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"It's bargaining power, Jim, but not as we know it"

Eurozone labor market

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Contents

Summary

- Eurozone labor supply has mostly, albeit not entirely, recovered from the pandemic shocks; This also means that there is relatively modest 'upside' potential in supply going forward.
- Whilst labor market tightness of the last 1.5 years is partly of a transitory nature, there is also reason to believe that some of this tightness is more persistent. Vacancy rates may come down this year, but unemployment may not rise as much or as quickly.
- Workers' bargaining powers have improved at the 'micro level', highlighting the risk that persistent tightness leads to a process of rising (nominal) wage growth.
- Geo-economics and medium-term trends such as ageing are likely to be conducive to this development.

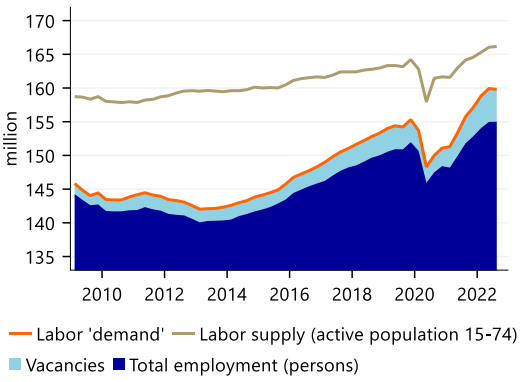
"Change is the essential process of all existence." - Spock

Full of surprises

In this piece we take stock of where the Eurozone labor market stands right now and then ask ourselves whether the economic slowdown that is currently in progress (or aimed for by monetary policy makers) will be sufficient to stop accelerating wage growth in its tracks.

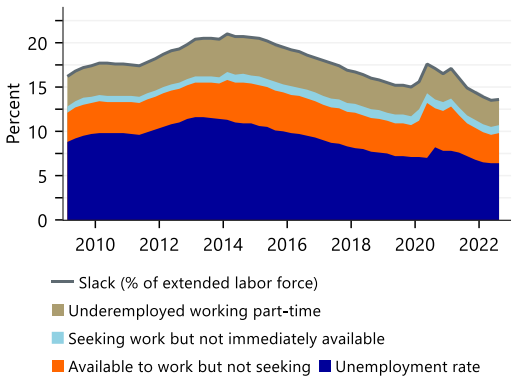
From whatever angle you look at it, the European labor market has been full of surprises over the past three years; from the pandemic shock in 2020 to the all but miraculous recovery in both demand AND supply in the two years that followed. **Change has been all around.** This is also illustrated in figure 1 below, which shows a measure of aggregate labor demand (employment plus outstanding vacancies) and the active labor force.

Figure 1: Eurozone labor market at a glance: remarkable post-Covid recovery



Source: Macrobond, RaboResearch

Figure 2: Broad measures of slack point to a (relatively) tight labor market



Source: Macrobond

Although in most sectors hours worked per employee has not fully recovered to its pre-pandemic level yet (which we will discuss later), at face value, the Eurozone has largely left the pandemic shock behind it. In fact, the post-pandemic recovery has resulted in a historical tightness of the labor market. This is reflected not only in an unemployment rate that is now at its lowest level in almost 42 years but also in broader measures of slack having dropped below levels seen before the pandemic (figure 2). With its ensuing pick up in wage growth and the 2021-22 energy supply shock in the backdrop, it is therefore no surprise that this labor market tightness and the risk of 'second round effects' have become one of the focal points in the monetary policy debate.

The key questions we would like to answer in this research note are:

- *Have the pandemic shocks fully run their course, or is there still some impact to be expected?*
- *And, if so, is the recent labor market tightness mostly a 'transitory' phenomenon that should dissipate as supply normalizes and the economy enters a slow-growth (or recession) episode?*
- *And would this then, in turn, be sufficient to bring about a slowdown in wage growth over the foreseeable future?; Or,*
- *Has the Eurozone labor market now shifted to a regime of more persistent tightness, with its potential consequences for wages (and hence core inflation)?*
- *And will demographic trends play an increasing role in labor scarcity over the next decades?*

But let's first take a step back and look at how the labor market has come out of Covid, as that – at least to some extent – explains current issues.

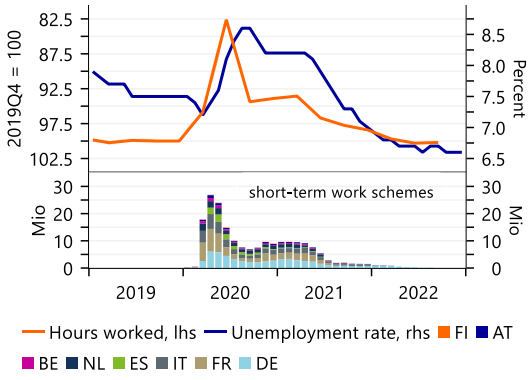
Scarring could have been a lot worse

"Things are only impossible until they are not" – Jean-Luc Picard

In the first phase of the Covid-19 shock in 2020, which hit economies hard, it was widely assumed that there would be significant long-term consequences for both labor supply and labor demand. We ourselves, at the time, were concerned that a sharp fall in labor supply (due to lockdowns, elevated sickness and significant fatalities) would prove persistent as such big shocks tend to lead to a rise in discouraged workers (which do not easily return to the labor market), slower investment, such as in human capital, and could have long-term adverse productivity effects.

