

Box 6

The need for further structural reforms in euro area labour markets

Structural reforms aimed at an efficient allocation of productive factors in euro area labour, product and capital markets are likely to have positive effects in terms of a higher economic growth potential and lower adjustment costs associated with economic shocks. Over the past few years, progress has been made regarding the integration of euro area product markets and the opening up of previously sheltered economic sectors. Euro area countries have also made some progress in improving the way the labour market functions, but many of the reforms in this area have been modest or have been introduced only recently.

One indication of still insufficiently functioning labour markets is the fact that in 2001 the euro area experienced an unemployment rate of more than 8% while, at the same time, firms in euro area countries reported difficulties in recruiting workers. This co-existence of unsatisfied labour supply and unsatisfied labour demand suggests that the euro area labour market's ability to match supply and demand – and thus to create employment by bringing the non-employed to work and by filling vacancies – is insufficient.

Importance of efficient labour market matching processes for monetary policy

Efficient labour market matching processes are very important for monetary policy:

- The functioning of the labour market affects the economic environment in which monetary policy is conducted. An inefficient allocation of labour has a negative effect on the level of potential output and, in

the short-run, limits the pace at which an economy can grow without creating inflationary pressures. If labour markets were to become more flexible and the job matching process more efficient, this should bring about a temporary increase in the potential growth rate of the euro area economy until the employment rate is higher.

- Bottlenecks in the labour market, resulting from matching inefficiencies, might also lead to general wage increases in excess of labour productivity growth, thus triggering inflationary pressures. In general, it is possible that more efficient matching processes may also reduce the risk of cyclical upswings, reallocations in production structures and the expected demographic changes in the euro area resulting in labour shortages and upward pressure on wages and inflation.
- A higher efficiency of matching processes of euro area labour markets accompanied by a higher degree of wage flexibility should speed up the adjustment of wages and prices to monetary policy actions and reduce the short-run effects of monetary policy on the real economy. This improved efficiency would facilitate the conduct of the stability-oriented monetary policy of the ECB.
- Efficiently functioning labour markets are particularly important for countries participating in EMU, because euro area countries are unable to use country-specific monetary and exchange rate policies to address asymmetric economic shocks.

Labour market reform measures conducted in euro area countries during the 1990s have contributed to strong employment growth and the considerable decline in unemployment in many euro area countries during the cyclical upswing between 1997 and 2000. This occurred despite an increasingly competitive global environment and skill-biased technological change, both of which tend to amplify the negative consequences of any remaining labour market deficiencies. It is difficult, however, to assess the extent to which these reforms have improved the labour market situation through providing better conditions for job creation and additional labour supply or through enhancing the ability of the labour market to match non-employed and vacancies.

Further structural reforms are crucial

Evidence gathered in a recent analysis indicates that significant mismatches are still present in a number of areas, leaving ample scope for the continuation of the labour market reform process.¹ In general, the persistently high rate of unemployment, the low level of labour force participation and the uneven labour market performance across euro area countries indicate that more progress in labour market reform is necessary.

Successful steps to make the matching process more efficient and labour markets more flexible include the following: improved job mediation, more flexible wages and increased wage differentiation, improved education, training and life-long learning, reforms of tax and benefit systems, less restrictive employment protection regulation, working time flexibility, and measures to increase labour mobility.

To seize the full benefits of labour market reforms, they need to go hand in hand with further progress in structural reforms on product and capital markets. A better functioning of the labour market will create most employment possibilities if product and capital markets also function more efficiently.

¹ A more detailed analysis of matching processes can be found in the ECB publication entitled "Labour market mismatches in euro area countries", March 2002.