AKTUELLER KOMMENTAR 27/7/2017

Thank God there is labor market slack!

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- According to the ECB's estimates the labor market slack in the euro area is much higher (18%) than the official unemployment rate would suggest (9.5%). As a result, wages are supposed to stall for longer and with them consumer price inflation.

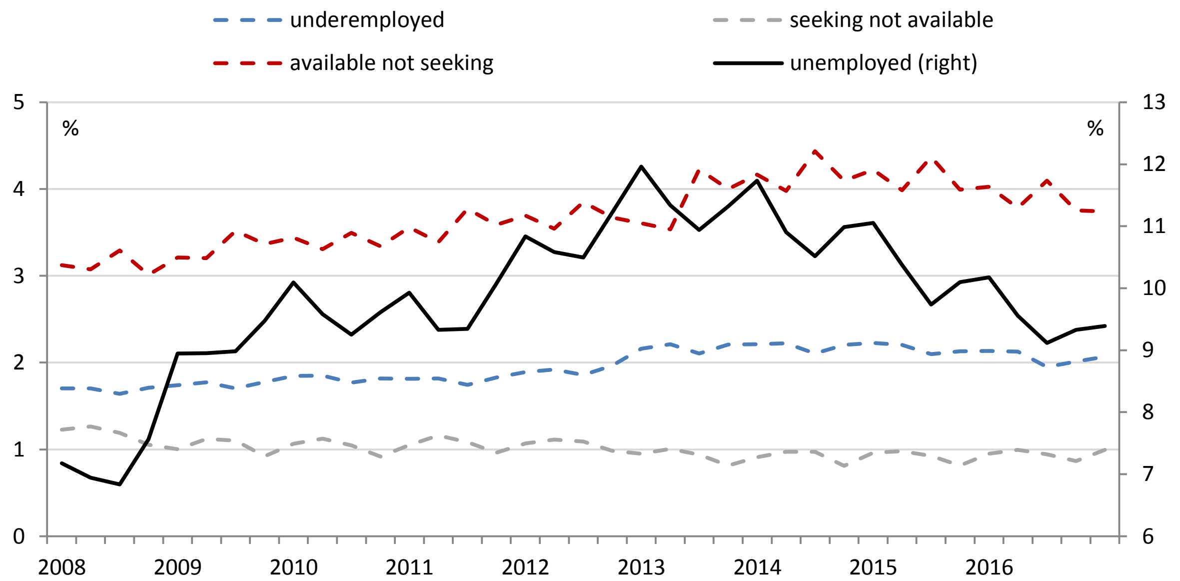
- Although it is difficult to say a priori what exactly the slack is, the ECB's estimates are most probably overestimated, as they mix both cyclical and structural factors.

In the Economic Bulletin from May 2017, the ECB defines the labor market slack as the sum of the official unemployment, underemployment, those available but not seeking work and seeking work but not available, expressed as a percentage of the extended labor force. Accordingly, the current labor market slack is estimated at 18%, almost double the rate of official unemployment. After deduction of "the very long-term unemployed and allowing for the time that the underemployed spend working", labor market slack would amount to 15%.

This labor market accounting exercise comes just in time to relieve the ECB's distress of explaining why wage growth and inflation are so persistently low. Although apparently appealing at first sight, this explanation however suffers from at least one crucial failure. When looking at details behind the slack calculations it becomes clear that most of its components are structurally rather than cyclically driven. Consequently, the cyclical shape of the headline slack – as shown by the ECB – is primarily driven by official unemployment.

This is shown in Figure 1 which breaks the labor market slack down into its four components. Whereas official unemployment started decreasing in mid-2013 after reaching its peak of 12% in the first quarter of 2013, all the other components continued to move sideward almost on or even slightly above their pre-crisis levels. This conclusion is broadly confirmed across different layers of the working-age population, as shown in Figure 2 for the prime-age individuals, and in Figure 3 for women.

