4.3. LABOUR MARKET: SLACK OR TIGHT?

Although labour markets have not yet fully recovered, reports of labour shortages are starting to emerge. In the second quarter of this year, total employment in the EU remained about 2 million persons, or 1%, below its pre-crisis level. At the same time, fresher data on job vacancy rates in the EU reached and increased above pre-pandemic levels in some countries. As labour demand is expected to continue growing in line with economic activity, signs of tightening so early in the recovery could weigh on the current expansionary cycle.

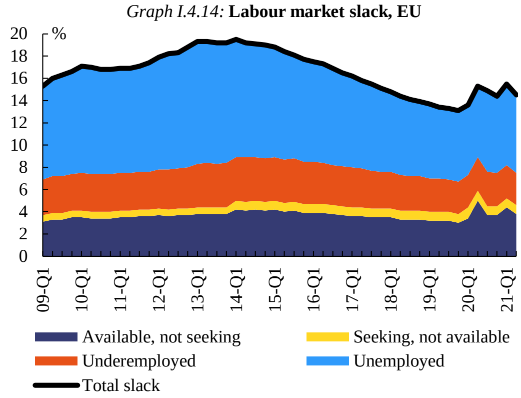
This Special Issue looks at the available evidence to assess the amount of slack in the labour market, and its potential implications for growth and inflation.

Labour market slack remained above pre-pandemic levels…

While hours worked contracted to a similar extent as value added during the crisis, the impact on headcount employment, though significant, was mild in comparison, partly due to the widespread use of job retention schemes that kept many employees attached to their jobs. As a result, the increase in unemployment remained significantly below what could be expected based on the historical relationship between GDP and unemployment ('Okun's law'). [56] At the same time, there was a significant increase in the number of people available to work but not seeking a job. [57] This can also partly explain why activity rates dropped, in contrast with the aftermath of the 2008 financial crisis. Eurostat's labour market slack indicator stood at 14.5% of the extended labour force in the EU in the second quarter of this year, down from its peak at around 16% in the previous quarter, but still above the pre-pandemic level of about 13% (see Graph I.4.14). [58]

In particular, the number of persons available to work but not seeking and unemployed remained relatively high. Developments in both groups have broadly followed the evolution of the pandemic: both saw an uptick in in the first quarter of this year after improvements at the end of 2020. [59] In the second quarter, a large number of persons that were available to work but not seeking in the first quarter returned to the labour force reducing the slack by 0.6 pps.. The decrease in the unemployment rate detracted another -0.2 pps. from the slack rate. Many workers who became jobless during the pandemic returned to work as the health situation improved. In particular, about 10.5 million people returned to the labour force from inactivity, 6 million of them as employed. On the other hand, nearly 9 million people left the labour force, more than 5 million were previously employed.

Graph I.4.14: **Labour market slack, EU**



Note: Seasonally adjusted data, reflects age group 15-74, and are expressed as % of the extended labour force.

Monthly unemployment figures show that the improvements of the labour market continued in the third quarter. In particular, the unemployment rate, at 6.8% in the EU in August, decreased by 0.5 pps. as compared to the second quarter average and was only marginally above its pre-pandemic level.

(56) European Commission (2020): Labour market and wage developments in Europe: Annual Review 2020. DG Employment, Social Affairs, and Inclusion. Available online at https://ec.europa.eu/social/main.jsp?langId=en&catId=791&furtherNews=yes&newsId=9873

(57) These people count as inactive according to the ILO definition.

(58) Eurostat's labour market slack indicator allows provides a broader definition of labour underutilisation than the unemployment rate. Besides the unemployed, it also includes the underemployed (persons in part-time jobs that would like to work more hours) and two categories of inactive individuals: those that are available for work but not seeking a job and those seeking a job but not available to work. The size of these groups is expressed as a percentage of the "extended labour force", which comprises the unemployed, the employed and the two categories of inactive individuals referred to above.

