PRAISE TO THE EURO AREA LABOR MARKET

WE ARE DOING IT BETTER

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The labor market, supported by European policies through COVID, has paved the way for a wage profile more aligned with price stability. Looking ahead, there are few reasons to anticipate wage-price spirals in the euro area. The actions of firms and workers together with the economic policy decisions made in the last decade deserve credit for Europe's success. However, there is no room for complacency. Monetary policy has been at work with its usual transmission lag. We must exercise patience, as only policymakers can, following the principles of **reading** data, **reporting** findings, and **reacting** only if necessary.

With the pandemic shock, we experienced an undershooting-overshooting cycle. Coupled with a war and an energy crisis, this cycle propelled inflation to unprecedented levels in our economies.

The ECB's decisive policy response, combined with the most synchronized monetary policy action globally, amplified the transmission's impact and reduced inflation from a staggering 10.6% in October 2022 to just close to the 2% target (2.3% in November).

Concerns about the labor market malfunctioning emerged, with the possibility of second-round effects. After all, wage dynamics in the United States spurred demand and inflation, in a vicious price-wage cycle. However, with today's fundamentals and labor market institutions, the euro area will forgo wage-price spirals.

1. Labor market: Supply, Demand and Institutions

Wages and employment are equilibrium variables shaped by the interplay between labor supply and labor demand within an institutional framework. Likewise, the measurement of wage pressures needs a comprehensive consideration of supply, demand, and institutional factors.

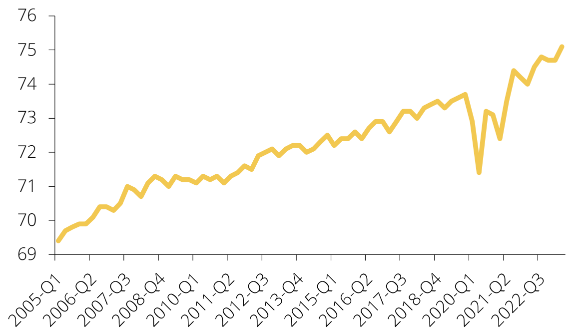
Institutions are crafted to regulate the interaction between supply and demand. When left unchecked, labor demand can overpower labor supply. However, excessive regulation may sacrifice efficiency, fostering segmentation and hysteresis.

For an extended period, Europe's institutional setting resulted in a sclerotic labor market characterized by persistent unemployment, segregated employment, and sticky wages. These factors acted as a drag on economic growth, contributing to significant inequality between countries – greater than the disparities observed across the fifty states in America.

However, a decade-long European reforms in the labor market, pensions, and social benefits earned commendation from the OECD Employment Outlook in 2020. The report highlighted the reduction of dualism in the labor market, the reform of job dismissal regulations for open-ended contracts, and the restructuring of hiring regulations for temporary workers. These changes, along with a more mature internal market and the implementation of new mobility and migration policies, have transformed the labor supply and demand landscape in Europe.

Over the last two decades, the euro area's activity rate has shown a consistent upward trend, expanding an extraordinary 5.7 percentage points. Remarkably, even the pandemic failed to disrupt this structural change; despite a temporary setback, the activity rate swiftly rebounded to its previous trend.

Chart 1 • Activity rates | In percentage



Source: Eurostat, Labor Force Survey.

In addition to labor market reforms, Europe successfully reduced uncertainty surrounding the euro project. Notable institutional changes since 2014 included risk reduction with stronger backstops for sovereigns and banks, the establishment of single resolution and supervision authorities, and the introduction of the first central fiscal capacity for euro area countries.

The institutional changes led to a more flexible and dynamic labor market, lowering the cost of creating new jobs. This benefited workers across all skills, with an overall improvement in job quality. The share of workers with tertiary education increased from 30% in 2012 to 38% in 2023, and the proportion of qualified professionals rose from 17% to 22%. Even those typically marginalized in the job market – low-skilled workers, migrants, women, and young individuals – benefited. Jobs with lower productivity, often associated with services, were also created.

Since the pandemic trough, **Europe has added more than 9 million jobs.** Due to the innovative euro area labor market and effective policy responses, the bust-and-boom cycle was shorter compared to the United Sates; employment had already recovered by late 2021, while the US took more than two years (until the end of 2022) to return to pre-pandemic employment.

2. Inflation and the labor market

The recent shocks were exogenous and predominantly supply-driven. Unlike previous crises, they did not result from imbalances in our economic system. Factors such as the pandemic, the need to readjust production, the abrupt halt in global trade flows, pent-up demand, energy shocks, and the war initiated an inflationary process.

While this process did not originate in the labor market, concerns about potential second-round effects persist. However, labor market developments in Europe were not conducive to significant wage pressures. Employment retention through generalized **furlough schemes**, increased **participation**, enhanced **mobility**, extended **working hours**, more **productive job search** by unemployed and inactive workers, and a dynamic labor demand met by an equally dynamic supply (a stable relationship between the two sides of the labor market, i.e., a stable **Beveridge Curve**) all contributed to the success of the European labor market.

