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Global

Global Economics View

The euro area isn't working – labour market reforms in the euro area and why they won't solve the euro area job crisis

- **The euro area isn't working, quite literally**. Unemployment in the euro area (EA) has risen by roughly 50% since 2007 and is now at record highs in the EA as well as in all GIIPSSC countries (Greece, Ireland, Italy, Portugal, Spain, Slovenia, and Cyprus) except Ireland. The divergence in unemployment rates across EA countries since the start of the crisis has been much greater than differences in growth performance.

- **There have been substantial labour market reforms,** particularly in Greece, Portugal, and Spain. Employment protection has been reduced, wage bargaining rules made less inefficient, and unit labour costs in these countries as well as Ireland have now fallen substantially – although much of that is the result of downward pressure on wages from the reserve army of the unemployed and the shedding of low-productivity workers by firms. Models and precedents for successful labour markets and labour market reforms in Europe also exist and more reform efforts are likely to come.

- **Much more needs to be done.** Labour markets remain quite rigid, in the EA periphery, but also Belgium, France or the Netherlands, which have at best started to reform. The main rigidities are i) high tax/transfer wedges on labour income, ii) high employment protection, iii) inflexible (wage) bargaining, iv) excessive involvement of courts in labour matters, v) low labour force participation, and vi) high labour market duality. Low skill levels for a significant share of the labour force remain a key weakness in many EA countries. More extensive active labour market policies could help in the meantime, but may be unaffordable for fiscally weak countries.

- **Labour market reform by itself will not solve the EA crisis**, although it is necessary to raise the path of potential output. Job creation also requires a return to growth of demand, which in turn requires an end to excessive private debt, weak banking sectors, fiscal austerity and policy uncertainty. In the short run, deficient aggregate demand is holding growth in the EA back more than structural rigidities. Structural reforms will help to raise the path of potential output in the medium term, but unless private and public debt burdens are reduced materially, many structural reforms could reduce demand and worsen output and employment in the near term.

- **Unemployment set to persist and create risks.** Even under relatively benign assumptions, the unemployment rate will not fall until 2014 at the earliest, in our view, and will still be above 10% at the end of this decade, and twice that level in Spain. Persistent high unemployment raises the prospect of a 'lost generation', but also feeds 'austerity fatigue' which is likely to turn into political instability and 'debt service fatigue' and debt repudiation eventually. Risks of wider social unrest are material.

- For a discussion of labour market rigidities and a detailed overviews of recent reforms, see Global Economics View - Taking Stock of Labour Market Rigidities and Reforms in the Euro Area

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The Euro Area Isn't Working

Unemployment is at record highs in the EA as well as Greece, Italy, Portugal, Spain, Slovenia, and Cyprus – and likely to remain high for many years.

There have been substantial labour market reforms in the EA periphery, but key weaknesses remain.

Labour market reform won't solve the job crisis – growth is needed and excessive public and private debt, a weak banking sector and policy uncertainty are bigger hurdles for growth than structural rigidities

Persistent high unemployment raise the risk of austerity fatigue, social unrest and sovereign debt restructuring.

The euro area (EA) isn't working. Quite literally. Roughly seven million more people are unemployed in the EA currently than in 2007 and in recent quarters the number of unemployed persons has been rising by almost half a million per quarter. Since the crisis started, unemployment has risen by 50% in the EA, doubled in Italy, tripled in Greece and Spain, and quadrupled in Portugal. It is now at record highs in all GIIPSSC countries (Greece, Ireland, Italy, Portugal, Spain, Slovenia, and Cyprus) except Ireland, as well as in the EA as whole. This is despite the fact that employment and labour force participation were relatively low in some of these countries even before the crisis.

(Un)employment matters greatly. In addition to its high social costs, unemployment makes it harder to repair the public finances, leads to skill degradation and creates the risk of greater social dislocation and social unrest.[1] In this piece we consider past and prospective labour market reforms and the outlook for unemployment in the EA.

We conclude that unemployment is likely to remain very high for a long time. In the euro area as a whole, unemployment may still be above 10% at the end of this decade and in Spain maybe twice that. This is despite quite extensive labour market reforms in the EA in recent years, particularly in Greece, Portugal and Spain. In all three countries and in Ireland unit labour costs have fallen significantly. Models and precedents for how labour markets and labour market reforms can work in Europe also exist, even though the initial conditions in the precedent countries were generally more favourable than they are in the EA today.

More reforms are still needed in the EA periphery, but labour market rigidities are possibly more extensive now in Belgium, or France, or even the Netherlands, and are also substantial in Austria, Finland and Germany. On average, the key rigidities in EA labour markets remain: i) high taxes and social security contributions ('tax wedges') on labour , ii) high employment protection, iii) inflexible, excessively centralised and insufficiently differentiated bargaining over wages and other conditions of employment, iv) excessive involvement of courts in labour matters, v) low labour force participation, and v) high labour market duality. In addition, poor average skill levels in the workforce, and among the unemployed in particular, are a key weakness, which will be difficult to remedy quickly. Extensive active labour market policies (ALMPs) may be needed to get the unskilled/deskilled unemployed back into jobs, which the periphery countries lack the fiscal space for, and EU funds remain 'de minimis'.

Labour market reforms alone will not solve the EA crisis and have little hope of bringing unemployment down quickly. For job creation to take off, growth of aggregate demand is needed. With ample idle labour and capital equipment, deficient aggregate demand, caused by excessive private debt, weak banks, fiscal austerity and policy uncertainty are bigger impediments to growth in the near-term than structural rigidities, in our view. Structural reforms – which need to include product market reforms as well, including opening up closed professions, lower barriers to entry and exit in the utility sectors and the service sectors generally – will pay off eventually, but the gains usually accrue slowly, and without short-term measures to boost demand the reforms could even exacerbate the current demand weakness. In the near-term, emigration may help containing unemployment, while more openness to immigration from youth-surplus, low-wage countries outside the EU may be needed to address adverse demographics in the future.