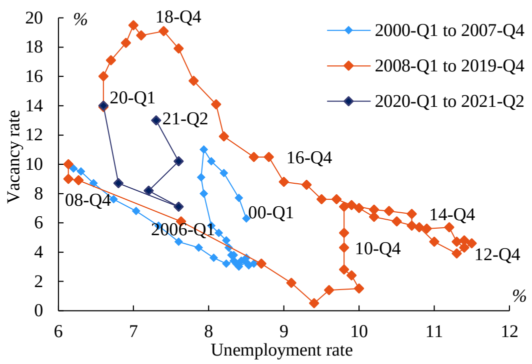
(59) A methodological change in labour market statistics is likely to have contributed to the uptick in the first quarter as some workers absent from their jobs for some time were counted as non-employed.

… amid rising labour demand, but no evidence of a deterioration of labour market matching…

The Beveridge curve, a negative empirical relation between vacancy and unemployment rates, provides an indication of the efficiency of matching of labour supply and demand. [60] Negative shocks to labour demand lead to a reduction in the number of vacancies and a higher unemployment rate. However, while vacancies generally react fast, it takes longer for unemployment to adjust. This is particularly evident during the COVID-19 recession (see Graph I.4.15). [61]

In the aftermath of the 2008 financial crisis, the Beveridge curve showed a clear 'outward shift', highlighting increased mismatch between supply and demand. Such pattern is not seen this time, as latest observations are still below the Beveridge curve observed between 2013 and 2018 (see Graph I.4.15). In the second quarter of 2021, vacancy rates, as well as indicators of labour shortages (at least in industry), were close to their pre-pandemic levels, but still below the peaks observed at similar levels of unemployment in 2018. Thus, there is not yet evidence that the efficiency of labour market matching has deteriorated as compared to the previous business cycle.

Graph I.4.15: **Beveridge curve, EU**



Note: To cover a long period, the share of manufacturing firms indicating labour as a factor limiting production proxied the vacancy rate.

(60) An upward shift in the Beveridge curve suggests a worsening of job matching efficiency.
(61) Vacancies in Graph I.4.2 are approximated by the share of managers reporting labour shortages as a factor limiting production in the manufacturing sector from the EU Business and Consumer Survey (see note to Graph I.4.2).

…or wage pressures so far.

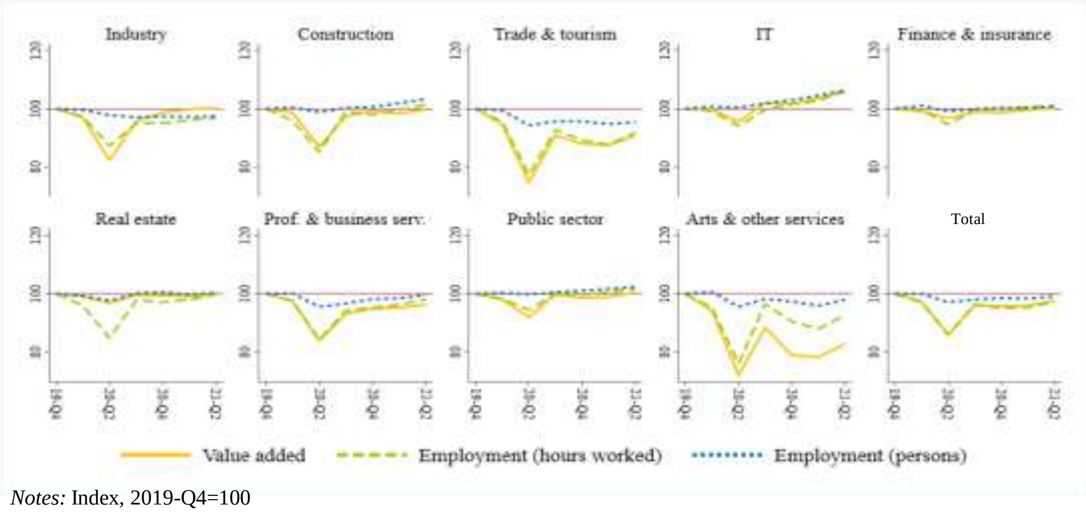
Furthermore, the index of negotiated wages does not indicate mounting pressures in the labour market. Data on negotiated wages [62] provide more accurate information on underlying wage developments during the pandemic. In contrast to other indicators, it is not biased by developments in hours worked and policy measures. [63] In the second quarter of this year, negotiated wages in the euro area grew at a rate below 2%, more moderately than in the period before the COVID-19 recession, at comparable rates of unemployment. The fact that there were no apparent wage pressures in the data by 2021-Q2 can be explained by the fact that wage setting tends to react with a lag to changing labour market conditions due to the staggered nature of wage contracts. In addition, the pandemic crisis may also have led to a reduction in the number of wage agreements being concluded, which may have kept some contractual wages unchanged.