The European **furlough schemes** played a crucial role in facilitating a smooth transition through the pandemic and establishing a wage profile more aligned with price stability. The labor market matching function – the set of institutions connecting workers and firms – did not undergo severe tests with waves of massive job destruction and rehiring.

In the US, employment plummeted to 133 million in April 2020, a staggering 26 million reduction. In contrast, the euro area experienced a more moderate decline of 5 million, marking a five-fold difference.

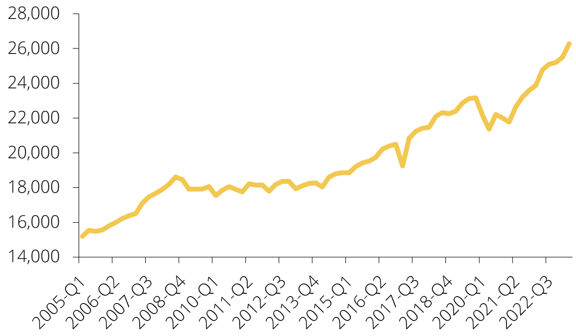
The recovery of the euro area labor market was swift. The **activity rate** surged from 73.5% in the second quarter of 2019 to 75.1% in 2023. After hitting a low of 71.4% in 2020, it surpassed previous peak values by mid-2021. This was a consequence of increased **transitions from inactivity to employment** and the activation of **marginally attached workers**.

Notably, in the euro area, a growing number of **inactive individuals are transitioning into employment**. Before the pandemic, an average of 2.5 million inactive persons moved into employment each quarter. Since the second quarter of 2020, it has risen to 3 million.

This shift implies a **reduction in marginally attached' individuals** – those willing to work but not actively searching for a job. As of mid-2023, there were 5.2 million, compared to 9.6 million by mid-2020 and 5.8 million just before the pandemic. The decrease in discouraged workers signals efficiency in the labor market adjustment.

The mobility of workers enhances the capacity to align supply and demand. **Workers born outside their country of employment** contributed significantly to the post-pandemic employment increase, accounting for 53% and reaching 26.3 million in the second quarter of 2023, a rise of 5 million from 2020. During the two financial crises, these workers numbered 18 million. However, between 2014 and 2019, their count increased to 23 million. The rapid recovery from the pandemic has brought us back in line with this positive trend.

Chart 2 • Employment, persons born outside the country they work | In thousands



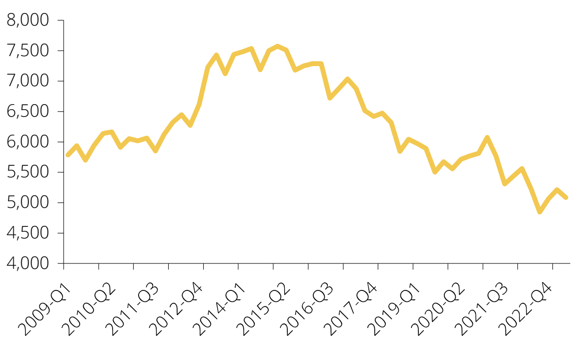
Source: Eurostat, Labor Force Survey.

The extensive margin, reflecting the number of available workers, has increased. However, supply can also be facilitated through the intensive margin if workers extend their working hours or take on additional jobs.

The recovery of **second-job holders** was gradual after the pandemic. By mid-2023, workers with two jobs had rebounded to 6.4 million. Nevertheless, the previous trend would have suggested a larger number today, indicating potential for additional adjustments in the future.

But we are making better use of the potential of our workforce. The number of **underemployed workers** – those working part-time but desiring full-time employment – decreased from 6.3 million at the end of 2019 to 5.2 million in mid-2023. This reduction was already underway before the pandemic, but returning to this trend is important to alleviate labor market pressure and fulfill workers' potential.

Chart 3 • Underemployed persons working part-time | In thousands



Source: Eurostat, Labor Force Survey.

For full-time workers, the pandemic induced a shift in hours worked. Many firms opted to adjust "hours" rather than "headcount." Subsequently, the number of hours worked did not fully recover. A pre-pandemic downward trend was already in place, which was accentuated by a one-off reduction during the crisis. It is worth noting that working shorter hours requires productivity gains to avoid cost pressures. However, it will also imply less pressure on future wage demands. Overall, in the intensive margin, there is still ample room to alleviate labor market pressures.

One of the most referenced indicators of labor tightness is the **unemployment rate**. In Europe, the current unemployment rate stands at 6.3%, the lowest this century.

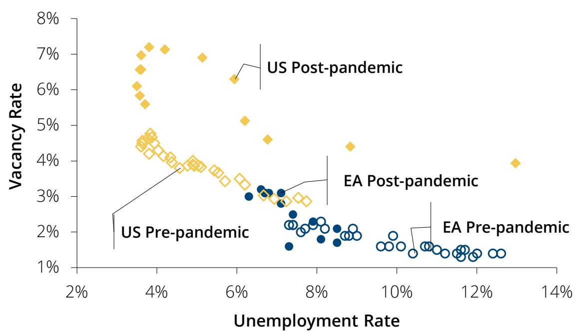
Nevertheless, variations in the composition of the unemployed affect labor market pressure. A higher proportion of subsidized unemployed individuals, who typically have higher reservation wages, exerts more pressure on wages. Conversely, a reduced share of long-term unemployed enhances the supply of more readily employable workers, mitigating wage pressures.

