4.2. CAN THE EU LABOUR MARKET WITHSTAND A SLOWDOWN IN ECONOMIC ACTIVITY?

This special topic tries to assess whether the EU labour market is likely to withstand the projected economic recession and subsequent mild expansion, with analysis largely relying on data from the European Commission Business and Consumer Surveys (BCS).

The EU labour market bounced back strongly from the pandemic shock. At the onset of the COVID-19 crisis, job retention schemes shielded workers and their incomes from a pronounced slump. Against the backdrop of the contraction of real GDP of almost 14% in the EU in the first half of 2020 compared to the last quarter of 2019, headcount employment decreased by a mere 3%, though hours worked fell by a massive 15%. With the (intermittent) economic recovery starting in the third quarter of 2020, headcount employment also started to rise again and increased in all but one quarters until the second quarter of this year. By then, both headcount employment and hours worked in the EU had surpassed their pre-pandemic levels, by 1.7% and 1%, respectively. By historical standards, this was a period of very job-rich growth. The mirror image of these dynamics is that productivity performed fairly poorly, even if it did recover its pre-pandemic level.

Employment and demand expectations moved in lockstep in the past two decades. BCS data show that managers’ employment expectations tend to closely follow demand expectations in services and industry\(^{(52)}\) (see Graph I.4.5-I.4.6). This relationship held even after the pandemic crisis broke out.\(^{(53)}\)

\(^{(52)}\) The sectors of services and industry are covered in this analysis as the surveys in the construction and retail sectors do not cover expectations for demand.\(^{(53)}\) Throughout this analysis, employment expectations in services refer to the balance of responses to question 5 (“How do you expect your firm’s total employment to change over the next 3 months?”) of the Joint Harmonised EU Services Survey. Demand expectations in services refer to the balance of answers to question 3 (“How do you expect the demand (turnover) for your company’s services to change over the next 3 months?”) of the same survey. In industry, question 7 (“How do you expect your firm’s total employment to change over the next 3 months?”) of the Joint Harmonised EU Industry Survey is the corresponding question for employment expectations while question 5 (“How do you expect your production to develop over the next 3 months?”) is used to proxy demand expectations.
Disaggregated data show that employment expectations decoupled from demand expectations in a number of industrial subsectors. While demand expectations fell in nearly all subsectors between mid-2021 and autumn 2022, expectations for employment did not fall in nearly half of surveyed subsectors. The group of resilient subsectors appears considerably diverse in their major business activity (in green in Graph I.4.8). The fall in the aggregate measure of demand and employment expectations over this period is mainly driven by energy-intensive subsectors (in red in Graph I.4.8).\(^{(54)}\)

The strength of labour demand in the services sector appears more widespread than in industry. Similarly to industry, managers in almost all surveyed subsectors expected a worsening in demand conditions between mid-2021 and Autumn 2022. By contrast, a markedly lower share of managers across subsectors expected a decline in employment expectations or only a very mild contraction. The trend line is flatter, and dispersion is greater (Graph I.4.9). In particular, a contact-intensive subsector ‘travel agency, tour operator and other reservation service and related activities’ (79), remains considerably upbeat in expectations about employment amid markedly worsening outlook for demand.\(^{(56)}\) By contrast, contact-intensive sectors of ‘food and beverage service activities’ (50), ‘accommodation’ (55), ‘food service activities’ (56)\(^{(57)}\) are among the most impacted in terms of expected developments in employment expectations relative to demand expectations in their firm.

The decoupling of employment expectations from demand expectations emerged as labour shortages increasingly became a hurdle to production. Evidence of unmet demand for labour arose with economic

\(^{(54)}\) 11 - Manufacture of beverages, 14 - Manufacture of wearing apparel, 15 - Manufacture of leather and related products, 18 - Printing and reproduction of recorded media, 19 - Manufacture of coke and refined petroleum products

\(^{(55)}\) 16 - Manufacture of wood and of products of wood and cork, except furniture; manufacture of articles of straw and plaiting materials, 17 - Manufacture of paper and paper products, 22 - Manufacture of rubber and plastic products

\(^{(56)}\) 69 - Legal and accounting activities, 80 - Security and investigation activities, 82 - Office administrative, office support and other business support activities, also contribute markedly to strong labour demand in services.

\(^{(57)}\) Along with 59 - Motion picture, video and television programme production, sound recording and music publishing activities, 60 - Programming and broadcasting activities, 63 - Information service activities, 81 - Services to buildings and landscape activities.
activity picking up from the pandemic lows, but according to BCS data, the share of managers reporting labour as a factor limiting production in their firms increased sharply in mid-2021 (see Graph I.4.10). Reported labour shortages in industry peaked in April 2022 and eased only mildly in the second half of 2022. In services, the peak was reached in July 2022. In parallel, vacancy rates reported by Eurostat, progressively picked up to a multi-year high in the second quarter of 2022.