[1] See also ILO (2013), "World of Work Report 2013: EU Snapshot", www.ilo.org/wcmsp5/groups/public/---dgreports/---dcomm/documents/publication/wcms_209607.pdf

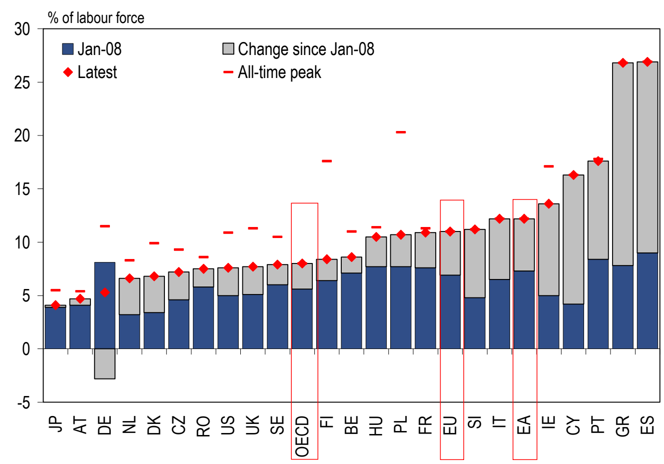
The job crisis in the EA also aggravates other risks. It raises the risk that reform efforts stall, even though on balance high unemployment often *increases* the pressure on governments to introduce structural reforms. High unemployment will further boost austerity fatigue, which could eventually turn into political instability and 'debt service fatigue', raising the risk of some form of sovereign debt restructuring/repudation in highly indebted periphery countries. In addition, the risk of a 'lost generation' and of wider social dislocations cannot be ruled out, which would further weigh on growth prospects.

The euro area isn't working – literally

Unemployment in the EA is at record-highs.

As of May 2013, unemployment rates were at record-highs (generally since the mid-1980s) for the EA (12.2%) and EU (11.0%) as well as in Slovenia (10.2%), Italy (12.2%), Cyprus (16.3%), Portugal (17.6%), Greece (26.8%), and Spain (26.9%).[2] Since January 2008 (the recent trough for the EA), the unemployment rate has risen in all EA countries except Germany, by almost 5ppts for the EA average and by more than that in all GIIPSSC countries. It is still rising in most countries with high unemployment, with the exception of Ireland. By comparison, unemployment in the non-EU OECD stood at 5.7%, having risen by less than 1pp since end-2007.

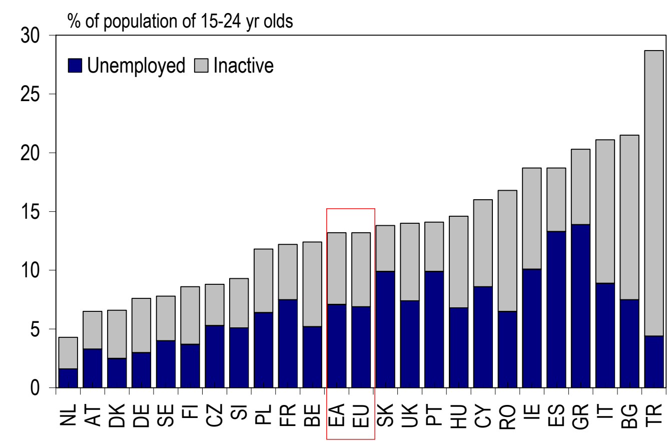
Figure 1. Selected Countries – Unemployment rate (% of labour force), 2008 – latest



Note: Latest data are for May 2013 for all countries and regions, except for Japan, Hungary, OECD (April 2013), and Greece and UK (March 2013). All-time peaks since early '90s in Germany, Romania, OECD; late '90s in Slovenia, Hungary, EU (changing composition); '00s in Cyprus, and '80s in the rest.

Source: Eurostat, OECD and Citi Research

Figure 2. Selected Countries – Young persons not in employment, education or training (% of 15-24 year population), 2012



Note: as % of 15-24 year population. *Inactive* are not employed, looking for work, or in education and training. Source: Eurostat and Citi Research

Youth unemployment and long-term unemployment are particularly high…

Long-term unemployment and youth unemployment – probably the most economically and socially harmful forms of unemployment – are particularly high in many EA countries. Conventional measures of youth unemployment suggesting that more than half of under-25 year olds are unemployed are misleading.[3] The 'NEET' (not in employment, education, or training) measure of youth unemployment is more

[2] In Luxembourg, unemployment is also at a record-high, but is still 'only' 5.7%.

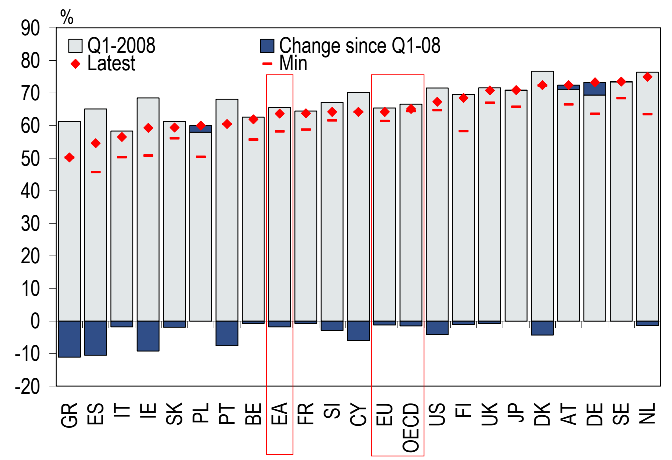
[3] Unemployment rates are calculated as the number of unemployed divided by the labour force (i.e. those willing, available and looking for work). But the labour force used in conventional measures of youth unemployment is a small part of the relevant population, as it excludes those in education or training, which are a large part of the 'teenage' population and still quite a large part of the 15-24 year age group. For instance, in Greece only 9% of 15-19-year olds are in the labour force, so a youth unemployment rate of two thirds implies that 6% of that age group are looking for work, but cannot find any. See also Gros (2012), "Europe's Youth Unemployment Non-Problem", Syndicate, June 6, 2013

appropriate and less dramatic, but still sobering: in 2012, around one fifth of young persons in Italy, Greece, Spain and Ireland were NEETs (Figure 2) and the NEET ratio has risen in all EU countries since 2008. Meanwhile, the number of people in the EA that have been unemployed for more than 12 months has almost doubled in the last 5 years to nearly 9m people.

…but unusually for a recession, labour force participation has risen

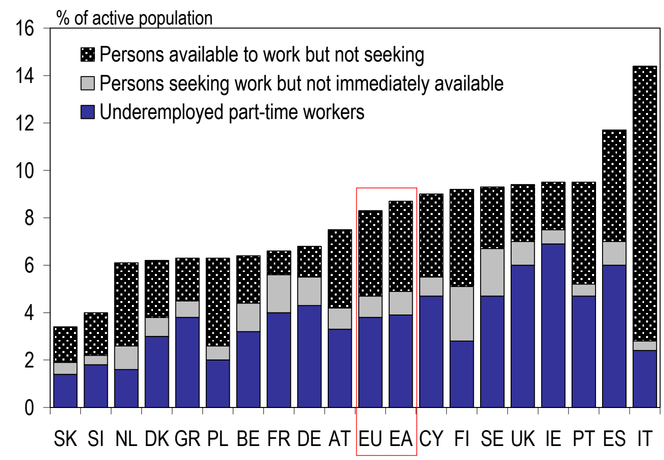
Labour force participation (LFP, the ratio of the labour force, i.e. the employed plus the unemployed looking for work, to the 15-64 year population) rates in the EA were relatively low in many EA countries even before the crisis, particularly among older workers and women, compared to many other industrial countries and to the EU's goal of reaching an employment rate (employment divided by the working-age population) of 75% by 2020. Since then, LFP has increased in a number of EA countries – mostly driven by higher rates of female LFP. This means that even though unemployment rates have risen, the drop in employment has been less severe: the EA employment rate has fallen by 2pp since end-2007 (Figure 3).[4] Even though GIIPS countries had larger falls in employment rates, they are still above the record-(generally 1990s) lows except in Cyprus, Greece and Portugal.