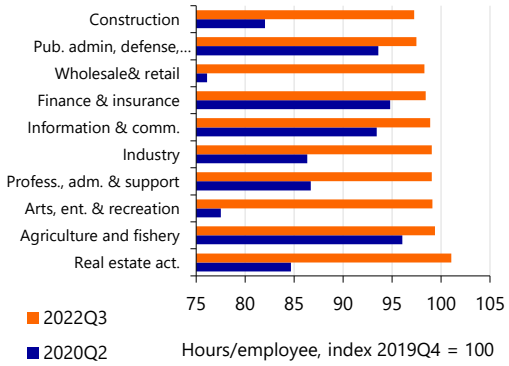
However, with the benefit of hindsight, such worse-case scenario's did not materialize. A key role, we believe, was played by the relatively swift introduction of short-term-work schemes in many Eurozone countries. By mid-2020, nearly 30 million people (18% of employed persons) were covered by such a scheme (figure 3).

Figure 3: Hours worked were the key shock-absorber in the pandemic



Source: Macrobond, RaboResearch

Figure 4: In most sectors, hours worked per employee has not fully recovered yet

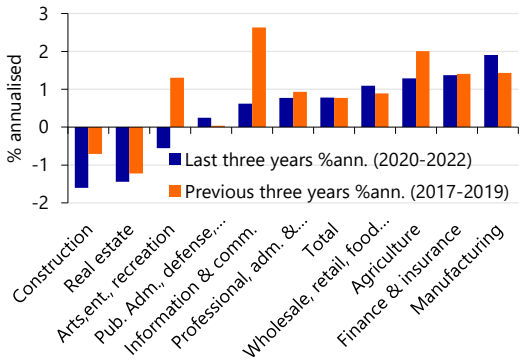


Source: Macrobond, RaboResearch

Alongside other support measures this strongly alleviated the impact on employees' well-being and also allowed many businesses to 'scale down' (and up again) hours worked to whatever level was required. **As such, these short-term work schemes prevented a huge unemployment wave and possible hysteresis effects.**

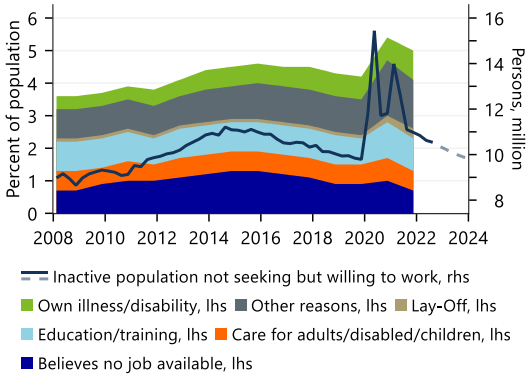
Fast forward, the use of these schemes has now been mostly phased out. Compared to end-2019, the number of hours worked per employee in 2022Q3 was still slightly lower in most sectors (figure 4), in particular in construction, retail/wholesale, public administration, education and healthcare. For some sectors, such as construction and arts/entertainment, this can be explained by the fact that activity has not fully recovered to pre-Covid levels, but a shift in desired work-life balances or higher care duties and (still) elevated sickness levels may also play a role in many types of economic activity.

Figure 5: Productivity growth damage? Last 3 years compared to preceding three years



Note: Gross value added per hour worked
Source: Macrobond, RaboResearch

Figure 6: Inactivity of those that would like to work has not recovered completely yet



Source: Macrobond, RaboResearch

However, the damage to average productivity levels (and growth) has proved surprisingly limited. **Despite the huge shocks to the economy, overall labor productivity growth over the past 3 years was 0.8%, exactly equal to the average growth rate in the three years preceding the pandemic.** Still, there are sectoral differences (figure 5). The construction sector, for example, saw a sharp fall in productivity and growth of productivity has lagged behind. In the arts, entertainment and recreation sectors we also saw a sharp fall in productivity. However, by 2022Q3 the 'productivity damage' had already been largely repaired. In information and communication productivity levels did not fall much, but average growth slowed more noticeably.

And no 'Great Resignation' either

"A man either lives life as it happens to him, meets it head-on and licks it, or he turns his back on it and starts to wither away"- Dr. Boyce

In the wake of the Covid-19 pandemic, the term "Great Resignation" (aka the "Big Quit") was coined in the US, as employees voluntarily resigned en masse, dissatisfied with their jobs and/or job prospects. Some people took the opportunity to retire (early) or engage in (re-)education, but many simply quit to look for jobs elsewhere. Working from home also shone a light on inequality and class differences. *If you cannot work from home, you cannot work at all.* One of the consequences was a sharp fall in the US labor force participation rate and a sluggish recovery of participation in the aftermath of the pandemic. Even now, in early 2023, the US labor participation rate is almost a full percentage point below its pre-pandemic level.

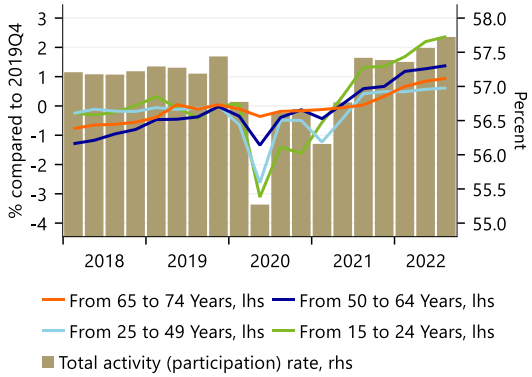
While there is little doubt that similar processes also played a role in the Eurozone, there are some **marked differences with the US**. Here too, the pandemic saw a sharp increase in people moving

into inactivity and a rise of people that had stopped seeking for jobs, even when they indicated that they were willing to work (figure 6).

Own illness and/or disability actually wasn't the key reason (although this became a bigger factor in 2021), but more people decided to stay longer in education (+0.3%-pts of population), said they needed more time to take care for others (+0.1%-pts) or felt there were simply no jobs available (+0.1%-pts). But the sharpest rise was in the "other reasons" category (+0.6%pts), which may reflect things like temporary retreat from the labor market due to Covid. Albeit speculative, we would add fears of becoming infected as a possible reason to that list.

