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GLOBAL ECONOMIC RESEARCH

EUROPEAN ECONOMIC PERSPECTIVES

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European Economic Perspectives

Euro-Area Employment Outlook

Recent euro-area data have been more encouraging, pointing to a modest recovery in second-half growth. However, a return to sustainable growth will require a durable improvement in the labour market. That is likely to be a gradual process.

On the surface, Europe's recent job-creation record does not look bad. European Central Bank (ECB) data show that euro-area employment rose by 0.2% in the first quarter of 2005, putting it 1.0% higher than a year earlier. This is the highest annual growth rate since 2001 **(Display 1)**.

However, there are several unsatisfactory aspects of this performance. First, and most obviously, rising employment has not been sufficient to reduce the unemployment rate. This remains stuck at just below 9%. In addition, the employment data in a number of countries have been distorted by job-creation schemes. In Germany, for example, many of the 196,000 jobs created over the last year have been subsidised by the government. Jobs paying full social security contributions continue to decline.

Employment growth is also heavily skewed by country. ECB data show that 1.3 million jobs have been created in the euro area over the last year. However, 530,000 of these were created in Spain. This means that a country accounting for 11% of euro-area GDP is responsible for 42% of its job-creation. Employment is rising in most other euro-area countries, but much more modestly **(Display 2)**.

An important recent development in the European labour market is that workers in many countries have become more willing to forgo wage increases to protect their jobs. In Germany, last year's landmark Siemens deal saw employees agree to an increase in working hours and a wage freeze in order to prevent production being moved to eastern Europe.

The impact of very low wage growth can be seen in **Display 3**. Although euro-area employment growth has risen, this has not boosted overall compensation growth (employment plus wages). Indeed, employee compensation growth fell to 2.5% in the euro area last year and to just 0.2% in Germany, well below the rate of inflation. This helps explain why German consumer spending has been so weak. It also explains why German companies have been able to boost profits at a time when nominal GDP growth has been so weak. Last year, whole-economy profits rose by 7.1% in Germany compared with 2.2% for nominal GDP.

There is some evidence that the squeeze on labour income is starting to ease. There has been a modest pickup in wage settlements, and the first quarter saw employee compensation growth in the euro area rise to 2.9%. Moreover, the euro's recent fall should give a boost to company margins and reduce downward pressure on labour costs.

Nonetheless, it is unlikely that we will see a speedy recovery in Europe's labour markets. Faster growth and a weaker euro will help, but there are important structural pressures that are unlikely to disappear. As **Display 4** highlights, the gap between labour costs in western and eastern Europe is huge and should continue to exert downward pressure on euro-area labour costs for some time to come. Hence, while the outlook for euro-area growth has improved, the labour-market recovery is likely to be gradual.

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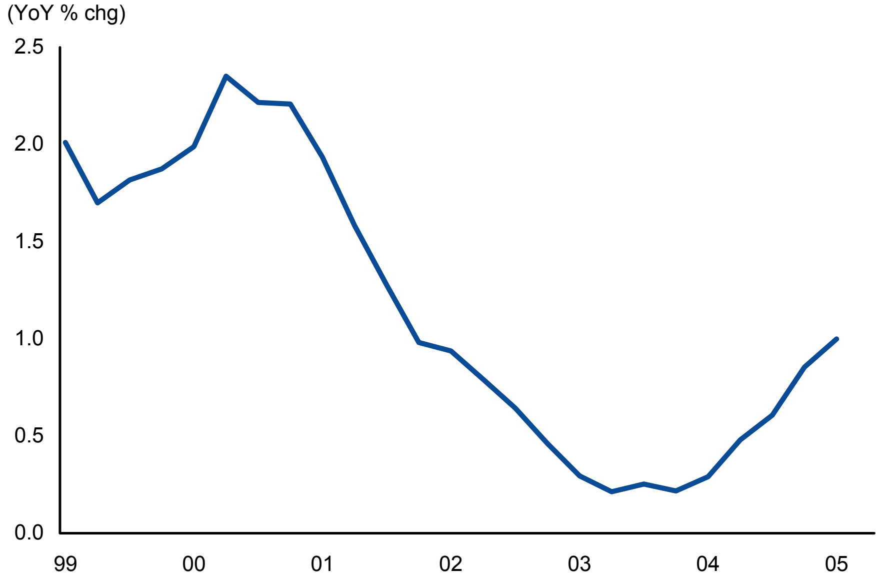
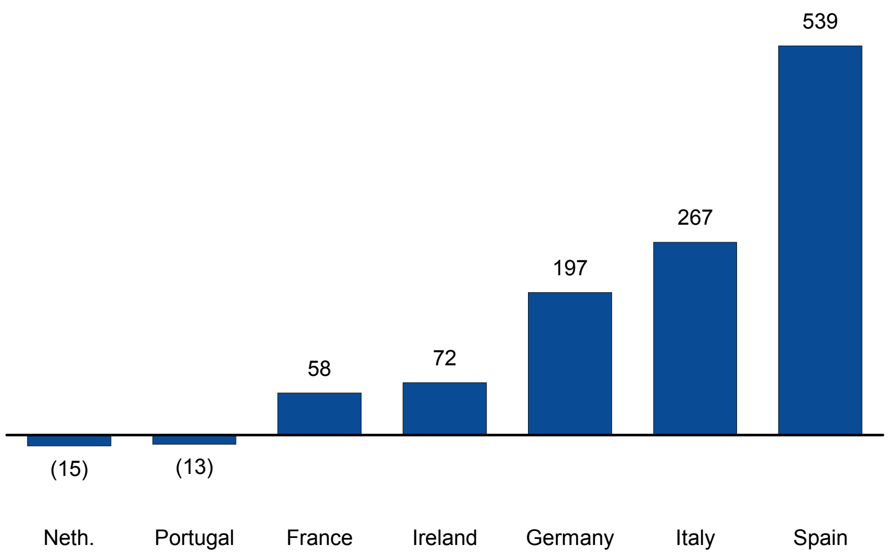
Display 1: Employment Growth Has Been Surprisingly Strong
Euro-Area Employment Growth