Figure 3. Selected Countries – Employment Rate (% of working age population), Q1 2008 – Latest



Note: Employment rate is employment divided by 15-64 year population. Latest data are for Q3 2012 for OECD average, and Q4 2012 for the rest. Data start in 80's except for Germany, Japan, US ('90s), Slovenia, , Slovakia (late '90s); EU-27, Cyprus, OECD ('00s). Source: Eurostat, OECD, and Citi Research

Figure 4. Selected Countries – Under-employment (% of active 15-74 yr population), 2012



Note: Underemployed part-time workers are persons aged 15-74 working part-time which wish to work additional hours and are available to do so. Part-time work is recorded as self-reported by individuals. Sources: Eurostat and Citi Research

The (un)employment statistics also somewhat understate the degree of labour market weakness in the EA, as 'underemployment' accounts for another 9% of the labour force (Figure 4).[5]

The divergence of unemployment rates in the EA since the crisis has been much greater than differences in growth performance

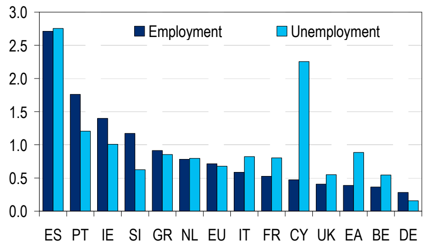
In addition to the general rise in joblessness, its divergence across EA countries has been stark. In January 2008, the highest unemployment rate in the EA (Spain at 9.0%) was less than three times the lowest (Netherlands at 3.2%). In May 2013, unemployment rates ranged from 4.7% in Austria to 26.9% in Spain. This has not solely been the result of differences in growth performance – for instance, the

[4] LFP tends to have a procyclical element, i.e. it falls when unemployment rises. Since Q1 2008, LFP slightly increased in the EA (by 1.1pp by end-2012) and EU (1.3), and by more in Luxembourg (4.4), Spain (2.0), Germany (1.6), and France (1.5). Ireland saw the largest drop in the EU (-3.4), and LFP has also fallen in Finland (-0.7), Portugal (-0.5), Slovenia (-0.4), and Belgium (-0.2).

[5] Underemployment captures underemployed part-time workers as well as those available to work, but not seeking and those seeking, but not immediately available.

maximum loss in employment during the crisis relative to the peak-to-trough fall in GDP has been almost 10 times higher in Spain than in Germany (Figure 5).

Figure 5. Selected countries – Ratio of (Un)employment loss (rise) and output loss



Note: Peak-to-trough (trough to peak) % loss (pp gain) in employment (unemployment rate) relative to peak-to-trough % loss in output from 2007 to Q1 2013.

Source: Citi Research

Not all parts of the labour market are doing equally poorly. For example, in the older (55-64yr) category, employment in the EA as a whole has actually risen in recent years, even though it rose less than the labour force did (so the unemployment *rate* still rose) and employment fell in the GIIPSSC countries.[6]

But the general picture is clear: the EA labour market is in crisis.

Labour markets and labour market reforms can work…

Two labour market models tend to be associated with low unemployment – 'flexicurity' and the 'Anglo-Saxon model'.[7]

Flexicurity (also known as the 'Danish model') rests on striking a balance between incentives (to look for jobs and to train) and income insurance: a high level of social protection (generous unemployment benefits (UB)/assistance (UA), or other social benefits) is combined with incentives and requirements for job search.[8] For instance, in Denmark UBs are 90% of earnings of up to €2,000/month, paid for two years, but the unemployed face stringent obligations to seek jobs and accept job offers received (supported by extensive counseling, job training and wage subsidies for low-wage jobs). Employment protection legislation (EPL) is usually moderate (the idea is 'to protect the worker, not the job') and labour relations are often cooperative (with high collective bargaining coverage). High taxes and social contributions are usually needed to pay for unemployment benefits and active labour market policies (ALMPs).[9] The other Scandinavian countries (Finland, Norway and Sweden) also feature several elements of a flexicurity model.

Figure 6. Stylised features of Flexicurity and the Anglo-Saxon Model

	Flexicurity	Anglo-Saxon model
Unemployment benefits and other social benefits	High	Low
ALMPs	Extensive, high penalties for job rejection	Low/moderate
Employment protection legislation (EPL)	Moderate/low	Low
Collective bargaining coverage	High	Low
Taxation and social contributions	High	Low

Source: Citi Research

'Flexicurity' and the 'Anglo-Saxon model' of labour markets tend to be associated with low unemployment.

The Anglo-Saxon model of the labour market, which prevails in Australia, the UK, and the US, and to some extent in Ireland, Japan, Switzerland, Canada, and New Zealand, puts more emphasis on incentives and features weak EPL, modest UBs and other social benefits. It also tends to feature weak trade unions and an emphasis on bargaining at the individual/firm level rather than the collective/ industry level. Taxation and social contributions are lower and the success of this model depends on creating effective incentives for job search and minimising

[6] See also "UK Economics Weekly - Grey Britain: Population Ageing and the Economy", Michael Saunders, February 2013, Citi Research

[7] There is a third, and more direct, labour market model for high employment: high state employment. For fiscal and efficiency reason we do not see this model as a plausible route for the regeneration of European labour markets and therefore ignore this option for the remainder of this study.

[8] See Torben Andersen and Michael Svarer, (2007), "Flexicurity – Labour Market Performance in Denmark," CESifo Working Paper Series 2108, CESifo Group Munich.

[9] ALMPs include job counselling and activation, training, employment incentives, subsidised employment, start-up incentives and direct job creation in the public sector.

rigidities that raise labour costs or impede flows in/out of employment. Most EA countries are somewhere in between these two models.[10]

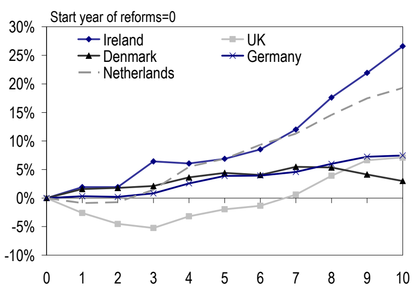
Precedents for successful labour market reforms in Europe in recent decades, include Ireland, the Netherlands, and the UK in the 1980s, Denmark in the 1990s, and Germany in the 2000s. These reforms were all implemented from a position of relative weakness of economic performance: Denmark, the Netherlands and the UK were among the countries with the lowest growth rates in the EU in the early 80s, Ireland had among the highest fiscal deficits and Germany was seen as the 'sick man of Europe' in 2000. Partly as a result of labour market reforms, inequality and poverty remained quite stable in these countries and most governments went on to win reelection.