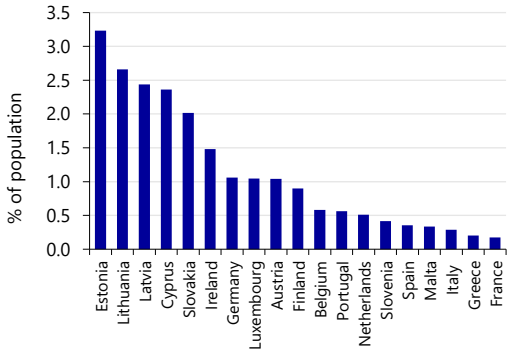
Although this development inevitably led to a rise in inactivity among those that would like to work (figure 6), quarterly data suggest that – if recent trends continue – **inactivity levels should have normalized over the course of this year**. What is even more striking is that the labor force participation (or activity) rate had already returned to its pre-pandemic level by mid-2021. And it has continued to rise ever since. Indeed, activity has not been this high since Eurostat records began. That stands in sharp contrast with the US.

Figure 7: Activity rate now higher than ever; with sharpest rise in low and high age brackets



Note: lhs: Activity rate minus activity rate at 2019Q4
Source:

Figure 8: Ukrainian refugees registered for Temporary Protection or similar schemes



Source: UNHCR, Macrobond, RaboResearch

Another interesting observation is that although the sharpest decline in activity during the pandemic was seen among the younger age brackets (which again underscores extended education as a motive), this is also the segment that saw one of the sharpest recoveries. A sharp rise in the activity rate, albeit from a low starting level, is also seen in the 50+ age segment, which could point to a tight labor market attracting more senior workers (figure 7)[1]. **These trends suggest that the pandemic has not caused any persistent 'discouraged worker' effects**, a conclusion one could also draw from transition or labor market flow data, which we discuss briefly in the box below.

Finally, immigration flows fell during the pandemic but asylum statistics indicate that such flows have more than fully recovered. Note also that these data (and the same holds for labor force statistics!) do not (yet) take into account the massive influx of refugees from Ukraine since the start of the Russian invasion. This is more relevant as – despite significant mismatches – a material share of these people will likely blend into the Eurozone labor force[2]. The UNHCR reports that in early 2023 more than 2 million Ukrainian refugees were registered in the Eurozone member states (and another 3 million more in other European countries). On a EU-27 population of around 450 million that is no small beer and for some its even more than that (figure 8).

[1] Obviously, we cannot exclude the possibility that this rise in activity is born out of necessity: garnering income to be able to pay the bills

[2] The ECB estimated last year that the labor force participation of Ukrainian refugees could range between 25% and 55% over the medium-term. It ponders a 0.2% to 0.8%-points rise in the labor force over time.

Labor market flows highlight the big shocks as well as recovery process

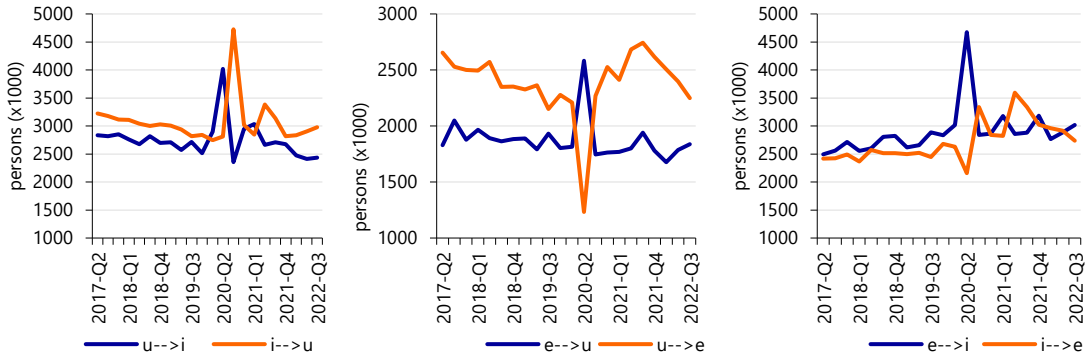
Labor market transition data can tell us more about the underlying processes and reasons causing the rise and subsequent fall in unemployment (and, in the opposite direction, vacancy rates). A transition is recorded when a person in the labor force survey reports to have changed his or her position from a previous state. The three states identified are being *unemployed* (U), *employed* (E) or *inactive*, (I, not in the labor force).

We have compiled and aggregated Eurostat data for a set of Eurozone member states (Germany is the key country missing because of a lack of historical data). Nevertheless, these transitions help us in understanding what has been driving the easing of labor market conditions during the pandemic and their subsequent tightening.

One key observation (panel 9a) is that although the outflow from unemployment to inactivity initially rose in the early phase of the pandemic, this was offset by subsequent opposite flows. This is *one indication that there was no persistent discouraged worker effect*. In fact, in recent quarters, fewer people have moved out of unemployment into inactivity, whilst the pace of people moving from being inactive back to (active) unemployment has actually been somewhat higher than before the pandemic.

Another observation is that the shock from employment to unemployment was really a one-off affair in 2020Q2 (panel 9b), whereas the process of transitions out of unemployment back into employment was more sluggish. The same applies to transitions employment to inactivity (quick an largely one-off) and from inactivity back into employment (more sluggish, panel 9c). This is consistent with the sharp rise in vacancy rates and reported labor shortages that reached their peak levels in the middle of 2022.