Source: European Central Bank and Alliance Capital Fixed Income; July 25, 2005

Euro-area employment growth reached an annual 1.0% in the first quarter of 2005. However, this is distorted by job-creation schemes in countries like Germany. Hence, it overstates the strength of the labour market.

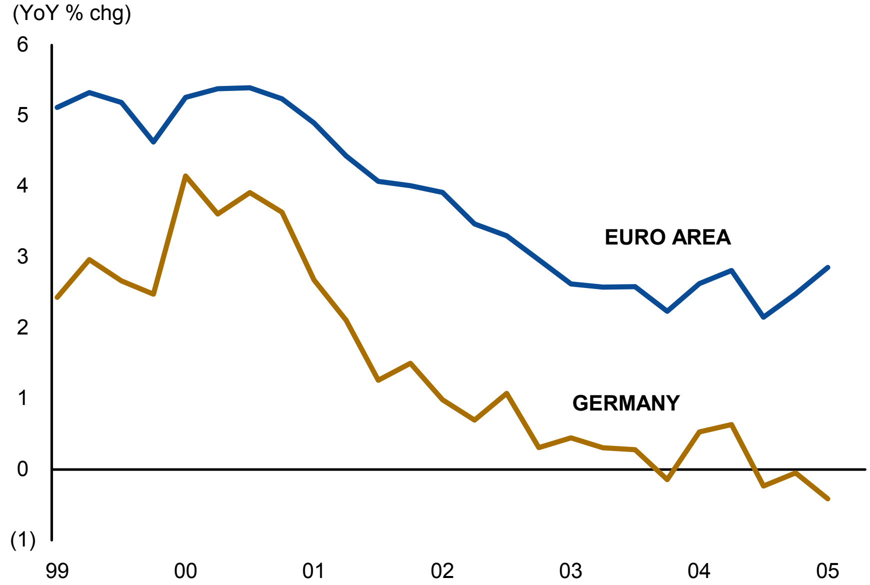
Display 2: Spain Is The Main Source of Euro-Area Job Creation
Annual Change in Employment (Thousands of Workers)



Source: Haver Analytics and Alliance Capital Fixed Income; July 25, 2005

Employment growth is also very skewed by country. Indeed, Spain accounted for 42% of all the euro-area jobs created over the last year. Italy has been the second biggest source of euro-area jobs. However, given the poor outlook for Italian growth, it is doubtful that this can continue for much longer.

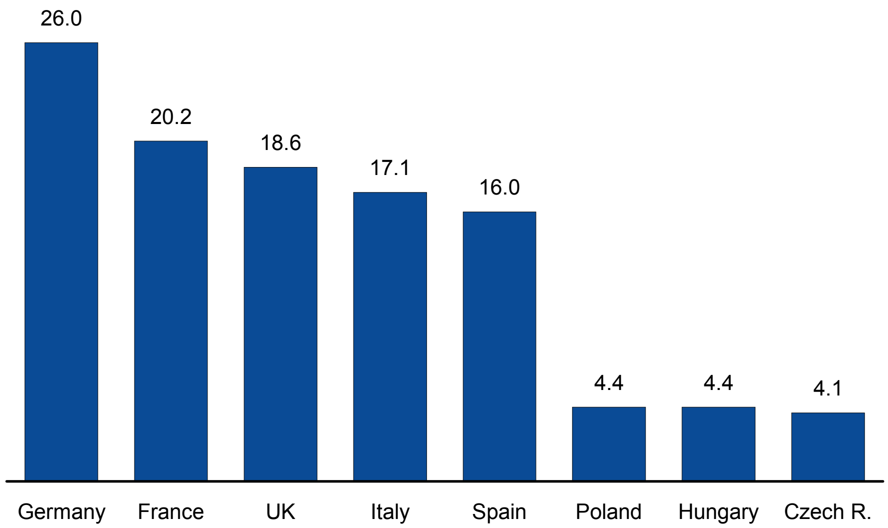
Display 3: Employment Growth Has Not Boosted Compensation
Total Employee Compensation Growth



Source: Haver Analytics and Alliance Capital Fixed Income; July 25, 2005

Euro-area workers have become more willing to sacrifice wage growth in order to protect their jobs. This means that rising employment growth has not given a boost to employee compensation. Although there are signs that downward pressure on labour income is starting to ease, this is likely to be a slow process.

Display 4: The Competitive Threat from Eastern Europe
Labour Costs per Hour in Manufacturing, 2003 (Euros)



Source: WIFO, IW, Eurostat and Alliance Capital Fixed Income; July 25, 2005

Eastern European wage costs are much lower than in the euro-area countries. This suggests that structural pressure on euro-area wages will remain intense.