ARTICLES

LABOUR MARKET ADJUSTMENTS TO THE RECESSION IN THE EURO AREA

The recent financial crisis and the ensuing recession have taken a heavy toll on euro area labour markets. Employment losses have been considerable and heavily concentrated in a few sectors. Despite a large contraction in employment, euro area wages have been slow to react, reflecting institutional rigidities. Moreover, there has been considerable cross-country heterogeneity in labour market reactions to the downturn in activity. Various policy measures have been enacted, aimed at maintaining employment through the crisis. This article argues that a timely dismantling of many of these measures would help to accelerate the restructuring process. Without sectoral reallocation and greater wage flexibility, the euro area may take many years to generate sufficient employment growth to absorb those workers currently displaced.

1 INTRODUCTION

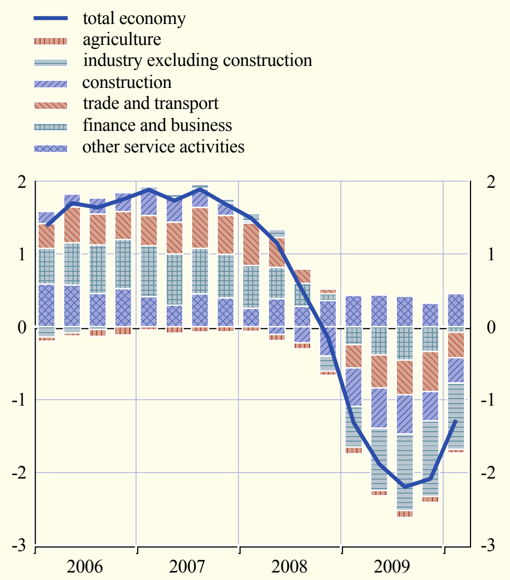
The recent deep recession triggered a swift and strong reaction in euro area employment. Between the second quarter of 2008 (the peak of euro area employment) and the fourth quarter of 2009 (when the decline in employment appears to have bottomed out), euro area employment fell by 2.6%, following a sharp decline in economic activity. By the end of 2009 euro area employment had fallen back to its mid-2006 level, effectively reversing two years' worth of job growth. Employment losses have been particularly heavy in industry and construction (see Chart 1). Moreover, the recent recession has seen considerable cross-country heterogeneity – in terms of employment (see Chart 2), hours and wage reactions, and in the policies adopted by way of crisis measures.[1]

Charts 1 and 2 show the evolution of euro area employment growth since 2006, according to national accounts data. After several years of

1 See also the boxes entitled "The composition of the recent decline in employment in the euro area" in the September 2009 issue of the Monthly Bulletin and "Employment developments in the euro area in 2009" in the Annual Report 2009.

Chart 1 Euro area employment growth and sectoral contributions

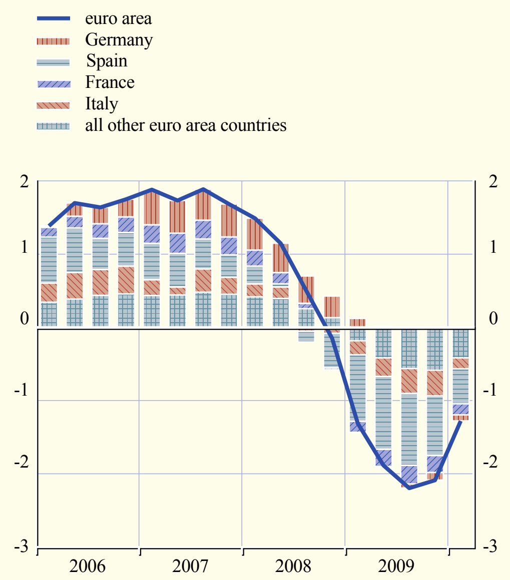
(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.

Chart 2 Euro area employment growth and country contributions

(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.

robust growth in the mid-2000s, in 2008 euro area employment growth slowed markedly – from a brisk 1.5% year on year in the first quarter of 2008 to a 0.2% contraction by the final quarter of that year. In the second half of 2009 euro area employment declined at a rate of around 2.2% year on year, but the rate of decline appears to have moderated in the first quarter of 2010.[2]

A wide variety of factors help to explain the considerable degree of heterogeneity seen in euro area labour markets during the recent recession. Differences in outcomes may partly reflect cross-country differences in sectoral composition and thus a higher exposure of some countries to the large sectoral shocks experienced in the context of the recent financial crisis. Moreover, differences in employment structure – with varying proportions of workers covered by permanent and temporary contracts – are also likely to lead to differing labour market outcomes. At a less aggregate level, firms' financial positions – and their ability to withstand the impact of a marked fall in output – undoubtedly play an important role. Similarly, the degree of labour shortage prior to the recession may have encouraged greater labour "hoarding" among firms fearing (post-recovery) constraints in some local or highly specialised labour markets. Furthermore, part of the large heterogeneity observed is due to the interaction of the various countries' distinctive institutional features and policies – including the willingness of workers' representatives to accept flexible wage-setting and wage moderation – which can help to mitigate the strongest effects of the recession on labour market participants.[3]

This article proceeds as follows: Section 2 examines euro area labour market dynamics since the onset of the crisis, focusing on the sectoral and compositional effects which characterised the recession. Section 3 examines the differing degrees of wage and labour cost responsiveness. Section 4 reviews the policy and institutional features which have contributed to shaping the differing adjustments observed. The article ends with an assessment of the current outlook for euro area labour markets and draws out policy implications (Section 5).