Labour market conditions vary greatly across countries

With labour market slack ranging from under 5% of the extended labour force in the Czech Republic to over 25% in Spain in the second quarter, labour market conditions vary greatly across EU countries. Unemployment was higher than before the pandemic in most of the countries (see Graph I.4.16). However, vacancy rates returned to or surpassed pre-pandemic levels in a majority of countries. In particular, they were at pre-pandemic levels in four countries with increased unemployment in 2021-Q2 (ES, IE, HR, PT) while in ten countries both unemployment and vacancy rates in 2021-Q2 were higher than before the pandemic (AT, BE, CY, FI, IT, LT, NL, PL, SI, SE).

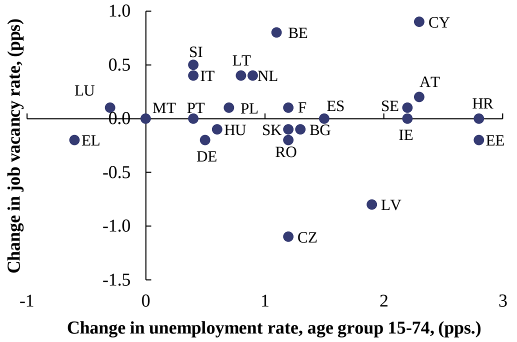
(62) SDW, European Central Bank
(63) The index of negotiated wages has also some caveats, including methodology harmonisation and coverage across countries.

Graph I.4.16: **Employment and gross value added evolution**



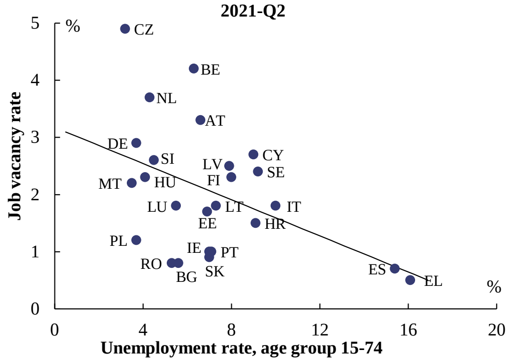
Notes: Index, 2019-Q4=100

Graph I.4.17: **Vacancies and unemployment, change between 2019-Q4 and 2021-Q2**



Notes: Vacancy rates cover sectors NACE B-S. Seasonally adjusted data. No data are for FR, DK. For IE, the vacancy rate for 21-Q1 was used.

Graph I.4.18: **Vacancies and unemployment rate, 2021-Q2**



Note: Vacancy rates cover sectors NACE B-S. Seasonally adjusted data. No vacancy data are avaialble for FR and DK.

There is also a negative relationship between unemployment (slack) and vacancy rates (see Graph I.4.17). Based on these indicators, labour markets in countries such as Czechia and the Netherlands appear tight (with low unemployment and a high vacancy rate),[64] while labour markets in countries such as Greece and Spain seem slack (with high unemployment and a low vacancy rate).

