Box 8

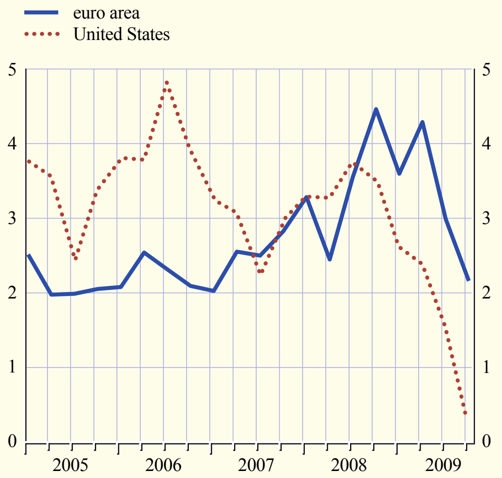
WAGE DEVELOPMENTS IN THE EURO AREA AND THE UNITED STATES DURING THE RECENT ECONOMIC DOWNTURN: A COMPARATIVE ANALYSIS

The recent economic downturn has translated into a sharp deterioration in labour markets in both the euro area and the United States. In the presence of negative or subdued growth in demand and overall activity, employers in both regions attempted to adjust overall wage costs, in terms of both quantities of labour used and wage rates. This box discusses the comparative developments in the latter, with a focus on the private sector.

At the outset, it should be noted that institutional differences as well as differences in the coverage and definitions of economic activities, employment and labour costs impair the comparability of data in the two economies. This box focuses on developments in hourly labour costs, which seem to be the closest available statistics. Euro area hourly labour costs are measured by the labour cost index, whereas for the United States the comparable indicator of employer costs for employee compensation is used. Overall, hourly wages adjusted earlier and more sharply in the United States than in the euro area. This may be partly explained by the earlier economic slowdown in the United States, which started in the final quarter of 2007, while euro area GDP growth remained relatively resilient until the second quarter of 2008. However, different labour market policies and a greater degree of wage flexibility also played a role.

Chart A Hourly labour cost growth in the euro area and the United States

(annual percentage changes)



Sources: Eurostat and Bureau of Labor Statistics.
Note: The data refer to the non-agricultural private sector.

Hourly labour costs

Both in the euro area and in the United States, the deterioration in labour market conditions has encouraged wage restraint over recent quarters, as illustrated by the developments in hourly labour costs (see Chart A).[1] In the United States, growth in wage costs

1 Comparing wage developments in the United States and the euro area raises the question of how these developments compare with the Japanese labour market. However, such a comparison is not straightforward, as the Japanese labour market is characterised by a number of idiosyncratic features. This notwithstanding, wage growth in Japan has been weak (or even negative), although recently the pace of decrease has slowed considerably.

decelerated throughout 2009. At 0.3%, annual wage growth in the final quarter of 2009 was substantially lower than the average prior to the downturn (3.4%). In the euro area, growth in hourly labour costs started to decline later than in the United States. It remained robust at around 4% in the second half of 2008 and early 2009. More recently, in the fourth quarter of 2009, annual hourly labour cost growth returned to levels closer to those observed before the downturn, somewhat above 2%.

Structural differences

The more pronounced deceleration in hourly labour cost growth recorded in the United States as compared with the euro area during the downturn reflects, first, the greater degree of wage flexibility. Wages in the euro area adjusted at a slower pace owing to the longer duration of contractual wage agreements of about two years on average.[2] In the United States, the most common wage-setting interval is about one year, which has allowed US employers to react more quickly in reducing labour costs. In addition, employers in the United States appear to have made larger adjustments to wages during the downturn. For instance, 5% of businesses reduced salaries in 2009, according to a recent survey by the Society for Human Resource Management, and a record 48% of US companies imposed freezes[3]. In the euro area, 2% of reporting firms cut base wages and 37% froze them between the onset of the financial crisis and the summer of 2009, according to a recent survey in the context of the Wage Dynamics Network (WDN).[4] In addition, the extensive use of variable pay plans in the United States (representing 11.2% of payroll in 2009) allowed employers to easily rein in wage growth during the recession. In the euro area, bonuses are only relevant in some sectors, such as financial services, while wage increases are still largely determined at the central or sectoral level. Information available from the relevant WDN survey confirms this picture, as only around 12% of firms asked used available flexible wage components to adjust overall costs.