A positive and encouraging trend is the **decline in long-term unemployment**. Although this decline predates the pandemic, the duration of unemployment is decreasing as the economy rebounds. The percentage of unemployed individuals for 12 or more months dropped from 44% at the end of 2019 to the lowest recorded figure in many years, at 37%, in mid-2023. During the sovereign debt crisis, this figure exceeded 50%, symbolizing the persistent pool of stagnant unemployed individuals that prevailed for decades in Europe.

The number of unemployed individuals receiving benefits is declining, although it remains relatively high. The implementation of new and extended benefits during the COVID crisis was appropriate to address the magnitude of the shock and the prevailing uncertainty. However, the time has come to return to pre-pandemic conditions. A more employable pool, demonstrating increased search effort, brings encouraging news to alleviate wage pressures.

The tightness and efficiency of the labor market can be assessed through the **Beveridge Curve**. A relationship between vacancies and unemployment, serving as proxies for (the slack in) labor demand and supply, respectively. In Europe, the Beveridge Curve has shown little change between the pre- and post-pandemic periods; the unfilled and filled circles align on the same curve. The situation differs in the American labor market, where there are two curves; the unfilled diamonds in the pre-pandemic period form a curve below the filled diamonds of the post-pandemic period. This means that, nowadays, employers have a smaller pool of unemployed to fulfill their vacancies. Or, in other words, the unemployed have more employment opportunities. In either case, the bargaining power shifts towards workers (suppliers), driving wages up. On average, there are now 1.3 vacancies for each unemployed person, compared to the pre-pandemic figure of 0.8. This indicates a tighter American labor market. In Europe, the corresponding figures are 0.2 and 0.35, suggesting a more fluid labor market, even though the ratio has increased.

Chart 4 • Beveridge Curve – USA and Euro Area
| In percentage



Source: Eurostat and US Bureau of Labor Statistics.

Having examined both supply and demand, we can now analyze **wages**, a crucial variable for monetary policy considerations.

Historically, wages in the euro area have demonstrated less dynamism than those in the US. Over the past 30 years, real hourly wages per employee increased by 51% in the US and 20% in the euro area, reflecting differing rates of productivity growth.

Since the onset of the pandemic, real hourly wages have experienced a robust increase in the US, reaching 7%, in stark contrast to stagnant real wages in the euro area. During the inflationary period of the last two years, real hourly wages declined in both regions, but the decrease was more pronounced in the euro area at -7%, compared to -3% in the US.

The fight against inflation needs market adjustments that do not fuel price pressures. **A more flexible and adaptable labor market is promising news for the euro area, and the wage data supports this observation.** Hitherto, there are no indications of significant wage pressures, even though real wages should recover.

3. What can we expect?

In Europe, the labor market has functioned as a safeguard, shielding income from the unpredictable impacts of exogenous, supply-driven, inflationary shocks.

However, the euro area stopped growing a year ago. If it would not have been for the employment created, inflation and stagnant growth would have spelled "stagflation".

We have avoided stagflation because firms correctly interpreted inflation as a transitory phenomenon, which matched with demand, required no employment adjustment, yet.

Four reasons contribute to this outcome. First, the **credibility of the ECB**, evident in anchored inflation expectations. Second, the **supply-driven nature of inflation** resulted in an immediate reduction once the supply shocks dissipated. Third, **fiscal policies** that, thus far, have steered clear of an overly expansionary stance and subsequent demand pressures. Finally, a **more flexible and mobile labor market** has effectively contained second-round effects.

However, complacency is unwarranted.

The labor market doesn't adjust gradually during recessions or prolonged economic decelerations. When firms initiate employment downsize, it occurs synchronously, leading to a spike in unemployment. Job destruction and the freezing of new hires are more synchronized in recessions than during upswings.

It took three years to reach the pre-pandemic employment trend; it will require less time to reverse those historical gains.

Monetary and fiscal policies must acknowledge the labor market's challenges, recognizing that labor demand is a '*derived demand*' from economic activity. Preserving workers' investments and aspirations is incompatible with tightening more than necessary.

Caution should guide wage increases, which should be driven by productivity gains, as observed in the past 35 years. **The success of an economy is not only measured by its overall performance, but also by the success of those barely included or excluded.** Acting at the margin is of the essence.

Monetary policy has been at work, albeit with its usual lag. We must exercise patience, as only policymakers can, following the principles of **reading** data, **reporting** findings, and **reacting** only if necessary.

In the meanwhile, we must **safeguard labor demand** to create new jobs, ensure **secure flexibility** for adaptability, harness **migration** for a broader labor market, and **address between-country inequality** to share prosperity and stability across all.

A pivotal element in achieving these goals is the **central fiscal capacity** approved by the European Council in December 2019, exemplified by the Next Generation EU. The implementation of an **EU-wide unemployment insurance mechanism** would also make a decisive contribution to further enhance labor market efficiency.