Europe

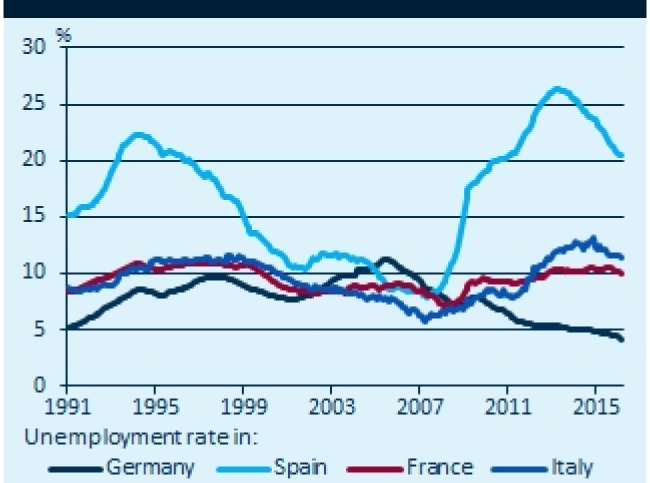
We can work it out

The Eurozone labour market has gone from strength to strength as the recovery has progressed. The unemployment rate for the region sits at 10.2%, the lowest level since April 2011. **This is still above the OECD's estimate of the equilibrium unemployment rate in the Eurozone (9.4%), although this gap has narrowed as spare capacity in the labour market has been eroded**. The theory goes that a move below the natural rate of unemployment should lead to an increase in inflation, something that has been missing in much of the developed world. However, there are a number of caveats to this view. Firstly, estimating the NAIRU is notoriously difficult so we cannot be sure that the OECD's estimate is correct. Furthermore, while labour market figures might be going in the right direction, how long might it take for this to feed through to inflation? The strength of the relationship between unemployment, wage inflation and inflation expectations depends on the shape of the Philips curve, which has flattened in recent years according to a range of empirical investigations.

Drilling down, Germany stands out for its extremely low unemployment rate, sitting at a post-unification low of 4.2% (see Chart 6). Reforms to the labour market in the early 2000s, known as the Hartz reforms, have been very successful in bringing down unemployment by making it easier to hire and fire workers, improving the training and matching efficiency of job searchers, and cutting the size and duration of unemployment benefits. However, in terms of setting a standard for other countries, these reforms can be unpopular among voters given their effect on wages and job security for the employed and welfare for the unemployed. The tightening German labour market has yet to trigger a strong acceleration in wages. This has led to industrial action by dissatisfied workers across a number of industries in 2015 and into 2016. The latest major strike, organised by airport workers in major city airports across Germany at the end of April, led to hundreds of flight cancellations.

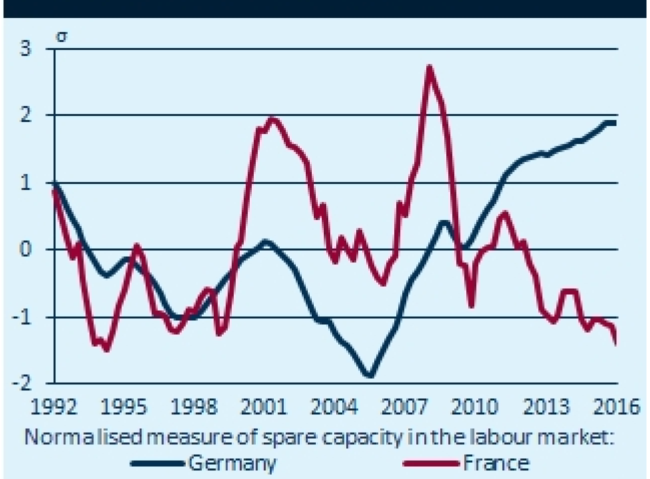
While unemployment rates in Germany, France, Spain and Italy have all fallen, the spare capacity remaining in each of these markets varies significantly. Our research finds that the German labour market gap, a normalised measure of spare capacity in the labour market, has closed, with unemployment actually now well below most NAIRU estimates. Meanwhile, France has made little progress in eliminating spare capacity (see Chart 7). While Italy currently has the largest labour market gap, the direction of travel has been positive since the beginning of 2015; a promising reflection on the reforms embarked upon by the Renzi government. Comparatively, France has been on a downward trend for the same period. This weakness gives context to the action taken by President Hollande last week when he pushed through labour market reforms by executive order, sparking protests across France. Finally, the Spanish case may come as a surprise to some; it has the highest unemployment rate of the four countries at 21% but has eroded a significant level of spare capacity since mid-2013, such that it has almost closed its labour market gap. This suggests that the recovery in the labour market has been predominately cyclical. Structural unemployment has pushed the NAIRU higher in post-crisis Spain, to an estimated 18.5% compared with 13.7% in 2006.

Chart 6: German at record lows...



Source: Eurostat (as of March 2016)

Chart 7: ... and running above capacity



Source: Eurostat, Haver, Standard Life Investments (as of Q1 2016)