Figure 7. Features of previous labour market reforms

	UK (1980s)	NL (1980s)	DK (1990s)	DE (2000s)	IR (1980s)
Labour costs					
Negotiated wage moderation		☑		☑	☑
Reduction in public sector payroll	☑	☑			☑
Reduction in the tax wedge	☑	☑	☑		☑
Reduction of generosity of UBs	☑	☑	☑	☑	☑
Labour Market Flexibility					
Deregulation of employment	☑	☑		☑	
Reduction in union power	☑		☑		
Reduction of minimum wage		☑			
Reduction of Employment protection	☑	☑			
ALMPs	☑	☑	☑	☑	☑
Education and training measures	☑		☑	☑	

Note: UBs stands for unemployment benefits. Source: Citi Research

Figure 8. Selected Countries – Employment Growth (Start Year of Reforms=0)



Note: Start year of reforms is 1987 in Ireland, 1980 in the UK, 1993 in Denmark, 2003 in Germany, 1982 in the Netherlands.

Source: IMFWEO and Citi Research

These reform examples shared a number of features. *All* of them involved a moderation in labour costs, achieved by a varying mix of negotiated wage moderation (through collective bargaining), less generous unemployment benefits, a lower 'tax wedge' (the sum of labour income tax and employer and employee social security contributions), and reductions in union power. Virtually all also included increased emphasis on ALMPs and education and training programmes, and in most, a reduction in the public payroll (Figure 7). Lower dismissal costs or easier dismissal rules only featured in some, but many of these countries had relatively low employment protection to begin with.

In terms of more recent outcomes, the labour market experiences of Germany and the UK are also instructive: In Germany, reductions in average working hours substituted for large movements in employment, while in the UK, wage flexibility contained the increase in unemployment. Many systematic studies also suggest that labour market reforms can raise GDP growth and lower unemployment, as least in the medium-term.[11] With regard to the euro area, Barkbu et al (2012) estimated that eliminating 50% of the gap between EA countries and OECD 'best practice' for labour market and pension policies could boost (real) EA GDP levels on average by 1½ pp after 5 years.

[10] It should be noted that even the US and UK feature some employment regulation. For instance, the US and now also the UK have national minimum wages and the UK is subject to the EU working-time directive.

[11] See e.g. IMF (2004), "Fostering structural reforms in industrial countries", Chapter III, World Economic Outlook, http://www.imf.org/external/pubs/ft/weo/2004/01/pdf/chapter3.pdf

…but conditions are not as benign in the EA today

Compared to previous reforms, EA periphery countries today suffer from a lack of social capital, lower skill levels in the workforce, and less fiscal space.

Compared to the countries that implemented successful labour market models and reforms discussed above, many EA countries are in a more difficult situation today.

Countries that successfully implemented flexicurity models tended to have relatively higher levels of social cohesion and skill in the labour force, and fiscal space to fund UBs and ALMPs. This applied not only to Denmark, but also to most other previous European labour market reformers. In addition to using some fiscal 'sweeteners', these reformers also had more flexible *product* markets, which probably reinforced the momentum for labour market reforms and their effects. They were also, at least for their size, very open economies. The external environment – while often challenging to begin with – quickly improved in previous reform examples, allowing export-based growth to resume relatively quickly (usually helped by nominal depreciations).

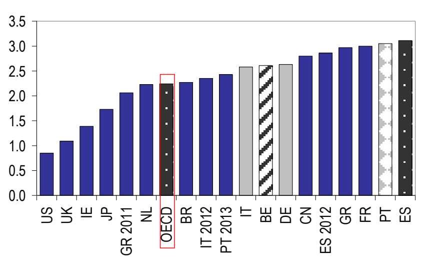
By contrast, in much of the EA periphery today, labour force skill, social capital and fiscal space are in short supply, all except Ireland are relatively closed economies and the external environment is more challenging. Despite the long-held ambition in the EU to move towards flexicurity, skill scarcity and lack of fiscal space also suggest that an Anglo-Saxon orientation of the labour market would seem more feasible for the EA countries, at least in the near-term.[12]

Substantial reform efforts have taken place…

There have been substantial labour market reforms in the EA, particularly in Greece, Ireland, and Spain.

There have been meaningful reforms of labour markets, benefit systems, and pensions in recent years in the EA, in particular in the periphery and often mandated by the troika programmes for Greece, Ireland and Portugal since 2010 and 2011.[13] In Greece, Portugal and Spain, severance pay has been reduced substantially, severance regulation eased somewhat, bargaining more decentralized and restrictions on the renegotiation of wages and non-wage terms of employment eased. Sizable cuts in public sector employment and wages, driven by fiscal consolidation motives, probably also helped to anchor modest wage expectations in the private sector.

Figure 9. Selected countries – Employment protection index, 2008



Source: OECD and Citi Research

Italy has taken less significant steps in the same areas, but faced somewhat less intense labour market rigidities to start with after a succession of minor reforms over the last two decades. Minimum wages/wage rules have been modified in Greece, France and Portugal, wage indexation has been suppressed in Belgium, Cyprus, Greece and Spain, and unemployment and other benefit systems reformed in roughly half of EA countries. Greece, Italy, Slovenia and Spain have also taken some steps to address the high level of labour market duality.

Virtually all EA countries have put in place some ALMPs to support job creation, particularly for the young and the low-skilled, and most EA countries have reviewed their education systems with a view to produce more employable school and university graduates and boost graduation rates. Finally, all EA countries have reformed their pension systems to some extent, generally based on fiscal considerations, but usefully also boosting the prospect of higher labour force participation in the face of adverse demographics. This is undoubtedly important with a medium– to long-term horizon, but probably has limited effects on labour costs or fiscal space in the present. Pension reforms have been most substantial in Greece, and Italy.

[12] See e.g. http://ec.europa.eu/social/main.jsp?catId=102&langId=en

[13] Ireland only introduced ALMPs and pension adjustments, but had a fairly flexible labour market even before the crisis.

More reforms are planned.

More reforms are probably on the way. Both Greece and Portugal have a number of labour market items left in the work schedule of their troika programmes. Spain has announced further reviews and reforms of labour markets, pensions and education still due in 2013. France is planning another pension reform to be approved by year-end, and Cyprus and Slovenia will probably raise the pace of reforms soon, as part of their troika programme and EC recommendations, respectively. Many EA countries are also planning to further reduce their public sector payroll.