COVID-19 has had differentiated impact on employment across sectors

The COVID-19 crisis has had diverse impacts across sectors. By the second quarter of 2021, employment had recovered in the IT sector, the public sector, finance and real estate, and for construction and professional and business services. It remained subdued in trade and tourism (NACE sectors G-I, -4%) and arts and entertainment and other service activities (NACE sectors R-U, -3%), and it is also somewhat below pre-pandemic levels in industry (see Graph I.4.16).

Sectoral developments show clear heterogeneity across countries. Industrial employment has returned to previous levels (or remained stable) in more than half of the Member States. At the same time, in some countries, both industrial production and employment remain below pre-pandemic levels (BG, CZ, DE, ES, FR, RO). In contrast to industry, there are only a few Member States in

(64) Labour market slack appears somewhat larger in the Netherlands on account of the comparatively large share of "underemployed", part-time workers who would like to work more hours.

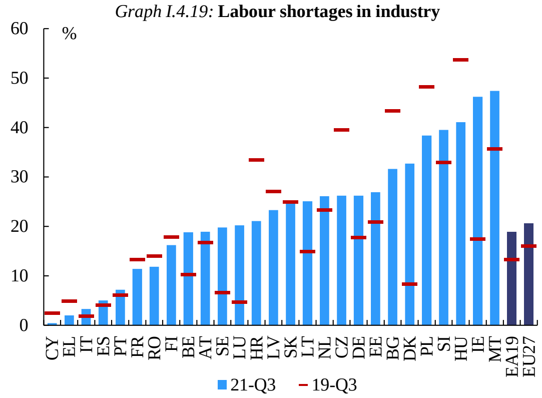
which output or employment have fully recovered in trade and hospitality. Output in trade, transport, food and accommodation services remains below pre-pandemic levels in almost all Member States. A full recovery in services employment can be observed only in a few Member States (including Lithuania, Romania and Slovakia).

Indicators of labour market shortages also vary considerably across sectors

Reported labour shortages in the Commission surveys also reveal pronounced sectoral differences. Labour market shortages reported by employers have increased in particular in industry in recent months, and are in the EU average above the pre-pandemic level, while this is not the case in services (see Graphs I.4.19, I.4.20 and I.4.21). After an initial drop in the first half of 2020, reported shortages started to rise again in 2020-Q4 and have shown dynamic increases in almost all countries in the third quarter of 2021 after more modest increases in the previous quarter. [65] In industry, the proportion of firms reporting that labour is a factor constraining their production was higher in 2021-Q3 than before the pandemic in about half of the Member States as well as in the EU average. At the same time, reported shortages in industry were below their pre-pandemic level in some Central and Eastern European Member States (including BG, CZ, HR, HU, PL), most of which had a high level of reported shortages pre-pandemic. By contrast, reported labour shortages in services in the third quarter 2021 were below pre-pandemic levels in most countries as well as the EU average. Higher labour shortages were recorded in Belgium, Denmark, Ireland and Malta. Finally, in construction, labour shortages have by now returned to their pre-pandemic level in the EU and the euro area.

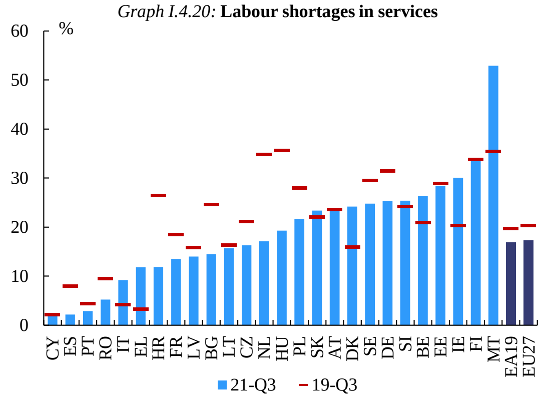
[65] As reported shortages are a survey-based indicator, it is available earlier than labour market statistics.