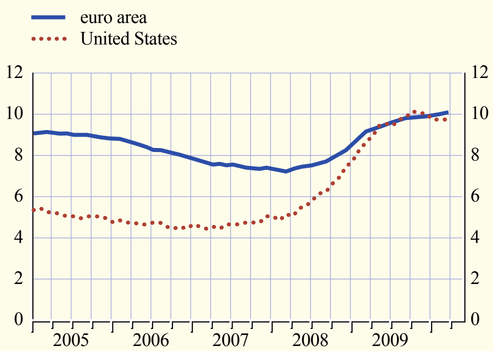
Second, in the United States, the wages or benefits of about half of the labour force are tied to changes in the Consumer Price Index. Consumer prices fell by 0.4%, year on year, in 2009, implying stagnation or even a decrease in the wages indexed to inflation. In the euro area, while formal or informal indexation also typically affects a large proportion of contracts, recent wage agreements suggest that the adjustment is not necessarily symmetric when inflation is low or even negative.[5] While, for example, wage indexation in Belgium indeed resulted in negative wage adjustments for 2010, the downward impact of such clauses is not automatic and needs to be agreed upon by employers and employees. The effect of indexation schemes in other euro area countries is, as of yet, unclear.

Third, unemployment increased earlier and more sharply in the United States than in the euro area, dampening wage growth. The US unemployment rate started to increase in late 2007, rising by more than 5 percentage points to 9.7% in March 2010. By contrast, the unemployment rate in the euro area started to increase only in 2008 and rose by less than 3 percentage points (see Chart B). In March 2010 it stood at 10%, the highest rate for more than a decade. The larger change in the

2 See 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.
3 According to Hewitt Associates, a US human resources firm.
4 See "Wage dynamics in Europe: final report of the Wage Dynamics Network", ECB, December 2009.
5 Around 35% of euro area firms surveyed in the context of the WDN reported some kind of inflation adjustment, formal or informal. See M. Druant, S. Fabiani, G. Kezdi, A. Lamo, F. Martins and R. Sabbatini, "How are firms' wages and prices linked: survey evidence in Europe", ECB Working Paper No 1084, 2009.

Chart B Unemployment rate in the euro area and the United States

(percentage of labour force)



Sources: Eurostat and Bureau of Labor Statistics.

US unemployment rate during the crisis may be explained by looser employment protection legislation compared with the euro area, as well as by the relatively larger sectoral shocks in the construction, real estate and financial sectors.[6] In addition, the extensive use of short-time working schemes supported employment in the euro area during the downturn.

Finally, the slower adjustment in wages in the euro area also reflected a mechanical boost to hourly wage growth owing to working-time arrangements during the downturn. The extensive use of flexible time accounts, particularly in Germany, allowed employees to work for fewer hours, thereby reducing overtime accumulated in the past without a decrease in their overall regular compensation. In addition, short-time working schemes subsidised by the government gave firms the opportunity to reduce the hours worked by their employees, while national governments complemented employees' overall pay. As companies still had to pay for fixed employment costs and in most cases agreed to provide a further top-up to their employees' pay (in addition to the government's subsidy), this also implied increases in wages on a per hour basis. Both flexible time accounts and the short-time working schemes were mostly used in industry, and, therefore, hourly labour costs in the industrial sector were the most affected.

By contrast, the usage of short-time compensation programmes in the United States is limited and, thus, has only had a marginal impact on hourly wages. In addition, the reduction in working hours under the US programmes entails a proportional reduction in weekly pay. Thus, the decrease in average hours worked per head in the United States did not feed through into higher hourly labour cost growth, as was the case in the euro area.

Conclusion

The recent economic downturn has led to a smaller adjustment in labour input in the euro area than in the United States. In parallel, hourly labour costs have adjusted less and apparently with a delay in the euro area, compared with a relatively strong and rapid adjustment in the United States. The more decentralised wage system in the United States, compared with those existing in a number of euro area countries, has probably facilitated a stronger downward adjustment in wage growth, driven by wage cuts, wage freezes and restraint in variable pay. In addition, the downward impact of indexation at times of low inflation appears to have been stronger in the United States, while a greater response in terms of unemployment increases further limited wage growth. By contrast, in the euro area, hourly labour cost growth first increased in 2009, reflecting both the impact of earlier agreed contractual increases and the more limited use of flexible wage components, as well as a mechanical boost, as hours fell owing to the government-subsidised short-time working schemes without a proportionate fall in overall compensation per head. More recently, hourly wage growth has also moderated in the euro area.

6 "World Economic Outlook", IMF, April 2010.

Looking ahead, hourly labour cost growth is likely to remain weak in the United States and decrease further in the euro area, where further downward adjustment is also expected in terms of employment in the context of a continued lagged response to the recent recession. While labour market rigidities and pro-employment policies in the euro area have warded off a sharper reduction in employment, the necessary adjustment in labour costs may have only been delayed and might thus extend further into the recovery.