Box 5

RECENT EURO AREA LABOUR MARKET DEVELOPMENTS IN A HISTORICAL CONTEXT

The financial crisis and the subsequent recession have had a severe negative impact on the euro area labour market and prospects remain subdued. This box compares labour market developments since 2008 with those in previous cycles and during other systemic financial crises in OECD countries. It shows that labour market adjustments since 2008 have been slower than in normal cycles but less adverse than in past recessions associated with financial crises. However, the renewed economic downturn and the weak outlook raise concerns about labour market developments in the near term.

Labour market developments in the euro area

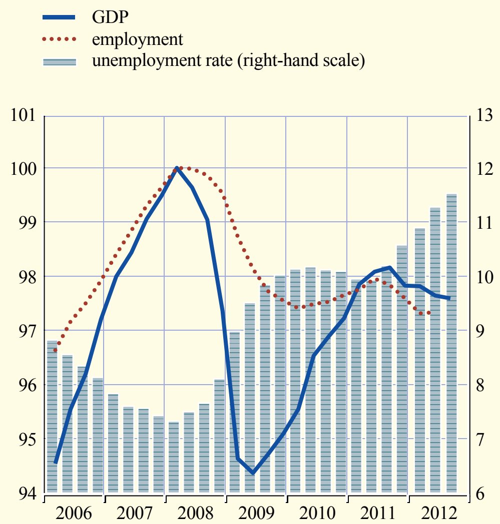
The financial crisis and the subsequent recession have had a severe negative impact on economic developments in the euro area. Activity has been affected quite severely, with a sharp contraction in real GDP, which is consistent with evidence on previous systemic financial crises.[1] Financial crises tend to be associated with harsher and more prolonged adjustment processes. This is partly because these episodes are often preceded by economic booms involving the build-up of large imbalances. Restoring public and private balance sheets often requires sharp adjustments which take time to complete, especially if they are inhibited by nominal rigidities and institutional frameworks.

In the early phases of the current crisis the employment adjustment was relatively muted, notably owing to a sharp adjustment in hours worked and the implied labour hoarding. However, since the start of the crisis in 2008 total employment has been reduced by more than 4 million persons and unemployment has soared above 11.5% in the euro area (see Chart A). These developments in the euro area as a whole mask the fact that labour market adjustments have varied substantially across countries.[2]

1 See Reinhart, C.M. and Rogoff, K.S., *This Time Is Different: Eight Centuries of Financial Folly*, Princeton University Press, Princeton, 2009.
2 See also the ECB's 2012 Structural Issues Report entitled "Euro area labour markets and the crisis".

Chart A GDP, employment and the unemployment rate in the euro area

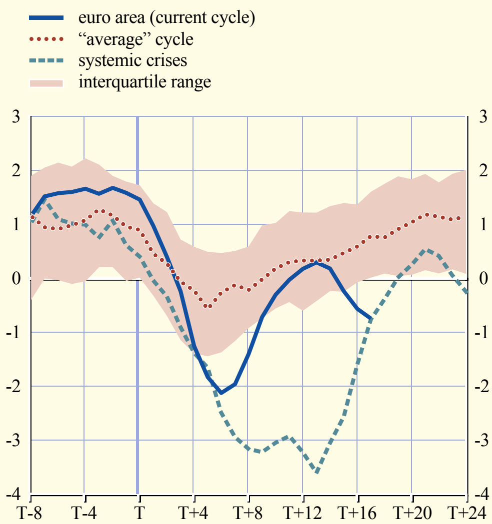
(index: Q1 2008 = 100; percentages of the labour force)



Sources: Eurostat and ECB staff calculations.

Chart B Employment

(annual percentage changes; quarterly data)



Sources: Eurostat and ECB staff calculations.
Notes: T represents the peak GDP level prior to recessions and the data cover a period from eight quarters prior to a peak (T-8) to 24 quarters after it (T+24). The cycle range for recessions in OECD countries is derived as the upper quartile less the lower quartile of developments during all recessions in OECD countries since 1970. The “average” cycle line shows the average development during all recessions in OECD countries not categorised as systemic crises. The systemic crises line is the average development during the previous five severe financial crises since 1970, which occurred in Spain, Finland, Sweden, Norway and Japan.