Figure 9: Labor market transitions in select group of Eurozone countries



*) France, Italy, Netherlands, Spain, Belgium, Ireland, Greece, Austria, Portugal and Finland
Source: Eurostat, RaboResearch

Albeit far from conclusive, we believe these data lend support to the idea that -from a supply perspective- there has been surprisingly little permanent damage to the Eurozone labor market. As such, it suggests that the sharp rise in vacancies during 2021-2022 was first and foremost the result of the large amount of transitions. Think of people that had been laid off or had voluntarily decided to leave a sector and look for work in another sector.

Unfortunately, these data do not record people switching jobs whilst staying employed, but we would argue that a larger-than-normal number of transitions from any state to another state (with falling unemployed after having been employed being an exception) would be an indication of more churn and therefore a predictor of future vacancies and hiring activity. The decline in these transitions since 2022Q1 may therefore be seen as a *well-in-advance* signal that the labor market is coming off the boil and that vacancy rates are likely to ease back down in coming quarters as vacant positions are filled.

Where are the workers?

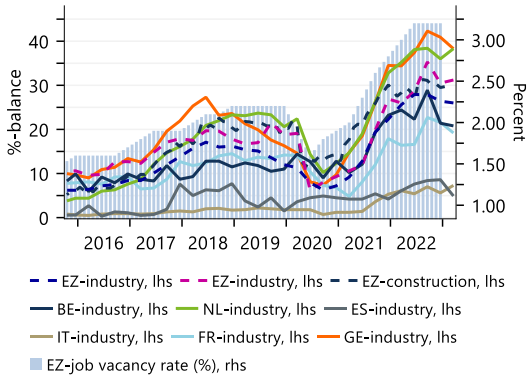
"I am a doctor, not a brick layer"- Spock

So far, we have largely focused on supply issues, basically concluding that whilst labor supply was clearly depressed in 2020 and still partly so in 2021 and early 2022, the situation has greatly improved and –by some metrics- even looks better than before. This is, quite a bit, in contrast with the situation that my colleague Stefan Koopman describes for the UK here.

However, the gradual improvement in labor supply did not prevent a serious increase in reported labor shortages over the course of 2021 in the Eurozone either. Demand for goods and services – and hence labor – simply outpaced the availability of new workers. And the massive shifts of workers between sectors that took place aggravated those shortages. Shortages rose sharply from mid-2021 and peak shortage levels were reached in the summer of 2022. Who doesn't remember the newspaper articles with stories of desperate businesses in search of employees, as they were trying to work themselves through backlogs (such as in industry) or faced a sudden rise in demand for goods and services (such as restaurants)?

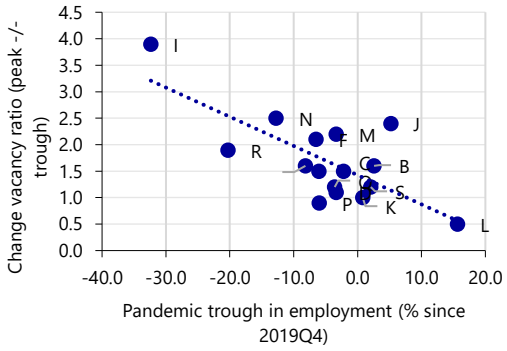
Whilst in several sectors and countries (Germany and the Netherlands in particular) the situation remains quite pressing, there are mounting signs that the labor market is coming off the boil. This is illustrated in figure 10, which also shows that the overall vacancy rate has, tentatively, peaked.

Figure 10: Labor demand coming off the boil, % of businesses reporting labor shortages (EC)



Source: Macrobond, RaboResearch

Figure 11: Biggest rise in vacancies in sectors that shed more labor in the pandemic



Source: Macrobond, RaboResearch

We cannot stress enough that the combination of the covid-19 shock and ensuing lockdowns had a disproportional impact on certain sectors. And as employees had 'left' these sectors, this also created a much sharper-than-usual rise in vacancies. **To a large extent those elevated vacancy rates were part of an adjustment process and ongoing churn. Put simply, it takes time to refill vacant positions, especially when labor is - temporarily - in short supply.**

This is also borne out by figure 11, which shows a negative relationship between the peak-to-trough decline in employment during the pandemic and the (subsequent) rise in the vacancy-to-employment rate (from trough to peak) for a cross-section of economic sectors[3]. The sectors with the biggest declines in employment (accommodation and food services and arts, entertainment and recreation) also experienced the greatest staffing shortages when demand came back on.

Having said this, we should note that even before the pandemic struck, the Eurozone labor market was already showing elevated signs of tightness. This obviously raises the question of

[3] B = mining & quarrying, C = manufacturing, D = utilities, F = construction, G = wholesale and retail, I = accommodation and food services, J = information & communication, K = finance and insurance, L = real estate, M = professional services, N = administration, P = education, Q = healthcare, R = arts and entertainment, S = other service activities

what will happen next, especially in light of the current economic slowdown, which – at first sight – appears to be less deep than initially feared, but still is surrounded by considerable uncertainty, as we argue here.

Which path forward?

"Well, I know this much: We can't avoid the future."- William T. Riker

One instrument that can help gauge the future path for the labor market is the Beveridge curve, which depicts the relationship between vacancies and unemployment over time. 'Normal' economic cycles are usually associated with movements *along* the (downward sloping) curve; structural shocks can lead to inward or outward shifts of the curve. For example, structural matching problems (such as persistent shortages in workers with certain qualifications) lead to an outward shift of the curve (more vacancies for each unemployed).

