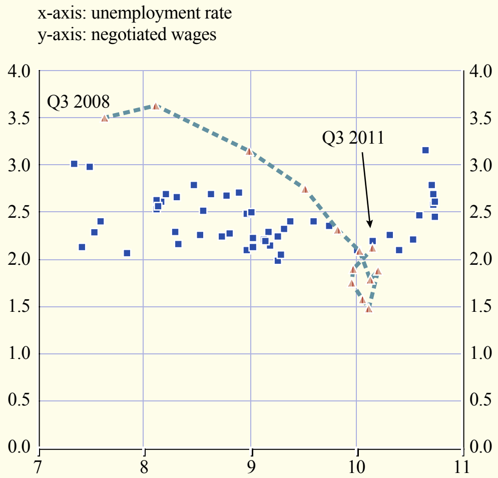
(percentages; year-on-year growth)



Sources: Eurostat and ECB calculations.
Note: Data refer to the period from the first quarter of 1996 to the third quarter of 2011.

Chart E Negotiated wages and unemployment

(percentages; year-on-year growth)



Sources: Eurostat and ECB calculations.
Note: Data refer to the period from the first quarter of 1996 to the third quarter of 2011.

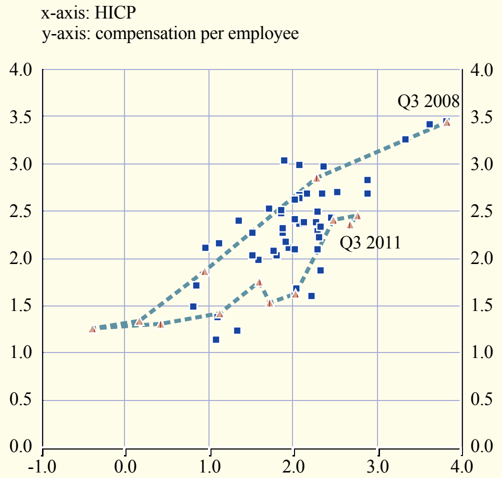
close to the sample low in less than a year (see Chart D). Growth in negotiated wages also decreased after the recession. However, it appears that the drop in negotiated wage growth did not reflect the labour market weakness until the end of 2009. Hence, the variable component of wages (i.e. bonuses, overtime payments, etc.) seems to have adjusted to labour market slack more quickly than the negotiated part. In general, the relationship between unemployment and negotiated wages seems to be weaker than that between compensation per employee and unemployment, as indicated by the Phillips curve-type relationship shown in Charts D and E.

The most recent data for 2011 show that compensation per employee deviated somewhat from its normal pattern (see Chart D). Although the labour market was still weak, with a high level of unemployment, compensation per employee increased. During 2011 the rate of wage growth accelerated, to levels slightly higher than the historical average. By contrast, negotiated wages remained below their historical average.

Although wage dynamics are strongly influenced by the adjustment in hours worked per employee, the sharp movements in compensation per employee in 2011, despite the weakening labour market, may also have stemmed from price developments in the euro area. There has been upward pressure on inflation owing to high food and energy prices, as well as to tax increases in some countries. In a number of euro area countries, wages are indexed to past inflation developments, which may inhibit wage adjustment when the labour market weakens. Chart F shows that compensation per employee and the HICP move in line with one another in the euro area, and that recent wage growth has been broadly in line with the historical relationship. The relationship is positive, which means that higher wages are associated with higher prices, and vice versa.

Chart F Compensation per employee and the HICP

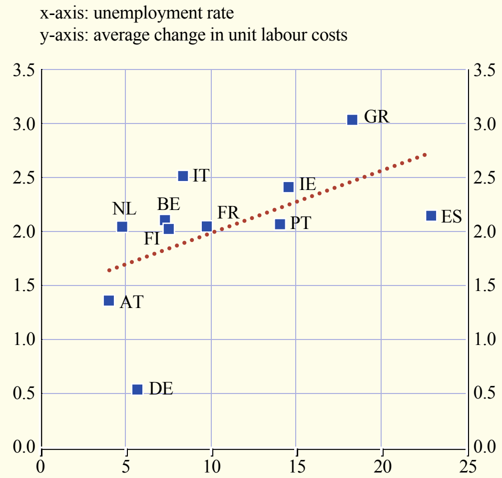
(year-on-year growth)



Sources: Eurostat and ECB calculations.
Note: Data refer to the period from the first quarter of 1996 to the third quarter of 2011.

Chart G Unit labour costs and the unemployment rate across selected euro area countries

(percentages; year-on-year growth)



Sources: Eurostat and ECB calculations.
Notes: The average change in unit labour costs refers to the period from the first quarter of 2001 to the third quarter of 2011 for all countries. Data on the unemployment rate refer to the fourth quarter of 2011 (for Greece and Italy, they refer to the third quarter of 2011).

Overall, this box shows that the 2008-09 recession led to some divergence in the historically strong relationship between labour market developments and economic activity in the euro area. Nevertheless, the latest available data show that the relationship is once again in line with its normal pattern, suggesting a weakening of labour market conditions on the back of falling growth in the euro area. This box only analyses labour market adjustment in the euro area as a whole, however, labour market adjustment has varied considerably across countries, reflecting differences in labour market flexibility and institutional arrangements, as well as the amount of progress being made on structural reforms. In general, euro area countries in which labour costs have been increasing relatively rapidly over the longer term have experienced a higher unemployment rate (see Chart G). Wage moderation and labour market flexibility are therefore key to reducing unemployment in these countries, and particularly at the current juncture, as short-term indicators are pointing to a further weakening of labour market conditions. Therefore, it is crucial that wage growth is contained in order to support employment.