2 FEATURES OF THE RECENT RECESSION

The recent recession has been the strongest downturn experienced in the euro area since the Second World War. Between the first quarter of 2008 and the second quarter of 2009, euro area real GDP fell by 5.3%, following a severe financial crisis and substantial corrections to overheated economies in a number of euro area countries. The systemic nature of the financial crisis which preceded the latest downturn has important ramifications for employment dynamics in the post-crisis period, since recessions triggered by financial crises typically give rise to longer-lasting macroeconomic effects than those resulting from other (non-systemic) recessions. These effects include higher losses in – and a more gradual recovery of – output and employment, as well as longer-lasting increases in unemployment and higher structural unemployment, following typically deep and prolonged declines in asset prices and sharp increases in government debt.[4]

EMPLOYMENT REACTIONS

By the first quarter of 2010 euro area employment was around 2.6% lower than at its peak in the second quarter of 2008. A simple scatter plot associating contemporaneous changes in employment with changes in output (Chart 3) demonstrates the high degree of heterogeneity in the labour market responses of the various euro area countries, regardless of the marked differences in the magnitude of the downturns experienced. In some countries (e.g. Germany), there has been relatively little change in employment, despite large falls in output;

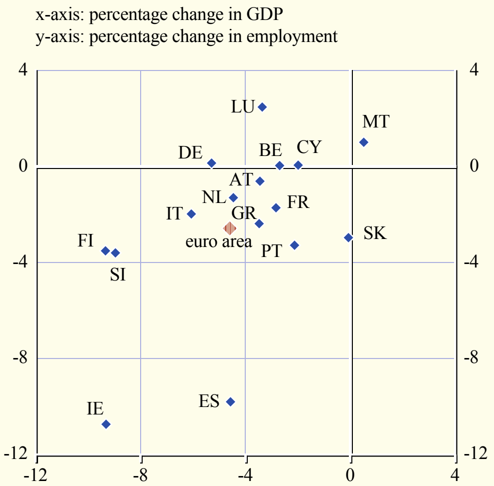
2 Eurostat's first national accounts estimate for the first quarter of 2010 appears to show a stabilisation in euro area employment levels in that quarter. This article is based on the data available up to 24 June 2010.

3 In addition, part of the difference observed can be explained by the varying reactions of each country's labour force to deteriorating employment conditions ("supply effects"); this aspect was explored in the box entitled "Recent labour supply developments" in the June 2010 issue of the Monthly Bulletin.

4 See, for instance, C. Reinhart and K. Rogoff (2009), "The Aftermath of Financial Crises", in *American Economic Review*, Vol. 99, No 2 (May), and S. Claessens, A. Kose and M. Terrones (2008), "What Happens During Recessions, Crunches, and Busts?", IMF Working Paper No 08/274.

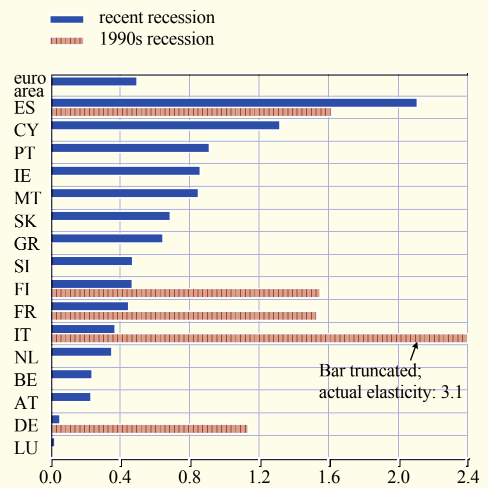
Chart 3 Changes in output and employment

(percentage changes; Q1 2008-Q1 2010)



Sources: Eurostat and ECB calculations.
Note: Data for Austria, Luxembourg and the Netherlands refer to Q1 2008-Q4 2009, while those for Ireland refer to Q1 2008-Q3 2009.

Chart 4 Elasticity of employment with respect to output; by country



Sources: Eurostat and ECB calculations.
Notes: Elasticities denote percentage reductions in employment divided by percentage reductions in GDP. Elasticities are computed using country-specific peaks and troughs, or using the latest data where a trough has not yet been reached (computations thus differ from Chart 3).

others (most notably Spain) have suffered disproportionately large falls in employment compared with their respective output losses.

Between its peak in the second quarter of 2008 and its trough in the fourth quarter of 2009, euro area employment fell by 2.6% – around half the size of the peak-to-trough contraction in GDP. These magnitudes suggest a euro area elasticity of employment to changes in output of around 0.5. That is, for each percentage point fall in GDP, employment has fallen by around ½ percentage point since the first quarter of 2008. At the country level, elasticities ranged from 2.2 in Spain to virtually zero in Germany, as shown in Chart 4.

Despite significant job losses across the euro area during the recession, the employment reactions of many of the euro area economies have, to some extent, been more muted than might have been expected – either on the basis of comparisons with other leading economies[5] or in relation to historical observations. Chart 4 also includes (where data permit) elasticity estimates for the last major recession to affect most euro area countries (brown bars), which occurred in the early 1990s. This shows a clearly higher reaction of employment to GDP contractions in the earlier episode, except in Spain. Systemic recessions following financial crises typically exert deeper and longer-lasting labour market reactions than non-systemic recessions. Thus, for several countries, the full employment effects of the systemic 1990s recessions lasted substantially longer (with employment troughs reached after 12 to 15 quarters) than those of the countries experiencing non-systemic recessions (seven to eight quarters).[6]

5 See the box entitled "A comparison of employment developments in the euro area and the United States" in this issue of the Monthly Bulletin.

6 Financial crises are defined following Chapter 3 of the April 2009 IMF World Economic Outlook. See also the box entitled "Labour markets and financial crises" in "Wage dynamics in Europe: final report of the Wage Dynamics Network" (ECB, December 2009), as well as the article entitled "The latest euro area recession in a historical context" in the November 2009 issue of the Monthly Bulletin. The rather lower responsiveness of euro area employment to the fall in activity during the recent recession is to a large extent confirmed by unemployment dynamics. See the box entitled "Links between output and unemployment in the euro area" in the October 2009 issue of the Monthly Bulletin or Chapter 3 of the April 2010 IMF World Economic Outlook.

CHANGES IN HOURS WORKED

Aside from the notable reductions seen in headcount employment, the latest recession has also been marked by a substantial reduction in total hours worked over and above that generated by job losses. Chart 5 uses data from the European Labour Force Survey (currently available only up until the fourth quarter of 2009), enabling a decomposition of changes in total hours worked into employment and average working hours effected according to employment status.