The current labour market adjustment compared with past systemic crises [3]

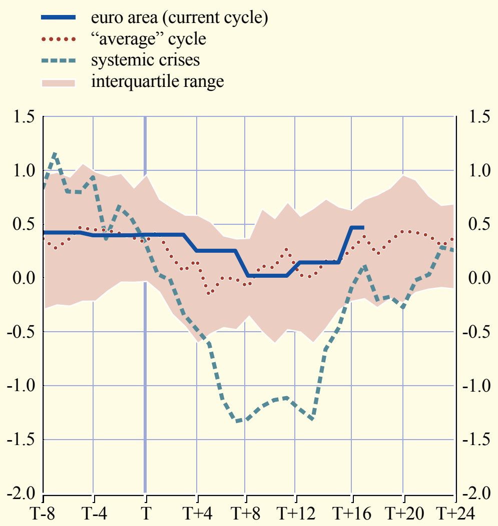
While euro area employment has fared worse in the period since 2008 than on average in previous cycles, it has not contracted as much as in previous systemic crises in OECD economies. In previous cycles employment rebounded on average around three years after the preceding peak in GDP, compared with an average rebound period of five years during systemic crises (see Chart B). The relatively better performance of employment in the current financial crisis may reflect various policy measures enacted at an early stage in the crisis to support employment.[4] However, owing to the weak recovery, and the subsequent deterioration as a result of the euro area sovereign debt crisis, employment has recently declined again.

Labour force participation has remained relatively resilient and in line with the levels observed during “average” cycles, while experience of past systemic crises typically suggests more significant falls in participation (see Chart C). In particular, participation rates for females and older workers

3 Prior to the current financial crisis, there had been five systemic banking crises in advanced economies: Spain in the late 1970s, Norway in the late 1980s, Finland and Sweden in the early 1990s, and Japan during the 1990s. For the definition of systemic crises, see Laeven, L. and Valencia, F., “Systemic Banking Crises: A New Database”, *Working Paper Series*, No 08/224, IMF, 2008. See also “What happens during recessions, crunches and busts?”, *Working Paper Series*, No 08/274, IMF, 2008, and the IMF’s World Economic Outlook, April 2009.
4 See also the article entitled “Labour market adjustments to the recession in the euro area”, *Monthly Bulletin*, ECB, July 2010.

Chart C Labour force participation

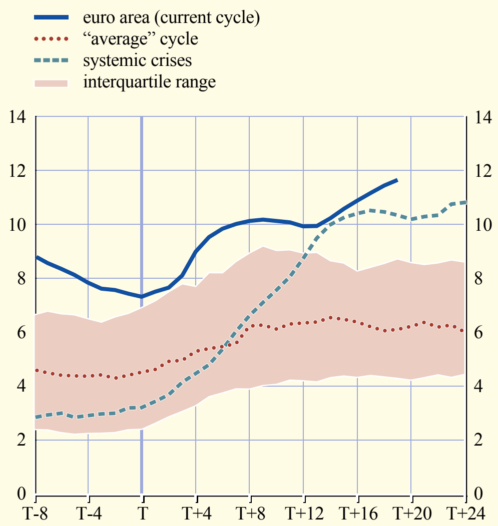
(annual percentage changes; quarterly data)



Sources: Eurostat and ECB staff calculations.
Note: See the notes to Chart B.

Chart D Unemployment rate

(percentages of the labour force)



Sources: Eurostat and ECB staff calculations.
Note: See the notes to Chart B.

have evolved more favourably than in past crises, offsetting negative effects on the participation of prime age workers and, in particular, young workers. These developments probably in part reflect past reforms to increase the integration of women in the labour market, as well as "added worker" effects resulting from an increase in the financial needs of households in the aftermath of the financial crisis. Finally, past pension reforms are likely to have supported participation by older workers, as they increased statutory retirement ages and made early retirement less attractive.[5]

Moreover, the euro area unemployment rate has increased sharply, rising from around 8% in 2008 to close to 12% in recent months. While a large increase is typical in a financial crisis, Chart D shows that the rise in unemployment has thus far remained lower than in past systemic crises, reflecting the relatively less adverse employment trends. Nevertheless, as the euro area unemployment rate was very high prior to the crisis, it remains above the level seen in past crisis episodes. Experience of past crises suggests that the unemployment rate will remain considerably above pre-crisis levels for some time (see Chart D).

This box focuses on labour market developments in the euro area as a whole. However, the adjustment has varied considerably across euro area countries, reflecting differences in labour market flexibility and institutional arrangements, as well as the extent of progress made on structural reforms. Looking ahead, the renewed economic downturn raises concerns about future labour market developments, which will also depend crucially on the extent to which institutional frameworks support flexible adjustments in wages and employment. Overall, further reforms to improve labour market flexibility would help to reduce the risk that the recent increases in unemployment could lead to higher structural unemployment.

5 The ECB's 2012 Structural Issues Report, entitled "Euro area labour markets and the crisis", finds that this change in the composition of employment can explain part of the limited wage adjustment observed in the aftermath of the crisis.