Figure 10. Labour Market Reforms, 2008 – 2013

	AT	BE	CY	DE	EL	ES	FI	FR	IE	IT	NL	PT	SI
Labour costs													
Labour tax wedge	↗	↗		↙	↑↓	↑		↙	↗			↑	↑
Generosity of UBs		↓↗				↓	↗		↙	↑		↙	↑
Public sector payroll		↙			↓	↓			↓	↙		↓	↓
Flexibility													
Bargaining flexibility/efficiency					↑	↑		↗		↗		↑	
Minimum wage				↑	↓			↙				↙	↑
Wage indexation		↙	↙		↙	↙							
Employment protection													
Severance pay and notice periods		↙			↓	↓			↑	↙	↙	↓	↓
Severance regulations					↓	↓		↙		↙		↓	↓
Labour market duality					↓	↓		↙		↙			↓
ALMPs													
Subsidies	↑	↑		↑	↑	↑	↑	↑	↑	↑	↑	↑	↗↙
Training and PES	↑	↑		↑	↑	↑	↑	↑	↑	↑	↑	↑	
Education/Skills	↑	↗		↑	↗	↗		↑	↑	↗		↑↙	
Labour Force Participation													
Pension benefit reductions	↑	↑	↑	↑	↑	↑	↗	↗	↗	↑	↑	↑	↑
Female participation	↑			↑↓						↑	↗		↑
Immigration deregulation/integration	↗						↗						

Note: See the companion paper (Global Economics View - Taking Stock of Labour Market Rigidities and Reforms in the Euro Area) for detailed definitions and reform overviews. UBs are unemployment benefits and ALMPs are active labour market policies. Diagonal arrows suggest moderate measures upwards/downwards. Two arrows in the same box indicate that some reform efforts were increasing rigidities, while others lessened them.

Source: Citi Research

More generally, we are cautiously optimistic about the prospect for further labour market reform, even in the absence of troika pressure or financial market pressures, as high unemployment itself will put pressure on governments to act. The – admittedly thin – empirical evidence (see e.g. IMF (2004)) also suggests that structural reforms, including labour market reforms, are more likely in the aftermath of extended economic weakness and rising unemployment and come in clusters (across countries and to some extent in time).

…but plenty more remains to be done

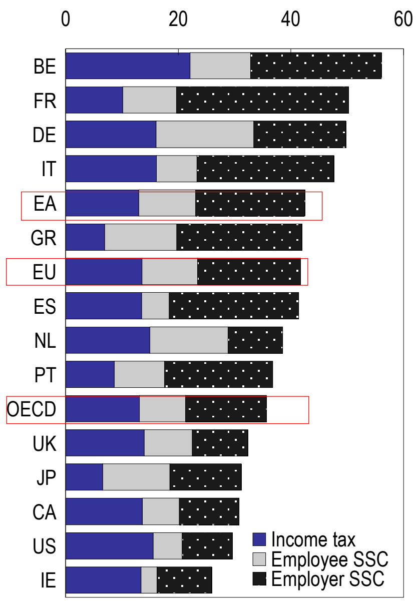
Labour market rigidity remains quite extensive in the EA, including high labour tax wedges, employment protections, bargaining restrictions, and labour market duality.

Even though progress has been achieved in deregulating euro area labour markets, plenty of work remains. Labour cost competitiveness has still only moderately improved (and non-wage labour costs remain very high), employment protection remains extensive (particularly in terms of the burden of regulation, including legal reviews and challenges leading to costly delays, rather than levels of severance pay and notice periods per se). Minimum wages are quite high, and labour market duality remains a major problem.

In many EA countries, there are still plenty of hurdles both to negotiating labour contracts with significant flexibility as regards compensation, hours and other terms of employment when the market environment and wider economic environment of the firm changes, or to the right to re-open and renegotiate employment contracts in response to enterprise-specific changes in economic circumstances. There remain far too many hurdles altogether to bargaining at the firm- or establishment level rather than at the industry- , sector- or economy-wide level, to bring pay, hours and

other terms of employment into line with productivity and other drivers of firm profitability. Wage indexation of some form is still quite common, but it only aggravates the rigidity of wages due to the restrictions on bargaining.

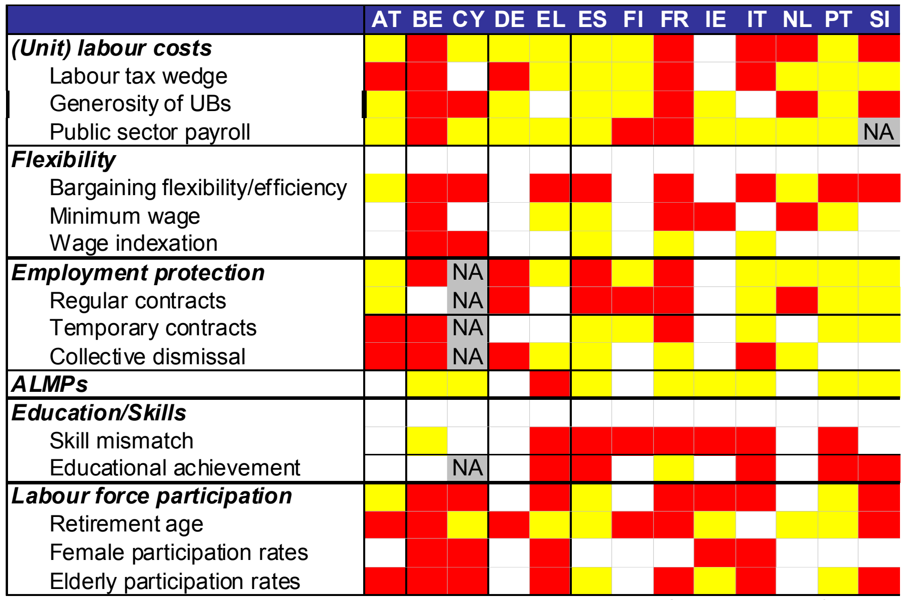
Figure 11. Selected Countries – Composition of Tax Wedge (% of labour costs), 2012



Note: For single individual without children at the income level of average worker. Includes payroll taxes where applicable. Data for Greece not available. SSC – social security contributions.

Source: OECD Taxing Wages (2013), and Citi Research

Figure 12. Labour market reform rigidities



Note: Red, yellow and white denote acute, medium or modest rigidities, respectively. Grey denotes lack of data. The colour coding is usually based on a range of indicators. For details and further discussion, see Global Economics View - Taking Stock of Labour Market Rigidities and Reforms in the Euro Area

Source: Citi Research

Skill mismatch and low average skill levels particularly in the EA periphery are key weaknesses…

…which are hard to remedy quickly and imply that extensive ALMPs are likely needed for a long time.