While part of the decline in total hours worked over the course of the recession reflects some reduction in individual working time accounts, part also reflects the very extensive use of shorter working hours schemes instituted in a number of euro area countries in a direct attempt to safeguard employment (discussed further in Section 4). This has resulted in considerable heterogeneity across countries, as shown in Chart 6.

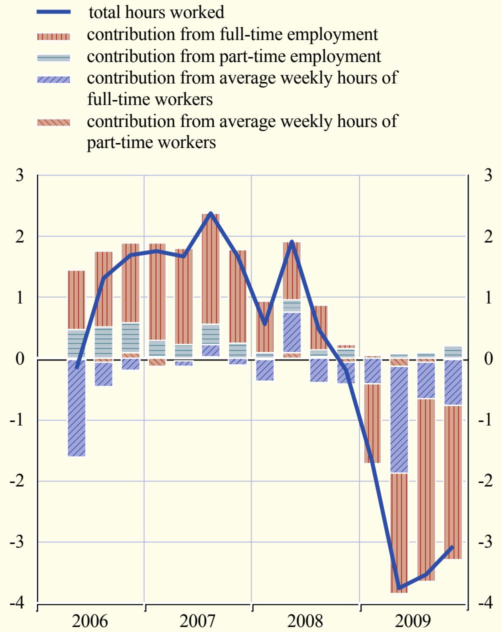
THE SECTORAL DIMENSION TO THE CRISIS

The sharp slowdown in employment growth observed in construction since early 2007 followed several years of rapid employment growth in this sector, particularly from the middle of the decade (see Chart 7). Industrial employment reacted later, but then declined markedly. So far, employment in industry and construction has fallen by 8.5% and 11.9% respectively from pre-crisis peaks.

Chart 8 shows the cumulative impact of these sectoral declines on aggregate employment developments in the euro area and the individual euro area countries since the first quarter of 2008. The decline in construction employment is particularly sizeable in those countries in which aggregate employment has fallen most, i.e. Ireland and Spain, in part reflecting a brisk correction to earlier overheating in the housing sector.

Chart 5 Growth in euro area total hours worked and contributions by worker type

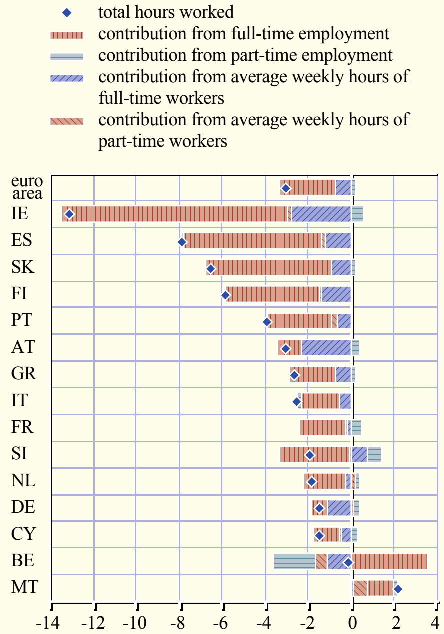
(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.
Note: Data for France are estimates.

Chart 6 Growth in total hours worked and contributions by worker type; by country

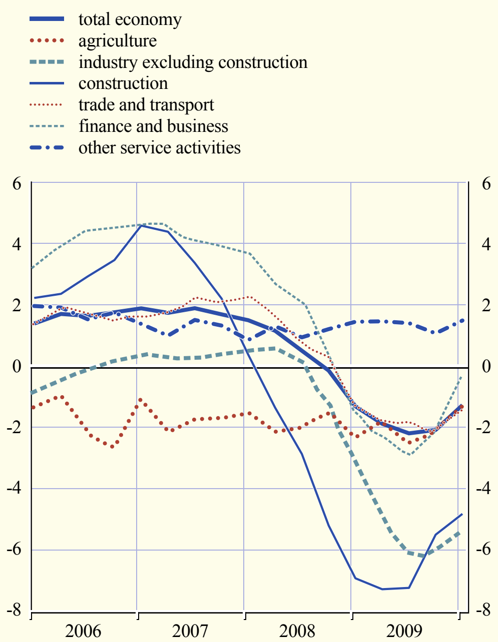
(percentage changes and percentage point contributions; Q4 2008-Q4 2009)



Sources: Eurostat and ECB calculations.
Note: Data for France are estimates.

Chart 7 Sectoral growth rates in euro area employment

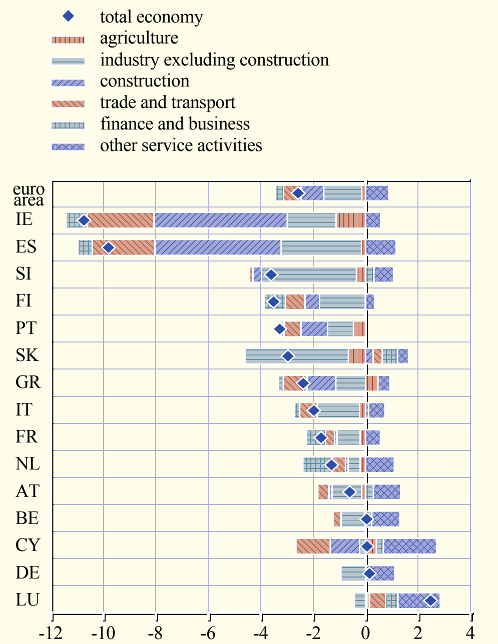
(annual percentage changes)



Sources: Eurostat and ECB calculations.

Chart 8 Sectoral contributions to aggregate employment developments; by country

(percentage changes and percentage point contributions; Q1 2008-Q1 2010)



Sources: Eurostat and ECB calculations.
Notes: Data for Cyprus are not seasonally adjusted. Data for Ireland refer to Q1 2008-Q3 2009, while data for France, Luxembourg, the Netherlands and Austria refer to Q1 2008-Q4 2009.

