

Box 6

**LABOUR MARKET ADJUSTMENTS DURING THE CURRENT CONTRACTION OF ECONOMIC ACTIVITY**

The contraction of economic activity in the euro area is increasingly affecting labour market conditions. Euro area unemployment increased from 7.3% in the first three months of 2008 to 9.2% in April this year, and employment remained virtually unchanged in the last quarter of 2008, given a year-on-year growth rate of 0.1% (Chart A). Looking at employment growth in the euro area broken down by sector (Chart B), the largest declines occurred in the manufacturing and construction sectors (6.4% and 1.3% respectively), while market services, including financial

**Chart A Employment growth and unemployment**

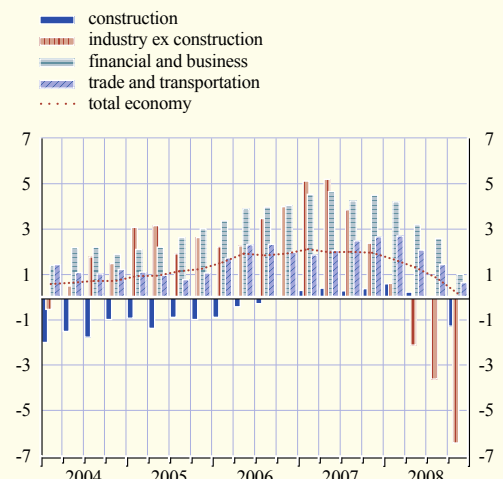
(annual percentage changes; percentage of the labour force)



Source: Eurostat.

**Chart B Employment growth by sector**

(annual percentage changes)



Sources: Eurostat and ECB.

and business as well as trade and transportation services, still exhibited slightly positive growth (0.8%) in year-on-year terms. Cross-country differences in the pattern of sectoral production have had an impact on the respective country's labour market vulnerability during this contraction and the extent to which the national unemployment rates are affected. In addition, cross-country differences in labour market institutions affect the repartitioning of adjustment between employment and wages, between specific groups of the workforce and between employees working under different types of contracts.<sup>1</sup>

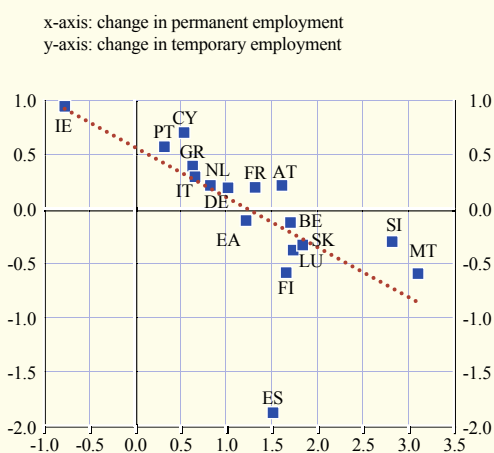
There was a negative relationship between the change in temporary employment and permanent employment as a percentage of the active population between 2007 and 2008 (Chart C). It is inherent to the nature of temporary employment to be more exposed to economic fluctuations. In recent years, temporary employment has boomed, as the changes in legislation on employment protection over the past decade have mainly affected this segment of the labour market. Employment protection for permanent workers, by contrast, has remained largely unchanged.

In several countries, the impact on employment has been contained by short-time working schemes and other measures to mitigate the effects of the economic contraction and avoid the shedding of labour. Moreover, the schemes have often been accompanied by government subsidies aimed at maintaining the purchasing power of affected workers in the short run. In the past, the construction sector, in particular, benefited from schemes to reduce excessive turnover due to seasonal cyclicality, while the current crisis has seen a sharp increase in these measures especially in the manufacturing sector. Indeed, different measures of hours worked at the country level indicate that the growth of hours worked was lower than that of employment. However, there is no series of official quarterly data on hours worked at the euro area level currently available.

1 See the cross-country comparison of institutions in P. du Caju, E. Gautier, D. Momferatou and M. Ward-Warmedinger, "Institutional features of wage bargaining in 23 European countries, the US and Japan", ECB Working Paper No 974, 2008.

**Chart C Changes in temporary and permanent employment in euro area countries**

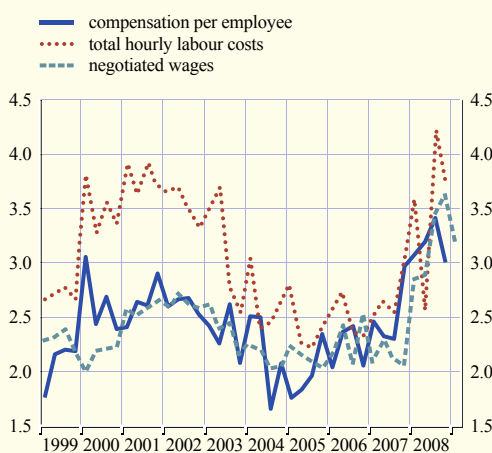
(difference between 2007 and 2008 as share of active population; percentage points)



Source: Labour Force Survey.

**Chart D Euro area labour cost indicators**

(annual percentage changes)



Sources: Eurostat and ECB.

At the same time, measures of annual wage growth remained relatively high until the end of 2008, following their strong increase at the beginning of 2008 (Chart D). The small adjustment in wages seen so far is partly related to the fact that most contracts are multi-year contracts and were concluded before the contraction started. A decomposition of changes in total compensation of employees into wages and employment highlights that, in the fourth quarter of 2008, the year-on-year growth of compensation per employee remained unchanged in comparison with that recorded in the fourth quarter of 2007, while employment growth fell by 2 percentage points over this period.

In the light of relatively rigid negotiated wages, firms seem to have been using alternative measures to adjust labour costs,<sup>2</sup> especially since the end of 2008. These measures include cuts in bonuses and other benefits affecting variable pay. In addition, freezes and cuts in basic wages or a postponement of previously agreed wage increases have taken place to safeguard employment, often in agreement between social partners. Finally, some wage increases were made in the form of one-off payments, or were limited in their overall amounts.

Short-time work and partial unemployment are efficient tools to protect some of the human capital in a company if the downswing is of a short-term nature. If used extensively over a prolonged period of time, however, the financial support of such government measures reduces the incentives for firms and workers to reallocate. In addition, over time, these measures generate a major fiscal burden without creating incentives for investment to foster recovery. The reallocation of workers across firms and sectors is important in order to make it easier to exploit profitable investment opportunities that emerge with the onset of a recovery. It is thus an important contributor to easing and supporting a recovery. At the same time, the reintegration of unemployed into the labour process in the future would be facilitated by labour market institutions that provide for mobility and foster investment in training and education.

<sup>2</sup> See the article entitled “New survey evidence on wage setting in Europe” in the February 2009 issue of the Monthly Bulletin.