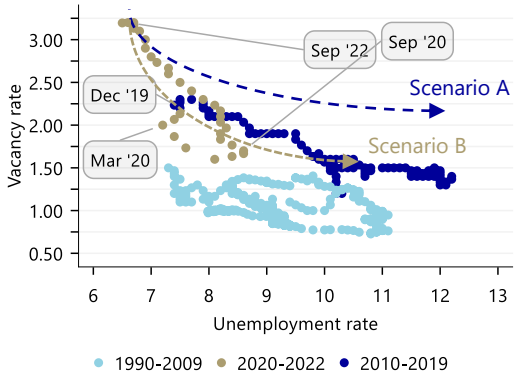
During the Covid-19 lockdowns, the Eurozone's Beveridge curve (see figure 12) actually shifted down, as vacancies fell but unemployment stayed low due to government support measures. But during the recovery, the curve shifted back up, followed by a sharp 'north-west' move *along* the curve, as vacancy rates hit record highs and the unemployment rate fell to a record-low. Although recent vacancy rates are unprecedented, so are unemployment readings!

In a recent study, which was part of the 2022 autumn forecast, the European Commission also concludes that there is no compelling evidence of a significant outward shift of the Beveridge curve. **Combined with the notion that vacancy rates should progressively decline as the labor market comes off the boil, this means that the most likely future trajectory in the current economic slowdown, in our view, is best described by the brown (Scenario B) curve, rather than the dark blue (Scenario A) curve. In other words, we could be facing quite a moderate increase in unemployment as the economy slows down.**

One key factor that may shape the path back down along the curve is potential labor hoarding by businesses. Having been burnt by the shortages in the aftermath of the pandemic, businesses may be reluctant to shed workers in large quantities as demand for goods and services cools. Such hoarding could be reflected in more volatile behavior of hours worked. But it also implies that unemployment may rise only moderately in this cycle, especially if the slowdown (or recession) is expected to be relatively shallow – as increasingly appears to be the assumption among many observers.

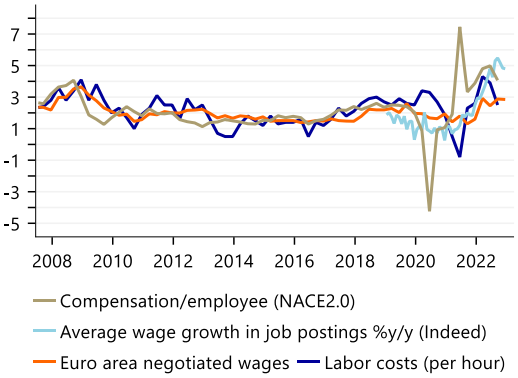
However, **too modest a rise in unemployment due to labor hoarding could not just stoke future wage growth but it could also lead to a fall in labor productivity (growth), which, in turn, could further raise unit labor costs and hence inflation.**

Figure 12: Beveridge curve



Note: vacancy rates before 2012 have been imputed/estimated from national data
Source: Macrobond, RaboResearch

Figure 13: Wage growth has accelerated



Source: Macrobond, RaboResearch

Wages are going up; but how far will they go?

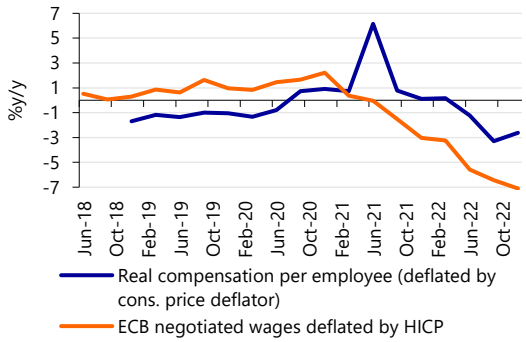
"I'm not a merry man."- Lt. Worf

Given the labor shortages discussed above and the huge energy price shock since mid-2021, it is no wonder that 'wages' have now become one of the biggest attention points (or should we say headaches?) of central bankers?

There is little doubt that wage growth has accelerated almost everywhere, but there are considerable differences, even among the big member states. Strongest wage gains (close to, or above double digits) were seen last year in several Eastern European and Baltic member states, such as Slovakia, Lithuania and Estonia. The Netherlands, Belgium, Ireland, Austria and Luxembourg also recorded significant increases in wages and salaries. In most countries this is a combination of a tighter labor market and high inflation, in some (such as Belgium) it is mostly because of (automatic) wage indexation.

Notably in Italy has wage growth stayed behind, albeit partly because wage negotiations have proved arduous (which also implies that current data may not fully reflect the upside risks). Italian wages were up a measly 1.5% y/y in December 2022. In Spain wages were up 2.7% y/y in January 2023 whilst in Germany the overall gain in pay rates was 2.5% y/y in November 2022. In France, data for December 2022 show a 3.8% y/y gain in wages. With the exception of Ireland, which eked out a small *real* gain, all member states saw worker's compensation outpaced by consumer price increases. **The ECB's own negotiated wages indicator stood at slightly under 3% y/y in December last year – far below the harmonized inflation rate of 10%.**

Figure 14: Painful real wage decline, but less painful at closer inspection



Source: Macrobond, RaboResearch

However, we should add that this **gap between inflation and wages has been considerably smaller in practice** (explaining why consumer spending has not slowed as sharply as feared). First of all, the consumer price deflator (likely a better reflection of overall costs faced by households) rose by around 8% instead of 10%. Secondly, compensation per employee (a broader measure that reflects wage drift, one-off price compensation measures and increases at the individual level – for example due to job changes, was up by around 5.3%.

Going forward, **negotiated pay** is on the ascend as well. This is reflected by indicators such as Indeed's Wage Tracker (still close to 5% y/y for the Eurozone as a whole). Strike activity in Europe has also increased noticeably, although - admittedly- this is largely based on anecdotal evidence. Late 2022, following stoppages, Germany's IG Metall union reached a 2-year pay deal with employers, agreeing to a 5.2% increase in wages from June 2023 and +3.3% from 1 May 2024, plus a (significant) lump-sum tax free inflation compensation of EUR3000 per worker. IG Metall's travails are often seen as an economy-wide bellwether and Germany's Bundesbank now expects overall wages to grow 3.9% this year and 4.2% next. Just three months ago it was forecasting 2.8% for 2023.