In both countries, the construction sector represented between a third and a half of total labour shedding. Sharp employment declines are also evident in the broad industrial sector and in trade and transport activities, accounting for some 15% and 10% respectively of total euro area employment losses. In comparison, contributions to total employment developments from the heavily hit financial and business services sector tend to be rather modest, in large part reflecting their limited share in total employment. The category "other service activities" – including the public sector – actually contributed positively, helping to stabilise employment developments.

The high sectoral concentration of employment losses seen during the recent recession raises important questions regarding the speed with which displaced workers are likely to be reabsorbed in the longer term. For some sectors (particularly construction, as well as certain manufacturing industries), some of the recent downsizing may become entrenched, partly as a result of a normalisation of earlier overheating and partly as the recession is likely to lead to significant restructuring in some branches of activity. This will inevitably bring about permanent reductions in employment in these sectors, raising the prospect of increased long-term and structural unemployment – particularly if the skills of displaced workers are not easily transferable to other sectors.

EMPLOYMENT COMPOSITION EFFECTS

In addition to the substantial sectoral variation in job losses seen during the recent recession, there has been considerable inequality in the distribution of employment losses across different groups of workers. How different segments of the labour market – in terms of age, contractual status or skills – are affected by the recession is, of course, to a large extent determined by the sectoral composition of employment and the sectoral exposure to the downturn. But the structure of employment itself, in particular the role and coverage of temporary employment contracts, is also an important factor in explaining the varying employment responses to the downturn in the euro area countries.

Temporary workers – i.e. those without the employment protection afforded by "permanent", open-ended employment contracts – have borne a disproportionate share of the employment adjustment across the euro area. Prior to the recession, the share of temporary workers in total employment had been consistently increasing, reaching around 17% of total euro area employment by the middle of 2007. Indeed, the growth in temporary contracts, as well as other forms of non-permanent working arrangements such as self-employment as a freelancer, contributed substantially to the rapid employment growth seen in the euro area before the crisis. But the prevalence of such contracts varied considerably across countries, with temporary contracts applying only to around 5% of workers in Slovakia, but almost one-third of all employees in Spain. As the effects of the financial market turmoil began to impact on the wider euro area economy, firms were able to react swiftly to the increased uncertainty as to future demand for their output by rapidly reducing the number of contract renewals for temporary workers.

Between late 2007 and early 2009 the share of temporary workers in total employment fell markedly. As Chart 9 shows, temporary employment adjusted relatively earlier – and to a greater extent – than other forms of employment in the course of the recession. This trend is particularly apparent in a few countries, most notably Spain, where temporary workers have accounted for virtually the entire employment adjustment (in part driven by developments in the construction sector, where the number of temporary jobs has halved since the downturn).[7]

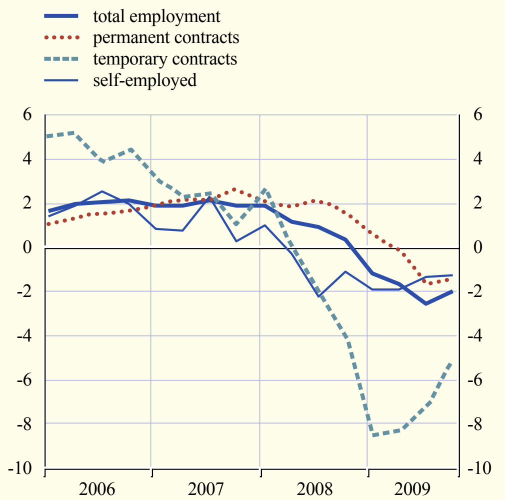
More recently, temporary employment appears to have shown signs of an earlier turnaround in comparison with more permanent forms of employment across the euro area, although it is still posting negative annual rates of growth. Workers with permanent contracts, benefiting from wide-ranging employment protection legislation, have been substantially less affected.

Meanwhile, part-time work has continued to grow (see Chart 10). It is, as yet, too early to assess the extent to which observed increases in the proportion of part-time workers in total employment during the recession simply reflect ongoing secular trends as opposed to the impact of the crisis. Certainly, the recession hit traditionally full-time sectors (such as construction and industry) particularly hard. Moreover, crisis measures – designed to protect jobs by means of shorter working hours – may themselves have helped to increase the part-time ratio, as ostensibly "full-time" employees work fewer weekly hours. Recent data from the

7 See, for example, S. Bentolila, P. Cahuc, J. Dolado and T. Le Barbachon (2010), "Unemployment and temporary jobs in the crisis: comparing France and Spain", FEDEA Working Paper No 2010-07.

Chart 9 Euro area employment growth by contract type

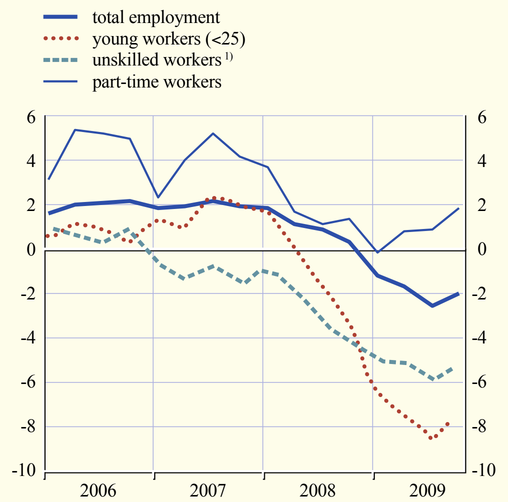
(annual percentage changes)



Sources: Eurostat and ECB calculations.

Chart 10 Euro area employment growth of selected groups of workers

(annual percentage changes)



Sources: Eurostat and ECB calculations.
1) Unskilled workers are defined as those with a lower secondary school leaving certificate or less.