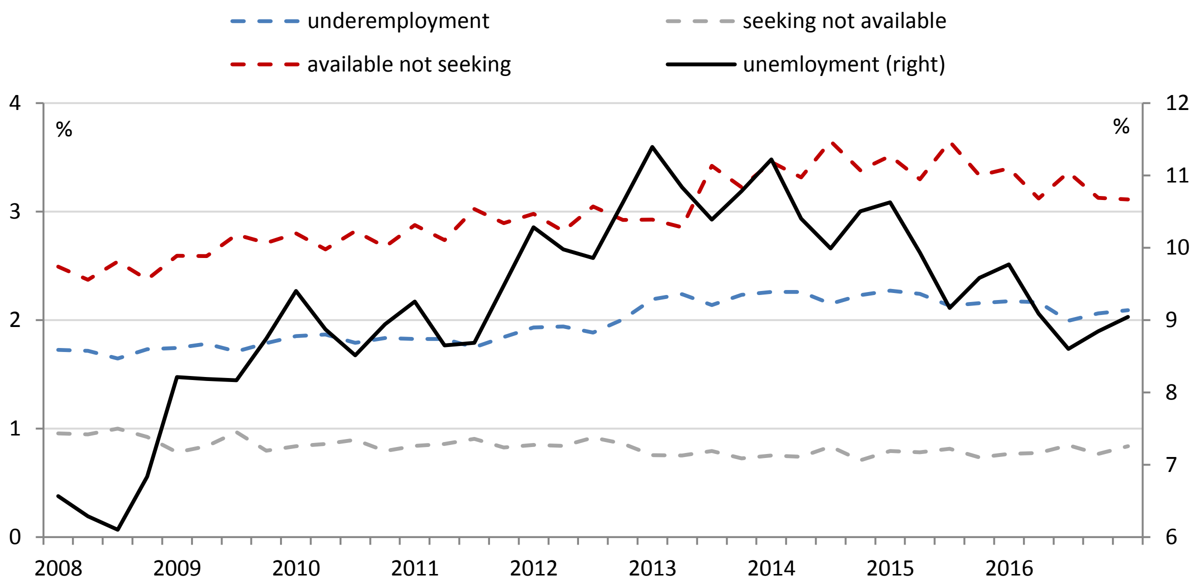
Figure 1. Labor market slack and its components for population aged 15-74



Note: Unemployed refer to individuals who are actively seeking work for less than two weeks. Underemployed are employed part-time for economic reasons. The latter is adjusted for the fact that around half of the time is already spent at work. All components are expressed as percentages of the extended labor force (official active population plus the two categories of potential additional labor force, namely, available but not seeking and seeking but not available).

Source: Eurostat and own calculations (Flossbach von Storch Research Institute)

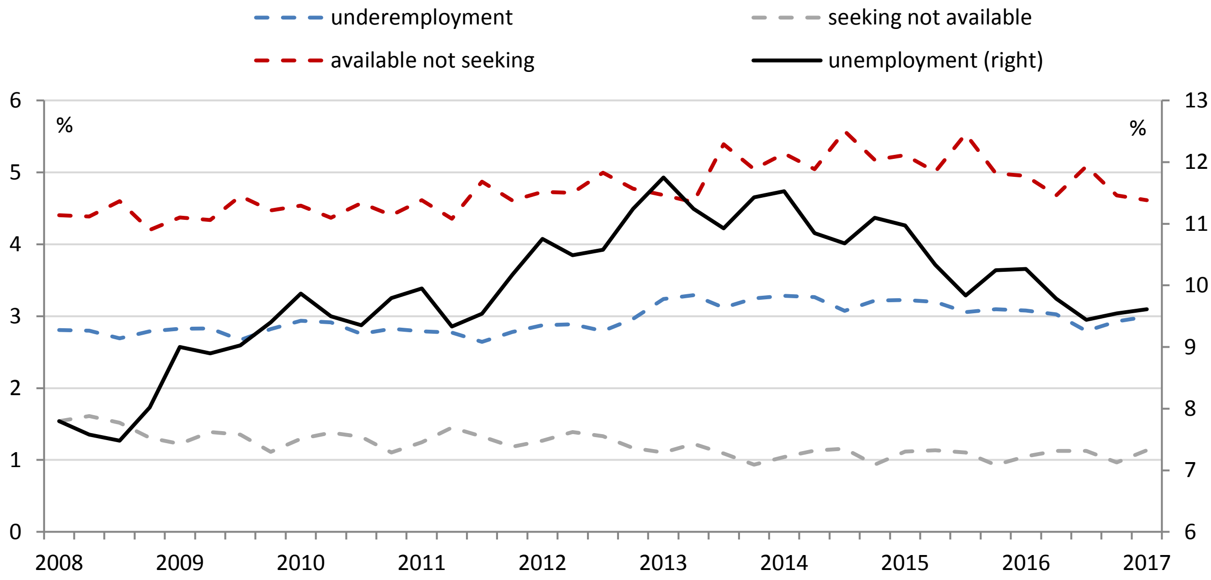
Figure 2. Labor market slack and its components for population aged 25-54



Note: same as for Figure 1

Source: Eurostat and own calculations (Flossbach von Storch Research Institute)

Figure 3. Labor market slack and its components for women aged 15-74



Note: same as for Figure 1

Source: Eurostat and own calculations (Flossbach von Storch Research Institute)

So what about low inflation? Over the short- to mid-term wage growth and thus inflation could remain subdued. This is most probably less so due to the alleged labor market slack, but rather to structural supply-side forces outside of the labor market, which are unlikely to dissipate soon.

Over the longer term it cannot be excluded that official unemployment will go down to or below the pre-crisis levels and wage-growth pressure arises. However, given the ECB's new focus on the extended unemployment, this might take it by surprise and put it suddenly far behind the curve.

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