The cushioning effect of labour shortages depends crucially on the matching efficiency of the labour market. A high degree of labour shortages can be compatible with either an overall tight labour market or a low degree of matching efficiency in the labour market. Though relatively stable in the short term, the Beveridge curve, see Graph I.4.11,[58] can shift in time due to structural changes in the economy. In particular, a worsening matching efficiency in the labour market, due to, e.g. skills mismatch or constrained mobility, shifts the Beveridge curve outward, meaning that the same level of vacancies or labour shortages go hand in hand with a higher unemployment rate. The trade-off implicit in the Beveridge curve, however, may not be linear: the steepness of the curve may increase at low rates of unemployment, as an additional job vacancy may not be filled as quickly as when there is a large pool of job seekers compared to vacancies.

Re-absorption of labour shortages could partly shield the labour market from the impact of slowing economic activity. Amid a tightening labour market, the unemployment rate in the EU has stabilised at record-low levels so far this year, falling from 6.3% in January to 6% in September. As employment expectations are gradually falling, the high share of labour shortages may decline before unemployment rates start increasing.

Labour shortages can act as a buffer to an increase in unemployment in the face of an economic slowdown. Estimates of the relationship between unemployment and economic growth (Okun’s law), augmented by labour shortages on a panel of EU countries over the 20 years before the pandemic, suggest that labour shortages play a statistically significant - though rather weak - role in reducing the transmission of a fall in GDP to unemployment.[59]

With unchanged matching efficiency, the labour market is set to remain resilient throughout the slowdown. In this case, a slowdown in demand produces a relatively mild increase in the unemployment rate in its initial phase, as the vacancy rates (or the degree of labour shortages) decrease before unemployment starts to rise. In Graph I.4.11,

GDP growth further decreases the impact of labour shortages. For further details, see Hüfner and Klein (2012), “The German labour market: Preparing for the future”, OECD WP No. 983.

[58] A 1-point increase in labour shortages in manufacturing decreases the unemployment rate by less than 0.01 pps. in the benchmark specification with no lags of the unemployment rates and GDP growth. The addition of the lags of the unemployment rate and

[59] The relationship between unmet demand for labour – vacancy rates or labour shortages – and unemployment rates. In Graph I.4.11, the indicator of labour shortages is defined as a weighted average (based on value-added weights) of sectoral indicators of labour shortages in manufacturing, services and construction.
this situation is represented by the green line, suggesting a roughly stable Beveridge curve.\(^\text{60}\)

**Otherwise, the EU economy could suffer a larger increase in the unemployment rate.** Job shedding in sectors most affected by the energy crisis, and a low ability of the labour market to match the affected workers with existing vacancies would suggest a deterioration in matching efficiency. In Graph I.4.11, the EU labour market would move along the dark blue line.

**The possibility of a ‘soft landing’ for the labour market has also received attention in the US, as economists try to assess the potential impact of monetary policy tightening.** As US economic activity has softened and its labour market remains very tight, a hotly debated question is whether there can be a “soft landing” for the labour market, i.e., whether job vacancies can fall from their historical highs without a substantial rise in unemployment. Blanchard et al (2022)\(^\text{61}\) argue that the current low unemployment rate and the very high vacancy-to-unemployment ratio suggest that not only is the labour market overheated but also that labour market matching has worsened, reflecting higher labour reallocation and lower matching efficiency, in the wake of the massive dislocations produced by the pandemic on the labour market. Counter-arguments to this conclusion claim that a soft landing is indeed possible, under two conditions. The first condition is likely to be met: in the current tight labour market, a fall in the vacancy rate would finding a job than would be the case if vacancies started out from lower levels, closer to historical averages. The second condition is that the economic slowdown is mild, associated with only a limited increase in job separations.\(^\text{62}\) In recent months, the US economy seems to corroborate the soft-landing hypothesis, as recent data show a sharp decline in job vacancies and little change in unemployment.\(^\text{63}\)

**In the EU, there is no evidence of deterioration in the efficiency of labour market matching.** The evidence suggests that the increase in labour shortages is largely linked to the sharp increase in labour demand in the aftermath of COVID-19, with no significant increase in mismatch. Labour market mismatch (along skills, sectors and regions) was not a significant contributor to unemployment during the pandemic period. The pandemic shock was exogenous and largely temporary, though with differentiated impact across sectors. Any increase in mismatch was also partly temporary and much smaller in magnitude than after 2008.\(^\text{64}\) Finally, and perhaps most importantly, at the current juncture labour shortages appear to be broad-based, widespread across many subsectors rather than concentrated in a few segments of the labour market. The available evidence suggests that the approaching slowdown in demand is likely to ease some of the existing labour shortages before markedly affecting unemployment. Over the medium term, the resilience of the labour market also depends on additional economic shocks, affecting the length and depth of the economic downturn as well as the policy response.

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\(^{60}\) Labour market resilience at the beginning of the downturn would also be consistent with a counter-clockwise cycle in the Beveridge space, as vacancies (or shortages) react faster to cyclical changes than unemployment.