In other words, although inflation has outpaced wage growth, the damage to real wages has not been as massive as suggested by headline indicators and the trend is for higher wage increases, which could see the wage-inflation gap narrow further going forward.

The risk of such wage growth becoming entrenched could also be stoked by uncoordinated or non-targeted government support. If governments keep supporting households too generically through income support, such as subsidies and/or price caps on energy and this is not taken into

account in wage negotiations between employers and employees, this could potentially lead to a situation where households – especially those who don't need it – are *over*compensated.

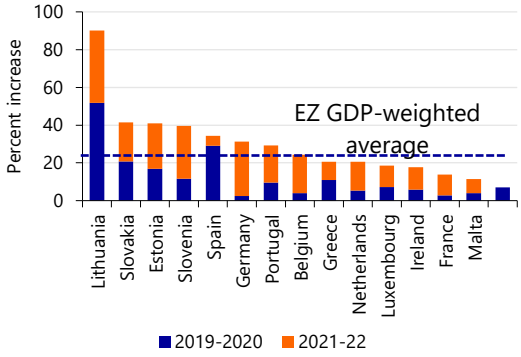
Minimum wages, convergence and more fairness?

Several member states[4] have opted to raise minimum wage levels significantly in recent years, also in recognition that the lowest income brackets were hit disproportionally by the Covid-19 and the more recent energy shock. **We estimate that the average GDP-weighted increase in minimum wages is around 7% for the period 2019-2020 and +18% for 2021-2022** (figure 15). In some of the Eastern member states (driven by convergence) and Spain, minimum wages rose even more strongly in the preceding years, but for countries such as Germany, the Netherlands, France and Belgium the recent jump is quite significant.

It is hard to establish whether such minimum wage increases are (or will be) having a positive impact on overall wages and costs, but – if anything – they may contribute to a higher 'reservation wage' among workers, for the simple reason that it raises the perceived 'floor'.

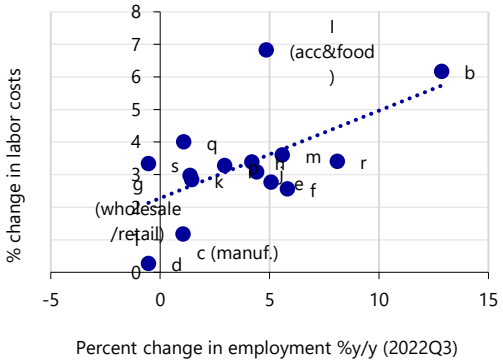
The Covid-19 shock has also caused considerable movement between sectors. Workers said goodbye to their former employers and may never return to their old sector again. The sectors mostly affected by this were, undoubtedly, the accommodation and food services, recreation and other (personal) services sectors. Against this backdrop it is no surprise that **– in order to lure employees back – businesses in these sectors have had to offer better rewards**. Whereas economy-wide wages and salaries in 2022Q3 stood some 8.2% higher than in the same quarter of 2019, this was respectively 11.3%, 11.6% and 14% for these particular sectors.

Figure 15: Minimum wages up sharply across the currency bloc



Source: Macrobond, RaboResearch

Figure 16: Wages are rising there where employment is rising



Source: Macrobond, RaboResearch

There is also a distinct positive relationship between the pace of employment growth and the rise in labor costs across sectors (figure 16) and labor costs are rising faster in those sectors with comparatively lower labor costs (not shown here). The latter could point at some impact from higher minimum wages.

Altogether, the evidence suggests that stronger demand for employees and 'convergence' or fairness motives have been drivers behind the surge in wages as well. If this is a new trend then it implies that wage growth will prove more persistent, as long as the labor market stays tight.

[4] Several member states do not have minimum wage legislation, but the EU Council adopted a directive on adequate minimum wages on 4 October 2022, which calls on countries with such legislation to raise them to adequate levels.

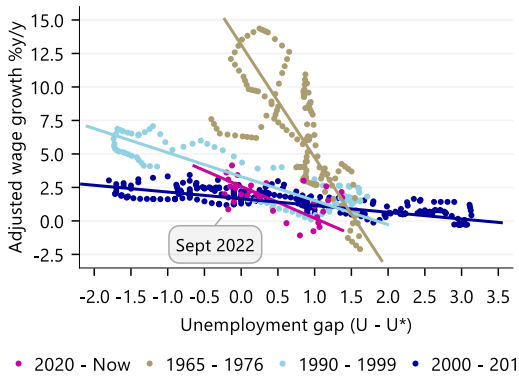
Phillips curve: flat, but not dead

Policy makers are keeping a close eye on recent wage settlements and are looking for signs as to whether and to what extent the labor market will remain tight. Can we assume that elevated wage growth will also persist beyond 2023?

For that question we turn to that often-cited, but sometimes hard-understood, relationship between labor market tightness and wage growth: the Phillips curve. The basic idea is simple: in a tight labor market (unemployment low compared to its structural level), wage growth tends to accelerate; in an environment of loose labor market conditions, wage growth tends to fall. However, productivity growth, inflation expectations and structural shifts in either labor supply or demand all make this curve a more challenging beast than is often acknowledged.