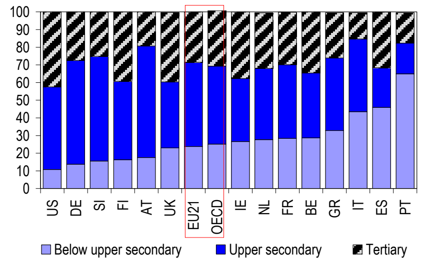
One of the major problems in many economically weak EA countries is that the mismatch between the skills available in the labour force and those appropriate to profitable employment is quite wide, and that the average skill level in the labour force is too low. For the bulk of the *stock* of workers, improving skill levels will be very difficult, except through extensive re-training. But the quality of school-leavers, i.e. the flow, is also relatively poor in some EA countries, due to low educational achievement, poor adaptation to changing labour market needs, and in some countries, low graduation rates. It is notable that employment of high-skilled workers in the EA since the crisis has actually continued to go *up*, rather than down.[14]

Low employability of parts of the workforce, particularly in EA periphery countries, and little hope of raising skill levels quickly probably mean that labour costs for these low-skilled workers have to fall substantially if they are to find sustainable employment in the private sector. A low-wage sector and probably extensive and long-lasting ALMPs may be necessary to get low-skilled workers back into jobs, but fiscally weak EA countries would struggle to pay for these ALMPs.

Even in the countries that have legislated quite substantial reforms to date, much remains to be done. In those countries, implementation of already-decided reforms remains a big concern, as is the involvement (and slow operation) of the courts in many aspects of the labour market. But a number of other EA countries are at best just beginning to reform, including Belgium, France and the Netherlands. It is in these countries that labour market rigidities are probably highest in the euro area today (Italy has also reformed little, and its labour market remains quite rigid). Labour market rigidities also remain substantial in the three countries with the lowest unemployment rates (Austria, Germany and Luxembourg).

[14] See ECB (2012), "Euro area labour markets and the crisis", Structural Issues Report, October 2012, http://www.ecb.europa.eu/pub/pdf/other/euroarealabourmarketsandthecrisis201210en.pdf

Figure 13. Selected Countries – Educational achievement (% of population), 2011

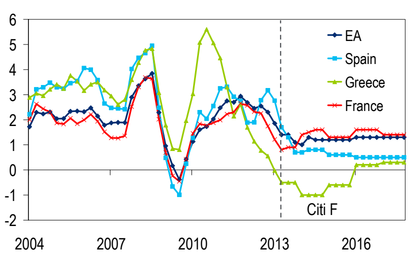


Source: OECD and Citi Research

Unit labour costs have fallen substantially in the EA periphery…

…but their significance is probably overplayed.

Figure 14. Selected countries – Exports of goods and services (2010 Q4=100)



Note: in euros at 2005 constant prices.

Source: Eurostat and Citi Research

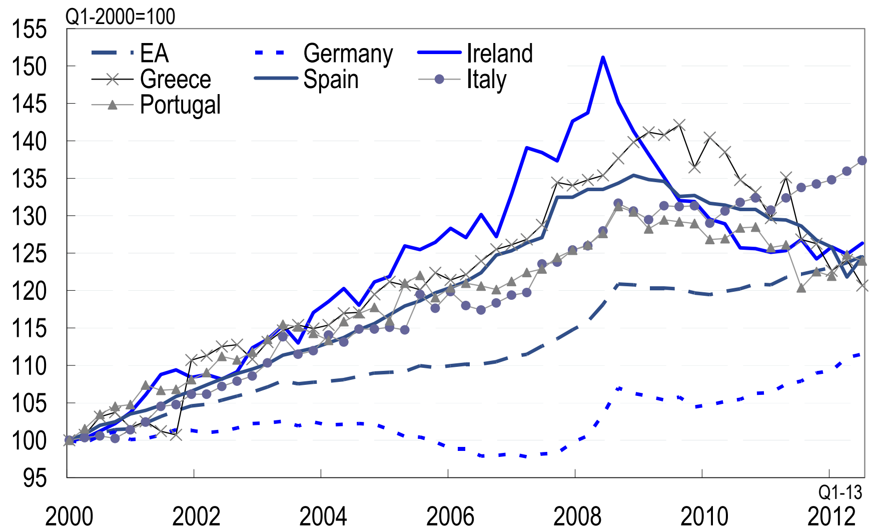
Labour force participation, particularly among women and the elderly, remains low in many EA countries, partly due to insufficient availability of childcare facilities and the design of tax and benefit systems. Finally, although jobs are scarce currently, especially in the periphery, EU member states benefit from free labour mobility across the EU. In addition, historical links to former colonies in South America and Africa create emigration opportunities for the mobile young in Portugal and Spain. Young Irish workers likewise are using emigration as an escape route from unemployment at home. Thus, in the periphery, emigration is moderating the increases in unemployment. But adverse demographics mean that in the medium-term, more workers will be needed, which may necessitate a greater tolerance for immigration as well as measures to boost LFP.

Unit labour costs have fallen in the EA periphery…

Unit labour costs (ULCs) – labour costs adjusted by average productivity per worker – have fallen substantially in many EA periphery countries. From the peak, ULCs in nominal terms have fallen by 18% in Ireland, 16% in Greece, 8% in Spain, and 7% in Portugal. In real (inflation-adjusted terms), the declines have been even larger. In all of these countries, (nominal) ULC *levels* are now below the EA average level and Germany's (Italy's nominal ULCs are on par with Germany's, but have remained relatively constant). However, ULCs have not adjusted in Belgium, France and the Netherlands, are still growing (or at best flat in real terms) and are above German or EA average levels. Improving competitiveness relative to Germany should not be the only, and maybe not the major, yardstick for EA periphery countries. But the reductions in ULCs in the periphery have also implied depreciations in these countries' real (effective or trade-weighted) exchange rates even though the euro's relative strength over the last 9 month has arrested these improvements.

The significance of ULC reductions can easily be overstated. A number of costs and impediments to production are not captured in ULCs, and these tend to aggravated by high uncertainty. ULCs used to be 10-30% below German levels in the EA periphery in 2000, and remain much higher relative to Germany currently. ULC reductions are also less meaningful in the presence of large rises in unemployment: under these circumstances, a plausible interpretation of ULC reductions is that (the export-oriented) part of the economy has shed its unproductive labour (which was overpaid relative to its productivity level when it was employed). The resulting recorded increase in average labour productivity may have little to do with an increase in the efficiency of labour usage: the average is up because the low productivity workers have moved into unemployment. The average productivity of the continuing employed plus the no-longer-employed may in fact have gone down. The major challenge remains of how to bring the unemployed (and presumably unproductive and uncompetitive) workers back into jobs without endangering that newly-found competitiveness.