European Labour Force Survey show a marked increase in the proportion of part-time employment, particularly for men, since the onset of the recession.[8] While female participation has also increased, job growth has occurred only in the part-time segment, helping to mitigate the effects of full-time job losses.[9]

Two other groups have been hit particularly hard by the recession: young workers (aged under 25) and the unskilled (those holding only basic school-leaving qualifications, if any). The stark decline in employment opportunities for younger workers is particularly evident in Spain and Ireland, which together account for roughly half of the decline in euro area employment of such workers. Since the onset of the recession, youth unemployment rates have almost doubled, to 20% for the euro area as a whole by April 2010 (though closer to 30% in Ireland and Italy, 35% in Slovakia and over 40% in Spain). Apart from the social and financial costs of long periods of inactivity, the strong decline in work opportunities for young people raises important longer-term macroeconomic issues. Such workers are potentially a source of economic dynamism, but are likely to miss out on productivity-enhancing training if they cannot gain access to the jobs which provide such training. Research suggests significant long-term adverse "scarring" effects of initial negative labour market experiences, including permanently lower employment probabilities and large earnings losses, which – for a small proportion of young people at least – may result in entrenched discouragement and a permanent detachment from the labour force.[10]

Regarding the unskilled, the downturn appears to have exacerbated the long-term structural decline in demand for such workers. Nevertheless, there is little cross-country variation in the decline in lower-skilled employment, other than that which can be attributed to the overall sectoral concentration of the downturn; such workers typically tend to be heavily concentrated in construction and industry.

3 THE RESPONSE OF WAGES AND LABOUR COSTS

As well as cutting employment, firms can reduce their labour costs in response to an economic slowdown by lowering wages. The responsiveness of wages affects the behaviour of other labour market variables, and the economy more generally. Broad-based evidence on the link between wages and employment, derived using several different

8 The European Labour Force Survey questions firms about the average hours worked by full and part-time employees. It is however possible that staff are reclassified during a severe downturn, despite the fact that their "standard" contracts remain unchanged.
9 See the box entitled "Recent labour supply developments" in the June 2010 issue of the Monthly Bulletin.
10 See, for example, K. Hämäläinen (2003), "Education and unemployment: state dependence in unemployment among young people in the 1990s", VATT Discussion Paper 312, and S. Burgess, C. Propper, H. Rees and A. Shearer (2003), "The class of 1981: the effects of early career unemployment on subsequent unemployment experiences", *Labour Economics*, Vol. 10, Issue 3.

methods, was recently explored by the ESCB Wage Dynamics Network (WDN).[11] The box below draws on results from the WDN survey, providing microeconomic observations on how firms have reacted to the crisis. The broad message of these findings is that the adjustment of employment has been faster and more widespread than that of wages.

11 For the summary findings and the related references to special studies and the literature, see "Wage dynamics in Europe: final report of the Wage Dynamics Network", December 2009 (available on the ECB's website at www.ecb.europa.eu).

Box

NEW SURVEY EVIDENCE ON LABOUR MARKET ADJUSTMENT TO THE RECESSION IN THE EURO AREA

This box looks at features of labour market adjustment during the recession using firm-level information. It briefly reviews some of the findings of the Eurosystem/ESCB Wage Dynamics Network,[1] in particular new evidence from a survey in which firms were asked about their responses to the contraction in economic activity during the recession. This survey was launched during the summer of 2009 in ten countries (Belgium, the Czech Republic, Estonia, Spain, France, Italy, Luxembourg, the Netherlands, Austria and Poland) and covered over 5,500 firms, 85% of which are located in the euro area. It therefore updates previous evidence, which was based on a survey conducted before the crisis.[2]

The firms' replies were in line with the macro evidence on the intensity of the recession. In the euro area countries surveyed, only 15% of firms did not see a negative impact on their activity, while in 38% of firms the negative impact was strong or exceptionally strong. This average hides substantial heterogeneity across countries; for example, while 44% of the firms in Belgium felt that they were suffering from a strong or exceptionally strong negative impact, the corresponding number in the Netherlands was 28% of firms. In addition, most firms perceived the recession as resulting in a fall in demand (41% of firms declared that they were being strongly or very strongly affected by a fall in demand), followed by difficulties in being paid by customers (29%), whereas financial constraints were declared to be relatively less important (19%). This held across countries and sectors and for firms of different sizes.

The most common response of firms to these declines in activity has been to reduce costs, while price reduction appears to be the least common. Indeed, around 73% of firms in the sampled euro area countries responded that reducing costs is a relevant or very relevant adjustment strategy. When looking in detail at the particular cost-cutting strategies that these firms implemented during the recession (see Table A), they mainly consisted of adjusting labour costs, which in most cases were contained by reducing the labour input in terms of permanent or temporary employment, or hours worked per employee. The percentage of firms that chose to reduce temporary employment as the main channel to adjust costs was very high in Belgium, Spain and the Netherlands (over 40%). Confirming that wages in the euro area initially responded very little to the crisis, only a few firms reported cuts in base wages as the main adjustment strategy to reduce labour costs; however, adjustment through flexible wage components was more common.

1 The WDN is a research network bringing together researchers from 24 EU central banks. It considers the sources and features of wage and labour cost dynamics that are most relevant for monetary policy, and the relationship between wages, labour costs and prices both at the firm and the macroeconomic level.

2 The survey is a follow-up to the WDN firm survey on price and wage setting, an ad hoc survey collecting information from the period before 2008 and covering over 19,000 firms in 20 EU countries. A summary of the evidence on wage setting from the original WDN survey is provided in the article entitled "New survey evidence on wage setting in Europe" in the February 2009 issue of the Monthly Bulletin.

Table A Cost-cutting strategies of euro area firms during the recession

Main strategy	Percentage of firms
Reduce labour costs	69.6
Adjust the amount of labour	
Reduce number of temporary/other employees	27.5
Reduce number of permanent employees	16.6
Reduce hours worked per employee	15.4
Adjust wages	
Reduce flexible wage components	8.6
Reduce base wages	1.5

Source: WDN survey.
Notes: All figures are employment-weighted. The sample includes Belgium, Spain, France, Italy, the Netherlands and Austria. The construction sector is not covered in the Spanish, French and Italian sample and financial intermediation is not covered in the Spanish and French sample.