So at the risk of oversimplifying things, we note that this relationship (figure 17) has become flatter over time; from the *steep-sloped high-inflation 1970s*, to the *flat post-Euro low-inflation 2000s*. Recent data, since the pandemic, show a slightly steeper curve again, a bit closer to that of the decade preceding the euro introduction. But the more interesting questions perhaps are these: i) does a relatively flat Phillips curve mean that unemployment has to move up a lot in order to get wage growth back down? (in which case we could conclude that wage growth is likely to be relatively high and sticky in the years ahead), Or ii) does the relative flat curve that sits at the low wage growth end of this chart actually mean that -whatever happens- wage growth will not go much beyond 3-4% (unadjusted for productivity), as we have seen so far? Or, iii) does the *tilt* in the *slope* since the pandemic actually point to a structural upward shift in the correlation between wage growth and unemployment (for example because of wage-price dynamics)?

Figure 17: Phillips curve: still flat…



Note: Wage growth adjusted for trend productivity (filtered)
Source: Macrobond, RaboResearch

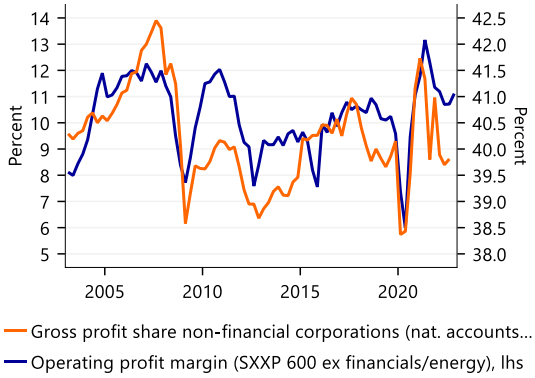
Taking into account the high vacancy rates still seen in many countries and the elevated problems among companies to find new employees (as per DG-ECFIN's surveys), we are inclined to say that upward pressure on wage rates is likely to persist this year and possibly next year as well. That is, unless unemployment suddenly jumps.

We would argue that the current labor market situation favors the 'micro' bargaining power of workers. As we highlighted in the previous section, overall compensation per employee has outstripped negotiated pay increases since the end of the pandemic (mid-2021). The Covid-19 pandemic has probably further loosened the relationship between employers and employees, which also means that workers 'can leave' at will to work from home for another employer. The labor market is tight, so changing job pays. Although there are huge differences in the ability to pay up[5], employers generally, and particularly large firms, seem in a fairly good position to pay higher wages (figure 18). Profit margins have clearly declined since the energy-crisis, but the impact has been considerably less than we had expected a year ago. And firms may be keen to hoard[6] labor as long as they maintain sufficient pricing power.

[5] Our RaboResearch Netherlands colleagues discussed this ability to pay for various sectors in the Netherlands here (in Dutch).

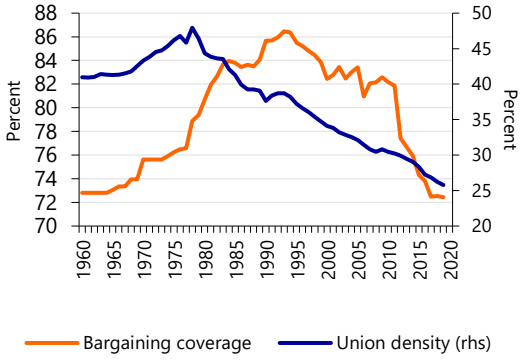
[6] Indicative, in that respect, is a recent survey in the UK, where only 14% of business leaders said they expected their business to reduce headcount over the next six months, while only a quarter (24%) of leaders plan to limit their recruitment.

Figure 18: Despite Covid and Energy crisis, (Big) business still has some fat/profit to trim?



Source: Macrobond, Bloomberg, RaboResearch

Figure 19: Bargaining powers weakening at collective level (Eurozone estimate)



Source: OECD, RaboResearch

So, for now, the labor market has shifted from a buyers' market to a sellers' market.

But this is not where this story ends. The flatness of the Phillips curve is also associated with a structural decline in employees' collective bargaining power. There is ample of evidence that suggests that such bargaining powers have continued to deteriorate, even in recent years.

This is reflected (see figure 19) in both a decline in union density (i.e. the number trade union members who are employees as a share of total employees) and a decline in coverage (i.e. the share of employees covered by one or more collective agreement). So, the loosening of the relationship between employers and employees and the lower collective bargaining powers could still, at some point, come to haunt employees, should the labor market situation change more drastically.

Despite this warning, we feel we are getting closer to a point where – after many years in which capital has trumped labor – tightness is becoming a more persistent feature of labor markets, something which could lead to a gradual shift in that power balance over time.

Against this backdrop there are other structural factors to consider as well. For the next several years, one of the reasons for persistent labor market tightness could be the speeding-up of the energy transition, financed by EU funds. Another could be additional government spending in key areas such as defense or for industrial policy purposes (semiconductor factories, investments in sectors to reduce dependence on China). The impact of geo-economic changes is hard to assess (as it also depends on whether there will be any crowding out in other sectors or on other types of spending), but on a qualitative level one could argue that these are supportive to labor market tightness in the coming years.

But from a longer-term perspective, especially for the labor market, it is perhaps the demographic challenge that looms largest.

Persistent 'demographic' tightness ahead?

"Live long and prosper!"- Spock

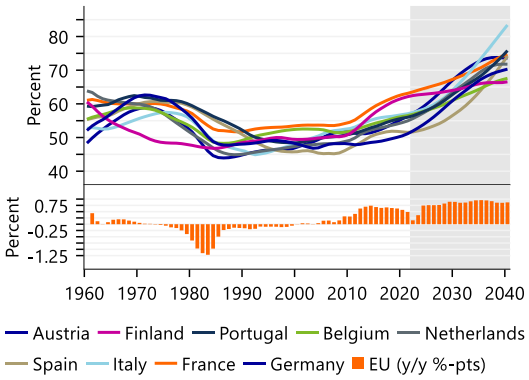
Demographic changes can be important drivers of changes in labor supply. But, to be fair, such changes are usually very slow and – to some extent – can be seen well in advance. After all, a decline in the birth rate will only be felt in earnest in the labor market 20 years down the road. Although this allows economic actors to respond in time, it also takes time to adapt education to different needs, to invest in labor-saving technologies and so on.