Figure 15. Selected Countries – Relative Nominal Unit Labor Costs (2000=100), 2000 – 2013 Q1



Note: Nominal unit labor costs are calculated as the ratio of compensation per employed over productivity per employed. Compensation per employed is the ratio of compensation of employees and the number of employed persons (employment excluding the self-employment). Productivity per employed is the ratio of real GDP and employed persons.

Source: Eurostat and Citi Research

For the EA periphery, the truth is probably somewhere in between: on the one hand, labour costs (say, per hour of work) have fallen much less than unit labour costs (except in Greece), but on the other hand exports have grown (except in Greece), suggesting that at least some sector of the periphery economies have shaped up.

Labour market reforms alone won't restore growth in the EA

Labour market reform won't solve the EA crisis and create jobs quickly – for that demand growth is needed.

In our view, labour market reforms will help or in the medium-term even be necessary for the euro area to prosper. But in the near-term they won't be sufficient to create growth and jobs. For growth, a pickup in (effective) demand is needed.

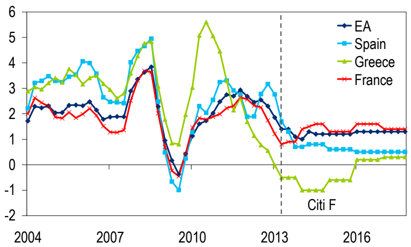
Fiscal austerity, excessive private debt and a weak banking system are more acute hurdles to growth than structural rigidities currently.

To the extent that reforms can boost private demand, say by awakening entrepreneurial, corporate and household animal spirits, *product market* reforms may well offer more promise than labour market reforms. Such reforms include opening closed professions, making it easier to open or operate businesses, improving the ability to collateralize land, property and other private possessions, and completing the single market for services in the EU. Thus, Barkbu et al (2012) noted that product market reforms have the potential to boost EA GDP by 2¼pp (if the distance to the frontier of OECD 'best practice' was halved), compared to 1½pp for labour market reforms, and that carrying out both product market and labour market reforms would potentially add another 0.6pp.[15] Product market reforms are also being pursued in many EA countries, but progress lags that made on the labour market side. Structural reforms also take time to show up in gains in output and employment. In fact, labour market reforms often *raise* unemployment in the short-term.[16] In the reform examples noted above, employment growth in some cases took years to gain sustainable momentum.

[15] See Barkbu et al (2012), "Fostering Growth in Europe Now", IMF Staff Discussion Papers, SDN/12/07

[16] See footnote 11.

Figure 16. Selected countries – CPI (%YY), 2004-2017F



Source: Eurostat and Citi Research

In our view, an excess of debt (public and private), a weak banking sector, continued fiscal austerity and substantial policy uncertainty (domestic and at the EA level) are larger impediments to growth currently than structural rigidities, particularly in the relatively closed EA economies. Consequently, debt reduction (public and private), a decisive restructuring of the banking sector and a reduction in policy uncertainty would likely boost demand much more in the EA in the near-term than structural reforms could.

Without debt reduction, a fiscal and/or monetary boost to aggregate demand and a reduction in policy uncertainty, the risk rises that structural reforms in fact make things *worse* in the near-term. Structural reforms often 'work' in the near-term by being deflationary or at least disinflationary, which would make it harder to repay outstanding debt. In principle this could be compensated by action from the central bank to counteract the disinflationary effect of the reforms, but there is a risk that the ECB will act too timidly. In addition, reforms often increase uncertainty in the minds of households and enterprises, and raise precautionary saving and/or reduce investment as a result.

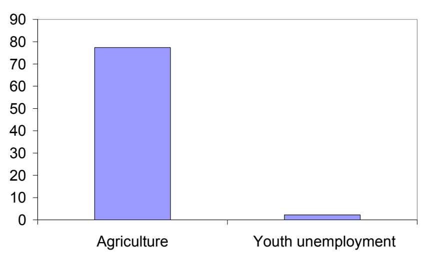
Some external help is available, but it is 'de minimis'

There are many bilateral and EU initiatives to fight unemployment and youth unemployment in particular, but the funds available are very small.

As we noted above, high structural unemployment and the poor prospect for many of the low-skilled unemployed in particular to find jobs mean that ALMPs and investment in education will have a major role to play to contain and eventually reduce joblessness. But many of the EA countries hit hard by unemployment have the least fiscal space. External help may be necessary.

There is certainly no shortage of initiatives. The latest EU Council had youth unemployment as its first agenda item and decided that measures tackling youth unemployment should be a focus for EU structural funds spending, e.g. by allowing unspent funds to be used on youth employment. It also decided to accelerate implementing the previously decided 'Youth Employment Package' and 'Youth Employment Initiative' (YEI), including encouraging and supporting countries to adopt a 'Youth Guarantee' (an offer of a job, education or training for young people within four months of leaving school or becoming unemployed) before the end of the year. In addition, the EU has promised to promote apprenticeships, traineeships and work-based learning through various initiatives, and further efforts to promote mobility both for workers and for students.

Figure 17. EU Budget – Spending on agriculture and youth unemployment (thd € per affected person), 2014-2020



Note: see footnote 19 for explanation.
Source: EC and Citi Research

There are also wider EU efforts to support employment (not just youth employment), such as those included in the 'Employment Package' (a range of recommendations to national governments, EU initiatives and some EU funds to support job creation presented by the European Commission in April 2012).[17] These are complemented by some bilateral initiatives in the areas of training and technical assistance.

These measures will surely be useful, but probably only at the margin. The financial amounts involved are 'de minimis'. Thus, the funds allocated to the YEI under the new EU budget for 2014-20 are a mere €8bn over seven years (funds are meant to be spent in 2014-5 already), less than 1% of the total 2014-20 EU budget and less than 0.1% of EA GDP in 2012.[18] For comparison, the new EU budget envisages

[17] For more detailed information, see http://www.bruegel.org/nc/blog/detail/article/1110-blogs-review-tackling-youth-unemployment/ and http://brusselsdiplomatic.com/2013/05/28/which-measures-takes-the-eu-to-tackle-unemployment/

[18] There is some confusion about the amount allocated for youth unemployment. The official council conclusions mention €6bn, while several statements by European Council President van Rompuy confirm that the funds were raised to €8bn. See also http://www.consilium.europa.eu/uedocs/cms_Data/docs/pressdata/en/ec/137702.pdf

spending more than 30 times on each farmer what will be spent on each unemployed youth.[19] And due to the recent attention that the topic of youth unemployment has received, there are proportionally more funds available to fight youth unemployment than unemployment more generally.