Table B Incidence of wage cuts and freezes in the euro area during the recession

Percentage of firms cutting wages			Percentage of firms freezing wages		
five years before the crisis	summer 2009		five years before the crisis	summer 2009	
	did cut	will cut		did freeze	will freeze
1.3	2.1	3.3	7.6	37.1	43.1

Source: WDN survey.
Note: See notes to Table 1.

The stronger the impact of a crisis, the more likely it is that a firm will resort to reducing labour costs and in particular employment. Similarly, larger firms are more likely than smaller firms to lay off temporary workers and less likely to reduce non-labour costs.

The evidence from the WDN survey data collected before the latest recession showed that workers' wages were rarely cut during the five-year period preceding the launch of the survey and that downward wage rigidity was prevalent in most euro area countries.[3] When revisiting these facts in the context of the recent financial crisis, the evidence suggests that downward wage rigidity is still prevalent. On average, approximately 2.1% of firms in the euro area countries sampled in the follow-up survey experienced cuts in base wages during the period between the beginning of the crisis and the summer of 2009 (see Table B). This compares with an average share of 1.3% for the same sample of firms before the crisis started. The incidence of wage freezes, however, has increased considerably with the crisis, from only 7.6% during the five years prior to 2008, to 37.1% by summer 2009. Overall, this implies that downward wage rigidity was still prevalent in the summer of 2009 and that many firms were freezing wages instead of cutting them, even in an environment of economic downturn associated with near zero inflation.

Finally, empirical analysis confirms that institutional factors are important in shaping firms' responses. In particular, the combination of higher-level collective wage bargaining and strong employment protection legislation reduces the scope to lower wages and increases the adjustment through hours per worker, rather than through employment.[4] The presence of centralised collective wage agreements also hinders the adjustment of wages, even of their flexible components, and induces firms to reduce labour costs through hours worked.

3 J. Babecký, P. Du Caju, T. Kosma, M. Lawless, J. Messina and T. Rõõm (2010), "Downward nominal and real wage rigidity: survey evidence from European firms", ECB Working Paper No 1105.
4 See the publication referred to in footnote 11 of the main text.

The economic downturn has had a discernible, albeit delayed, downward impact on euro area wage pressures. Chart 11 shows four different indicators of wage growth: compensation per employee, hourly labour costs, compensation per hour and negotiated wages.[12] Following the onset of the recession, all these measures initially continued to rise. This reflected contractual wage agreements in the euro area (their average length, as identified in the WDN survey, is about one and a half years), made in 2007-08 – a time of increasing labour market tightness and high inflation rates. By 2009 these trends had reversed markedly, as the environment of weak activity, rising unemployment and low inflation led to lower outcomes in wage negotiations. By late 2009 most labour cost growth measures had slowed to below their average growth rates since the beginning of Monetary Union.

Reflecting the trends in GDP, employment and wages, unit labour cost growth rose for a considerable time, peaking at 5.9% in annual terms in the first quarter of 2009, as labour productivity fell sharply as a consequence of labour hoarding (see Chart 12). Since then unit labour cost growth has decreased rapidly, turning negative in the first quarter of 2010 as productivity grew rapidly.

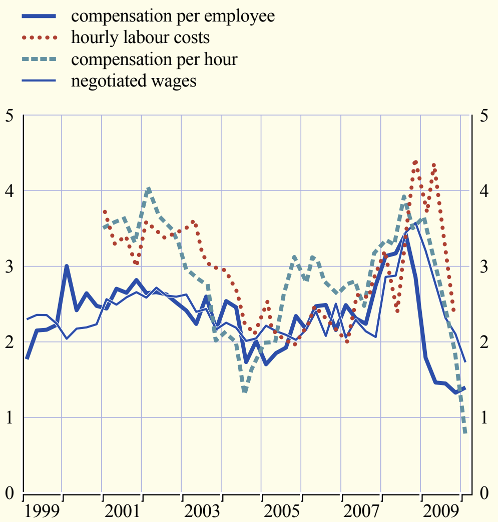
The responsiveness of wages to the economic downturn has varied substantially across euro area countries, reflecting their exposure to the recession and the impact of different wage-setting institutions. Given that different countries had very different wage patterns before the recession, Chart 13 shows the annual average growth in actual compensation per employee over the crisis (from the second quarter of 2008 to the first quarter of 2010), the annual average growth rate for the pre-recession period (from the first quarter of 1999 to the first quarter of 2008), and the difference between the two series.[13]

12 See the "Prices and costs" section of this issue of the Monthly Bulletin for an explanation of these indicators.

13 Wages in this instance are defined as compensation per employee. Another measure of wages – hourly labour costs – has evolved somewhat differently during the crisis owing to trends in hours worked.

Chart 11 Euro area wage indicators

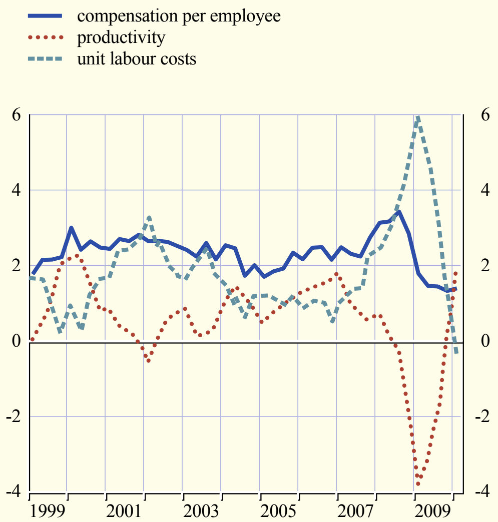
(annual percentage changes)



Sources: Eurostat and ECB calculations.

