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PRESS RELEASE

Euro area labour markets and the crisis
(Article for the September 2012 Economic Review)

This article summarises the main findings of the Eurosystem's 2012 Structural Issues Report and reveals persistently large differences between the labour markets of the euro area countries. There were already divergences in the labour market situation before the crisis, but this was accentuated by the Great Recession. The countries were hit by different kinds of shocks which also varied in magnitude. Subsequently, the policy reactions diverged too, depending on the perceived shocks, budgetary possibilities and the labour market institutions, such as employment protection legislation or the wage formation process. As a result, divergent labour market consequences of the crisis have been observed, ranging from almost no impact (for instance in Germany) to very severe adjustments (like in Estonia, Ireland, Spain and Greece). Because of the considerable use of short-time working schemes, the impact on the Belgian labour market remained rather limited. It should nonetheless be stressed that the crisis is not over yet and several countries are experiencing a further deterioration of economic conditions. The SIR was finalised in March 2012 and therefore does not incorporate the most recent developments.

In a context of largely diverging situations at country level and the ongoing crisis, it seemed difficult to identify "best practices" to improve labour market functioning in the future. Nevertheless, several policy conclusions have been drawn.

The response of wages to the crisis has remained limited, pointing to the presence of downward wage rigidities, which are an impediment to restoring competitiveness – and thus employment – particularly in those euro area countries with previously accumulated external imbalances. In the presence of high unemployment, a flexible response of wages to labour market conditions should be a key priority. Moreover, it could also facilitate the necessary sectoral reallocation which underpins job creation and reductions in unemployment. In this respect, short-time working schemes, although successful in mitigating employment losses in some EU Member States, including Belgium, might actually hinder the reallocation of the labour force from declining sectors towards growing ones if they are kept on for too long. Also, in a context of growing mismatches in the labour market, higher wage differentiation across different types of workers and jobs is needed according to the SIR to contribute to a proper matching between labour supply and demand and will particularly benefit some of the hardest-hit worker groups.

Given the abrupt impact of the crisis on some specific groups of workers and the increase in the structural component of unemployment, the main aim of active labour market policies (ALMP) should be to limit, as far as possible, the risks of significant hysteresis effects from the increase in unemployment, particularly given that almost half of the jobless have been out of work for more than a year. In this respect, ALMPs should be designed to facilitate the return to work especially of young and less-skilled people including appropriate training policies to close the gap between the labour skills supplied and those demanded, especially in those countries more affected by the possible permanent downsizing of certain sectors. Such policies would also help to increase the downward pressure on wages exerted by the unemployed and limit the fall in potential output growth associated with higher structural unemployment.

Labour market segmentation tends to amplify employment adjustment to negative shocks and gives rise to a disproportionate burden of the adjustment process on specific groups of workers (those on temporary contracts, younger workers, low-skilled). The longer these groups are out of work, the greater the danger that their skills will deteriorate, making it harder for them to find work in the future and possibly leading to higher structural unemployment. According to the SIR, regulations on labour contracts should avoid wide differentiation across different worker types and instead focus on lowering employment adjustment costs across the whole economy. Meanwhile, labour market institutions which facilitate higher internal flexibility (e.g. in terms of hours and wages) can help firms to accommodate negative shocks at a lower employment cost.

According to the SIR, major labour market reforms are essential for the Member States in order to foster job creation, bring down unemployment and restore competitiveness, while also lowering the risks of a permanent decline in potential output growth. A comprehensive reform strategy to increase labour market flexibility is a key ingredient for a solid economic recovery in economies with additional positive spillovers on the correction and prevention of macroeconomic imbalances, fiscal consolidation and financial stability. In a monetary union such as the euro area, a flexible and well-functioning labour market can provide an economic environment which greatly facilitates the price stability-oriented monetary policy of the ECB. Reforms which deliver greater flexibility in employment and wages will reduce adjustment costs associated with idiosyncratic shocks and enhance both the efficiency and effectiveness of the monetary policy transmission mechanism.

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