We would argue that a shrinking population per se is not the key problem, but rather it is a combination of declining flows into employment from younger generations (the result of a low

birth rate) and – more importantly – a sharp increase in outflows of employment into retirement. **The overall result is that the ratio of people earning money to take care/pay for people that no longer contribute to production (but do add to demand and inflation) will be worsening significantly.** Moreover, declining flows of young people into the labor force will also make it more difficult for the economy to adjust skills needed for things such as the energy transition[7].

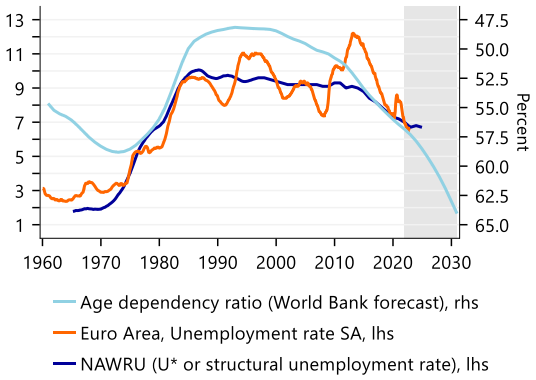
In our view this demographic challenge is best reflected by the age-dependency ratio; this is usually defined as the number of people younger than 15 or older than 64 as a percent of the people in working ages (15 to 64). Figure 20 plots this ratio and projections by the World Bank. Not only is this ratio sharply accelerating in many countries (Germany, Italy, Austria and the Netherlands in particular) in the coming decades, it will also reach uncharted territory.

Figure 20: Going beyond the 60s



Source: Macrobond

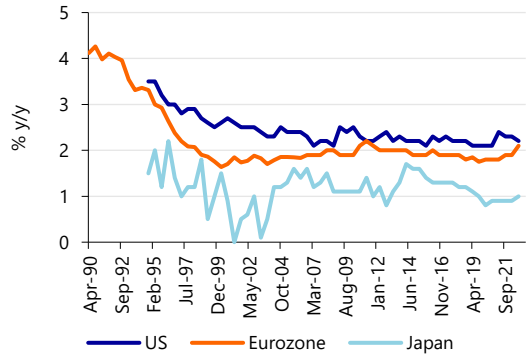
Figure 21: Higher dependency ratio could lead to structurally tight labor markets



Source: Macrobond, RaboResearch

In figure 21 we have plotted the Eurozone age-dependency ratio ADR together with an estimate of Eurozone unemployment (based on national data, with GDP volume as weights) and an estimate of the NAWRU (from the European Commission and backdated with national sources by ourselves). This figure suggests that the fall in the age-dependency ratio (after the post-war baby boom) in the 1970s and early 80s may have contributed to a rise in both cyclical and structural unemployment, followed by a long phase (1990-2020) of more 'normal' labor market conditions, where structural unemployment was relatively stable (or slightly declining) but where cyclical swings were considerable. **However, the acceleration in the ADR may now herald a new phase of more structural tightness of labor markets.**

Figure 22: Long-term (6-10y ahead) inflation expectations from Consensus Survey



Source: Consensus Economics

The question whether this will indeed become a pressing issue depends on whether businesses and government labor policies can unlock additional supply, such as raising participation rates in certain age brackets, or activating those in long-term unemployment. But whether this is going to be sufficient remains to be seen.

Of course, one could point the finger to Japan and argue that ageing there failed to spur wage growth (until very recently, at least). But one should be careful in drawing parallels, especially as the Eurozone has a much lower share of manufacturing in its economy (c. 16%

[7] A recent EIB poll warns that the EU's investment in green technology is being held back by a lack of skilled workers.

versus some 22% for Japan in the 2000s). Productivity gains are harder to achieve in service-sector oriented economies and so labor-saving technologies may be slow to catch-up. But, more importantly, Japan's deflation (or low inflation expectations) problem has been much more entrenched (figure 22) for a long period of time. This means that a combination of higher bargaining power by workers combined with significant pricing power enjoyed by firms could still make the difference between a scenario of persistent stagnation in real wages (Japan) or a transitory decline in real wages followed by a recovery.

Bringing it all together

"I would gladly risk feeling bad at times if it also meant that I could taste my dessert" – Data

After this deep dive into the European labor market, we conclude that labor supply has mostly, albeit not entirely, recovered from the pandemic shocks. This is a remarkable feat by itself but also means that there is relatively modest 'upside' potential in supply going forward.

Although we believe that part of the labor market tightness that we have witnessed over the last 1.5 years is of a transitory nature (reflecting massive labor market transitions), there is also reason to believe that some of this tightness has a more persistent component, especially if firms decide to hoard labor to prevent future hiring problems. Vacancy rates may come down this year, but unemployment may not rise as much or as quickly.

As we argue in this piece, workers have found new bargaining powers, albeit largely at the micro level so far. Yet it highlights the risk that if the current tight labor market situation persists it will likely support a process of rising (nominal) wage growth. As long as businesses remain in a decent position to pass on these higher cost increases, this could still fuel ratcheting-up effects for a number of years at least. And even if demand in the economy cools down, accelerating demographic trends, reflected in a rising age-dependency ratio, could well prevent labor market tightness from easing sufficiently quickly to offset these effects.

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