Graph I.4.19: **Labour shortages in industry**



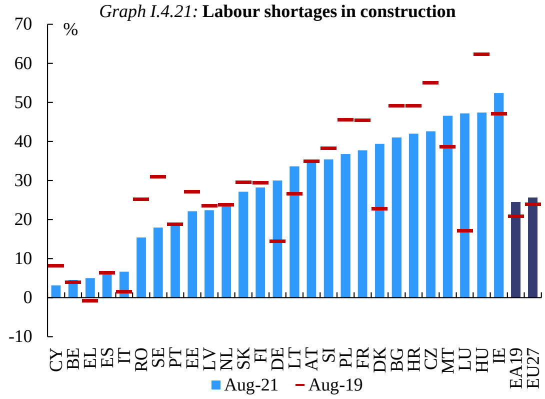
Notes: The data show the proportion of firms reporting that labour is a factor limiting their production.

Graph I.4.20: **Labour shortages in services**



Notes: The data show the proportion of firms reporting that labour is a factor limiting their production.

Graph I.4.21: **Labour shortages in construction**



Notes: The data show the proportion of firms reporting that labour is a factor limiting their production.

Sectoral mismatches could be on the rise

By the second quarter of 2021, long-term unemployment significantly increased among people previously working in sectors most affected by containment measures. Some of the workers laid off in hospitality and other affected activities may return to employment as their sectors reopen. Other sectors such as corporate travel may not return to pre-crisis activity rates, but workers are likely to find work in growing service sectors demanding similar skills profiles. In a third group of activities, for instance in manufacturing, the pandemic may have reinforced and accelerated structural shifts away from routine-intensive jobs. While employment losses in manufacturing were much more muted in this crisis than after 2008, some of the job losses in routine-intensive occupations may prove persistent, based on the experience of previous recessions.

Conclusions and outlook

There are a number of possible explanations for the apparent coexistence of labour market slack and growing labour shortages.

– First, vacancy rates typically respond faster than unemployment rates over the business cycle, as filling open positions takes time.

– Second, while containment measures and policy support have helped to weather the health and economic crisis, they may have also temporarily reduced the incentives to search for a job, resulting in higher vacancy rates.

– Third, with restrictions easing and economic activity strongly rebounding, labour demand is swiftly growing while the labour force is less reactive than usual. In particular, health risk concerns may keep some people from returning to work, while labour mobility, both within countries and across borders, may have been hampered.

– Fourth, structural labour market mismatch might be on the rise, linked to the sectoral reallocation of labour and an acceleration of changes in the relative skills demand triggered by the COVID-19 shock. The assessment of this hypothesis will require tracking the future evolution of Beveridge curves and other mismatch indicators.

Developments in labour market slack and shortages will also depend on the strength of the recovery and the future course of policy support. New data and information on the labour market will help assess the relative importance of these explanations.

In the near term, managers expect labour demand to continue growing, according to the Commission's Employment Expectations Index. Also, the Indeed job posting indicator [66] shows an increasing trend throughout the third quarter and at the beginning of the fourth for Germany and France albeit at slowing growth rates. As economic conditions are promptly improving, it is reasonable to expect the remaining pandemic-induced slack to be re-absorbed into the labour market as suggested by the developments in the second quarter.

Policy support continues to affect labour markets. An estimated 2.7% of the euro area workforce benefited from short-time work schemes in July 2021, against an average of 6.2% in the first five months of the year. [67] These figures indicate that the upper bound of possible job losses associated with the future withdrawal of job retention schemes remains sizeable but is shrinking over time. As the gradual exit of these workers from short-time work schemes is expected to continue in a context of strong economic growth, the number of possible layoffs is expected to be moderate. This view is supported by the experience of the recent period: despite the ongoing withdrawal of short-time work schemes over recent months, the latest monthly unemployment data show a declining trend in joblessness in most EU Member States.

[66] Daily job posting data from the Indeed platform provides a timely indicator of labour demand, though the representativeness of the sample is likely to be skewed towards white-collar jobs.

[67] ECB, Economic Bulletin, Issue 6, 2021