The €8bn figure understates the total amount of resources available to fight youth unemployment (or employment), as a number of other 'pots' of money are used at least in part to support employment (notably the European Social Fund and some of the funds left unspent in the EU budget) and the EIB is supposed to give preference to projects supporting employment prospects. But the conclusion remains that the scale of the external help available is very limited and unlikely to make a noticeable dent in the employment numbers.

An outlook: high unemployment to persist, and several risks to rise

History provides little reason to be optimistic about the prospects for euro area unemployment. For instance, in all recessions in Italy, Portugal and Spain since the 1970s, the earliest unemployment peaked was 5 quarters after real GDP growth turned positive and much later in some cases.

Unemployment is likely to stay high for a long time – above 10% in the EA even at the end of this decade, and twice that in Spain.

Unemployment in the EA may peak in 2014 (the EC is a little bit more optimistic, expecting the peak to probably come at some time this year already). But the point is not so much whether unemployment will peak in 2013, 2014 or 2015. Rather, the issue is that unemployment will likely stay high for a long time. Some simple calculations are quite instructive (and sobering). The evolution of unemployment is determined by the change in the 'output gap' (i.e. output growing faster than potential output) and the effect of falling output gaps on (un)employment. The latter is usually referred to as 'Okun's law', and is regularly estimated by researchers.[20]

Persistent high unemployment bears risks of skill degradation ('lost generation'), austerity fatigue and maybe even social unrest.

ECB (2012) estimates the Okun's law coefficient for the EA to be 0.3, meaning that a 1pp reduction in the output gap would lower the unemployment rate by 0.3pp.[21] The IMF also produces forecasts for the output gap which imply that the EA output gap would fall by roughly 0.5pp each year each year in 2015-2018.[22] If we put the two together, unemployment in the EA would only fall by less than 1pp *until the end of the decade*.

There is some reason to believe that this would probably be a little too pessimistic and that employment may react more strongly to output than historically – this is where the labour market reforms and more flexibility would presumably make a difference, and emigration could also help. In fact, the IMF's actual forecasts imply that unemployment would be *three times* as responsive to changes in the output gap. Although that implies that unemployment would fall faster if and when (above-potential) output growth resumes (the IMF thinks in 2014, we think it might be a year later), it still expects unemployment to be above 10% in the EA even in 2018. For Spain, the IMF expects unemployment to be more than twice as high (23%) in 2018.

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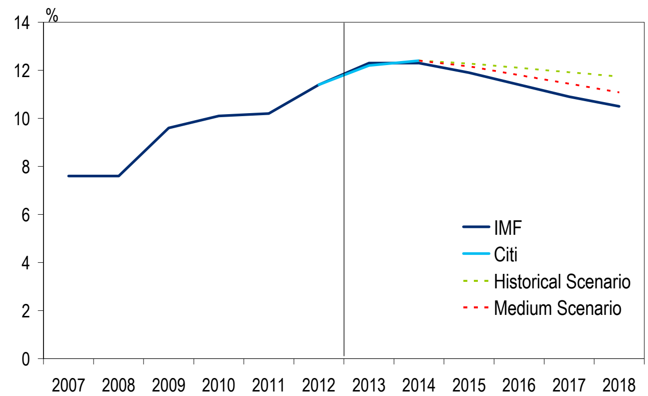
[19] The calculation is based on an assumption of a budgeted allocation for agriculture and rural development of €387bn for the 2014-2020 EU budget (see http://europa.eu/newsroom/highlights/multiannual-financial-framework-2014-2020/) and 5m employees in the EA in agriculture, forestry vs €8bn allocated to 3.6m unemployed under the age of 25.

[20] Formally, we think of the change in unemployment as given by the change in the output gap, multiplied by the output elasticity of (un)employment. Strictly speaking, of course both output and employment are jointly determined, so this is an illustrative shortcut rather than a structural relationship.

[21] See reference noted in footnote 14.

[22] See IMF (2012), "World economic outlook", International Monetary Fund

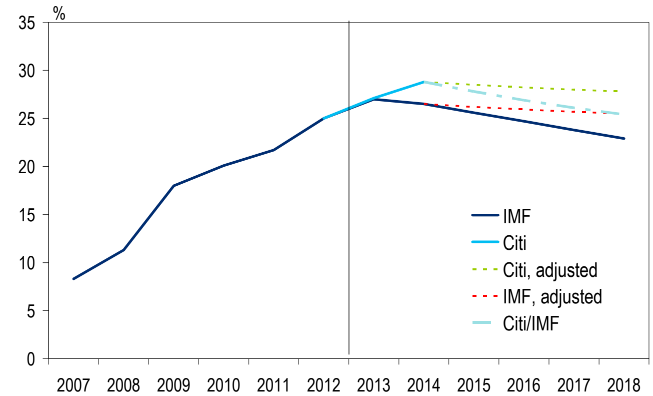
Figure 18. Euro area – Unemployment rate (%), 2005 - 2018F



Note: Citi forecasts until 2014. Both historical and medium scenarios use IMF output gap forecasts. Historical scenario uses an elasticity of the unemployment rate with respect to changes in the output gap of 0.3 based on estimates in ECB (2012), the medium scenario uses an elasticity of 0.6.

Source: IMF and Citi Research

Figure 19. Spain – Unemployment rate (%), 2005 - 2018F



Note: Citi forecasts are until 2014. Citi/IMF scenario uses estimated values for changes in the output gap (implying reductions in the output gap that range from 1pp in 2015 to 0.4 in 2020) and the output gap elasticity (at a value of 1) to match IMF unemployment forecasts. 'Citi, adjusted' and 'IMF, adjusted' use the same assumptions for the output gap, but an output gap elasticity of unemployment of 0.3.

Source: IMF and Citi Research

Austerity fatigue could easily evolve into debt service fatigue which raises the risk of some form of sovereign debt restructuring in highly indebted EA countries.

One risk is that reform efforts will run out of steam before EA economies have become competitive, so that even these forecasts would prove optimistic. An even more worrying risk is that continued high unemployment will raise the prospect of widespread social unrest. ILO (2012) noted that its 'social unrest index' had risen by more in the EU than in any other region since 2006/7.[23] Even if the more extreme reflections of public dissatisfaction are avoided, these factors will likely have a significant impact on political decisions and outcomes, and on growth prospects. 'Austerity fatigue' is often closely related to 'unemployment fatigue' and before long could become 'debt service fatigue', a risk we have been highlighting repeatedly in recent years.[24] These considerations all play a major role in our assessment that sovereign debt restructuring will be a material risk for a number of EA economies with high public debt.

[23] See reference noted in 1.

[24] See Global Economics View - The Euro Area Crises Are by No Means Over

Notes

Notes

Appendix A-1

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