Chart 12 Euro area labour cost indicators

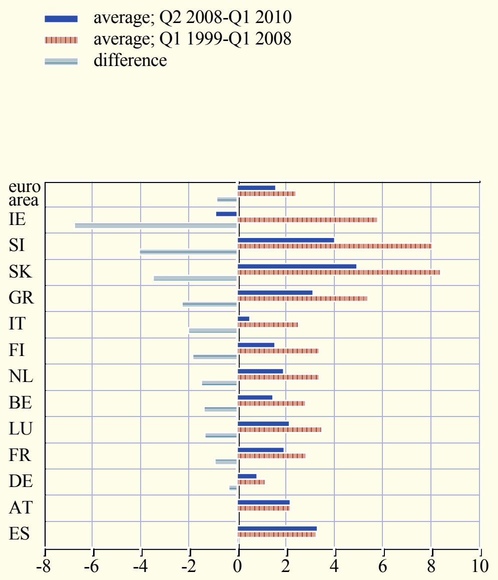
(annual percentage changes)



Sources: Eurostat and ECB calculations.
Notes: Productivity is given by GDP divided by total employment. Unit labour costs are compensation per employee divided by productivity.

Chart 13 Average growth in compensation per employee prior to and since the start of the recession; by country

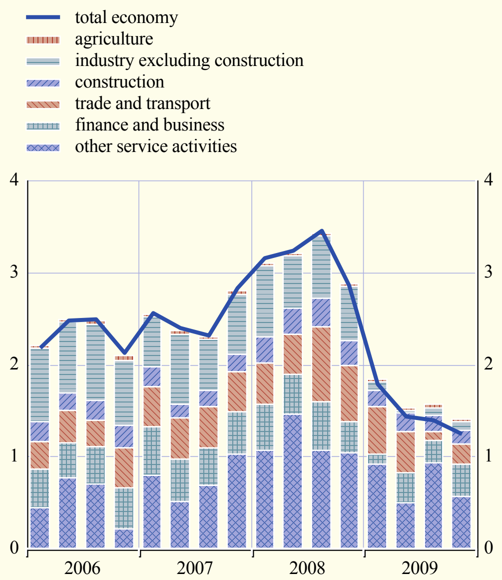
(annual percentage changes; percentage points)



Sources: Eurostat and ECB calculations.
Notes: Cyprus, Malta and Portugal are excluded owing to data limitations. Data for Greece are from Q1 2000. Data for Ireland refer to the period up to Q3 2009, while those for Luxembourg, the Netherlands and Austria refer to the period up to Q4 2009.

Chart 14 Euro area growth in compensation per employee and sectoral contributions

(annual percentage changes and percentage point contributions)



Sources: Eurostat and ECB calculations.
Note: Sectors are weighted using compensation weights.

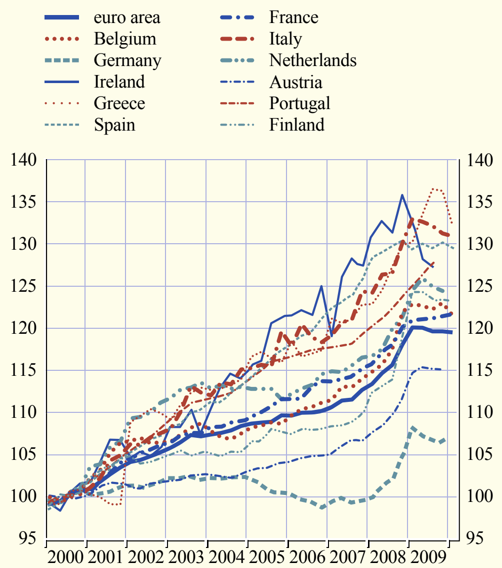
Since the onset of the recession, euro area compensation per employee has grown at around 1.6% on average in year-on-year terms, 0.8 percentage point below its pre-crisis average. This slowing is widespread, with growth in compensation per employee moderating in almost all euro area countries. The most notable decelerations tend to be in the smaller euro area countries.[14] This may reflect relatively flexible wage-setting institutions in these countries, and a greater willingness of employers and employees to allow wage growth to slow in order to limit the loss of employment, in view of their relatively large employment and GDP losses during the crisis. Relatively rigid wages in Spain – in comparison with the very strong employment reaction – partly reflect the institutional structure of wage-bargaining agreements in that country. Sectoral bargaining is dominant and is coupled with regional-level negotiations, meaning that it is relatively difficult for wages to adjust to firm-level productivity. Therefore, despite low inflation during the recession and relatively widespread wage indexation, the burden of Spanish labour market adjustment has fallen more on employment.

Turning to the sectoral breakdown of euro area compensation per employee, Chart 14 shows that three sectors have accounted for the majority of the slowdown since the peak observed in the third quarter of 2008.[15] Industry, trade and transport, and other service activities have each contributed around 0.6 percentage point to the slowdown. Indeed, wages in industry barely grew in 2009. This partly reflects the impact of reduced hours worked per employee in this sector, consequently lowering the average take-home pay per employee.

14 Pre-crisis wage growth in Slovenia and Slovakia should be interpreted with caution, as it could partially reflect convergence.
15 The sectoral breakdown of compensation per employee is currently only available up to the fourth quarter of 2009.

Chart 15 Unit labour costs; by country

(index: 2000 = 100)



Source: Eurostat.
Notes: Quarterly data up to Q1 2010 (Q3 2009 for Ireland, Q4 2009 for the Netherlands and Austria). The estimates for Portugal are based on annual data. Unit labour cost developments for Greece and Portugal may differ from the calculations by the respective NCBs. The Greek pattern of unit labour costs reflects substantial volatility in quarterly data on employees' compensation.

In the latest quarter, over half of the annual growth in total compensation per employee was contributed by "other service activities", reflecting the more resilient nature of public sector wages. In construction, the relatively modest slowdown in compensation per employee – despite a heavy fall in output – should be seen against the backdrop of heavy employment losses in that sector.

While the previous analysis focused on the moderation of wage growth during the recession, the outlook will also depend on how countries seek to maintain (or restore) competitiveness. Unit labour costs rose relatively quickly in several countries in the decade preceding the crisis, in particular in Ireland, Greece, Spain, Italy and Portugal (see Chart 15). Of these countries, only Ireland and – to a lesser extent – Italy have seen sustained improvements in their competitiveness over the last two years. Thus, substantially more adjustment seems to be necessary in several euro area countries before they can benefit from strong wage competitiveness, which will facilitate balanced and sustainable employment and output growth.

4 THE ROLE OF LABOUR MARKET POLICIES AND INSTITUTIONS

Governments across the euro area have implemented a number of crisis measures to counter the worst effects of the recession. Almost all countries have adopted a range of policies designed to reduce working time, lower labour taxes and ease labour market transitions for job-seekers. In addition, around half have increased benefits and assistance for the unemployed. Many of the crisis measures introduced, along with strict employment protection legislation in many countries, may have contributed in the short run to cushioning the impact of the crisis. However, as several of the measures are having undesirable effects on longer-run employment prospects, a timely dismantling of many of them would help to accelerate the restructuring process.

The main thrust of the temporary working-time reduction measures has been to facilitate the downward adjustment of hours, as a partial alternative to that of employment (see Charts 5 and 6). Official estimates of the impact of the measures show that there have been sizeable effects in Germany (the "Kurzarbeit" scheme) and Italy (the "Cassa Integrazione Guadagni" scheme), where such schemes at their peak applied to around 1.3% and 3% of full-time equivalent workers respectively. Indeed, the bulk of the decline in total hours worked in Germany is attributable to private sector reductions in average working weeks, rather than reductions in headcount employment (see Chart 6).

Many of the short-time working schemes across the euro area, initially implemented on a short-term basis, have already been extended or are due to expire in 2010. These programmes have helped to avoid excessive labour shedding and to maintain human capital in the short run. However, as the recovery takes hold, and since economies need to restructure, necessary adjustments could be hampered if employment is frozen in certain sectors. The measures also generate a major fiscal burden without creating incentives for investment to foster recovery.[16]

Reductions in tax on labour have generally been applied to social security contributions. To the extent that such measures help to reduce the burden on firms of employing labour, they are likely to have aided employment developments. The tax wedge in most euro area countries is high by international standards. Lowering this wedge could help to tackle weaknesses in earlier reforms, but such efforts add to the fiscal consolidation requirements of certain countries. Therefore, whether they can be pursued further may depend on fiscal tightening in other areas.

Many countries have implemented measures to help the unemployed in their job search (active labour market policies). Most governments have launched or extended training programmes for the unemployed to help restructure their economies, and many have taken steps to improve the flow of information in the labour market and thereby enhance the job-finding prospects of the unemployed. Maintaining or extending such measures could help the jobless to find jobs at a time of ongoing sectoral reallocation, to the extent that budgetary resources allow. In addition, job subsidies to private employers have been introduced or increased in many countries. The aims of such subsidies should be to limit displacement effects and to ensure high levels of job take-up.[17]

Many governments have extended unemployment benefits (for instance, by broadening eligibility criteria) to mitigate the social impact of the crisis. However, these measures reduce job-search incentives, as well as adding to the fiscal burdens of euro area countries.

One of the most important institutional factors determining labour market dynamics over recent years has been the degree of employment protection legislation. Reforms to moderate employment protection legislation ahead of the crisis and to encourage temporary employment contracts were factors behind the robust employment growth that occurred in the years prior to the crisis. Employment protection legislation varies substantially across European countries and across types of contract (temporary or permanent). Some countries have relatively high levels of protection against the individual and collective dismissal of permanent workers, which have at least temporarily contributed to labour hoarding and mitigated the employment reaction. By contrast, low firing restrictions applicable to temporary workers have permitted sizeable reductions in the number of these workers. Such labour market dualism therefore shifts the adjustment burden onto the latter group. Over the longer term, employment protection legislation may even curtail net job creation, as firms become reluctant to hire in the face of high adjustment costs.

5 CONCLUSION

This article has examined the evolution of euro area labour markets during the recent recession. Several key findings have emerged. The reduction in euro area employment has been sizeable, following the deep fall in activity on the back of a large financial crisis. However, it has been somewhat less severe than might have been expected, at least in relation to historical patterns. Furthermore, there is a high degree of heterogeneity in labour market responses across the various euro area countries, in large part attributable to developments in construction and manufacturing. Several groups of workers have been disproportionately affected by the crisis: temporary workers, the young and the unskilled, many of whom have been displaced from the above-mentioned sectors. Wages reacted

16 See also the box entitled "Labour market adjustments during the current contraction of economic activity" in the June 2009 issue of the Monthly Bulletin.

17 See OECD (2010), "Labour markets and the crisis", Economics Department Working Paper No 756.

only slowly and to a lesser extent, reflecting institutional rigidities in some countries, and this may have contributed to the drop in employment.

Looking ahead, employment can be expected to continue to fall in 2010, albeit at a slower rate than has been seen so far. With considerable room for an expansion in hours worked, in the longer term, there is some risk that job creation will be insufficient to bring down unemployment for a significant period of time if wages do not moderate sufficiently to stimulate labour demand. Questions remain as to the transferability of the sector-specific skills of those newly laid off from construction and some industrial branches, which may now need to be permanently downsized.

Policy reforms should now be geared towards facilitating restructuring and generating sufficient employment growth to absorb those workers currently displaced. Efforts to reduce the degree of labour market dualism in many countries should concentrate on increasing labour market mobility and flexibility, rather than seeking to extend employment protection to temporary workers. In the recovery phase, further reforms aimed at extending flexible contracts are likely to encourage employers to hire, in an environment characterised by a high degree of economic uncertainty. Further measures enhancing training options for displaced workers and designed to improve the efficiency of job searching will also be required, as well as reforms of tax and benefit systems to reinforce financial incentives to work. Employment growth will also depend on a restoration of competitiveness – at firm, sectoral and national level. This will require further reforms of product markets and wage-setting institutions, so as to ensure that local labour market conditions are adequately reflected in wage bargaining.