4 What can we learn from the ECB Survey of Professional Forecasters about perceptions of labour market dynamics in the euro area?

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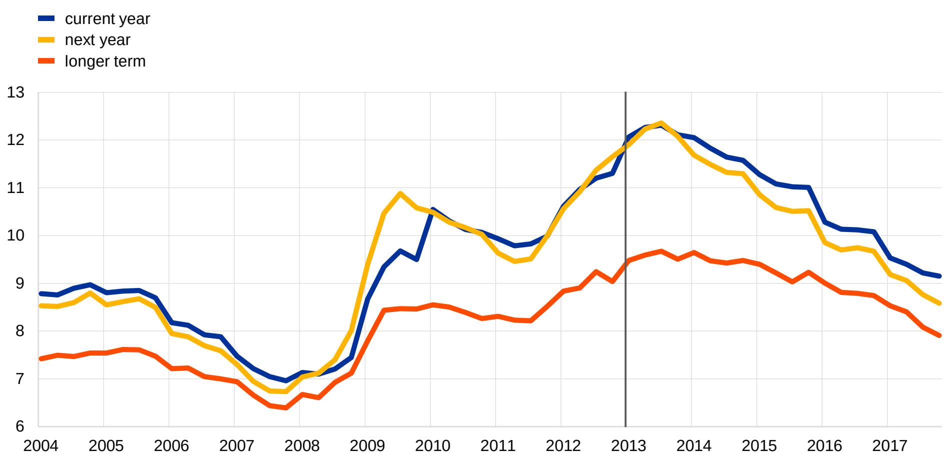
Over the last ten years labour markets in the euro area have been subject to a number of shocks, leading to large fluctuations in the unemployment rate and pay growth. In response to these developments, professional forecasters have been repeatedly adjusting their expectations for the unemployment rate and annual growth in compensation per employee (hereafter referred to as wage growth), both upwards and downwards. This box examines the revisions to the expectations reported in the ECB Survey of Professional Forecasters (SPF), and how those expectations compare with the actual data outturns.

Between 2008 and 2013 the economic setbacks associated with the financial and sovereign debt crises led participants in the SPF gradually to adjust their expectations for the unemployment rate upwards and those for wage growth downwards (see Charts A and B). This is in line with the traditional notion of unemployment as the driver of labour market slack and, in turn, quantity-price dynamics in the labour market: the more unemployed workers there are competing for jobs, the lower the wages that firms need to offer to recruit or retain workers. This co-movement was also visible in the opposite direction during the temporary recovery of 2010-11, when shorter-term wage growth expectations were revised upwards at the same time that labour market slack was projected to diminish (as indicated by the narrowing gap between shorter-term and longer-term unemployment rate expectations). In 2013, however, a different picture emerged, with expectations for both the unemployment rate and wage growth successively revised downwards.

Chart A

Unemployment rate expectations

(percentages)

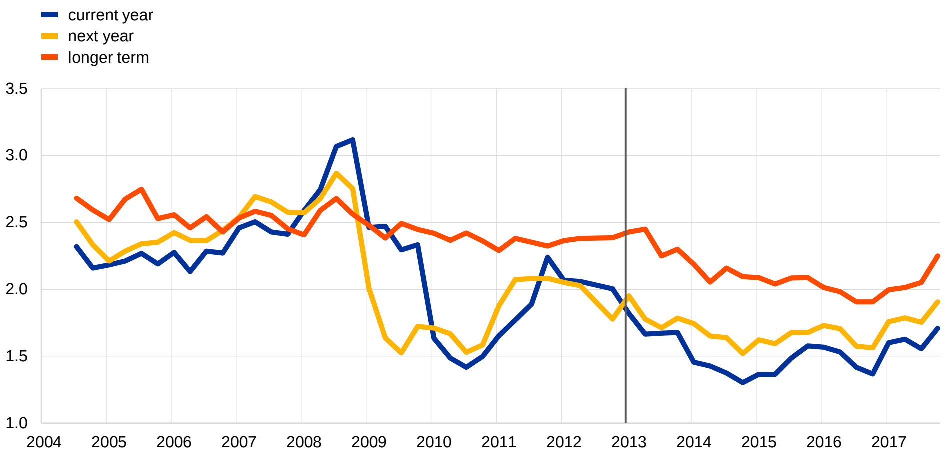


Sources: SPF and ECB staff calculations.

Chart B

Wage growth expectations

(annual percentage changes)



Sources: SPF and ECB staff calculations.

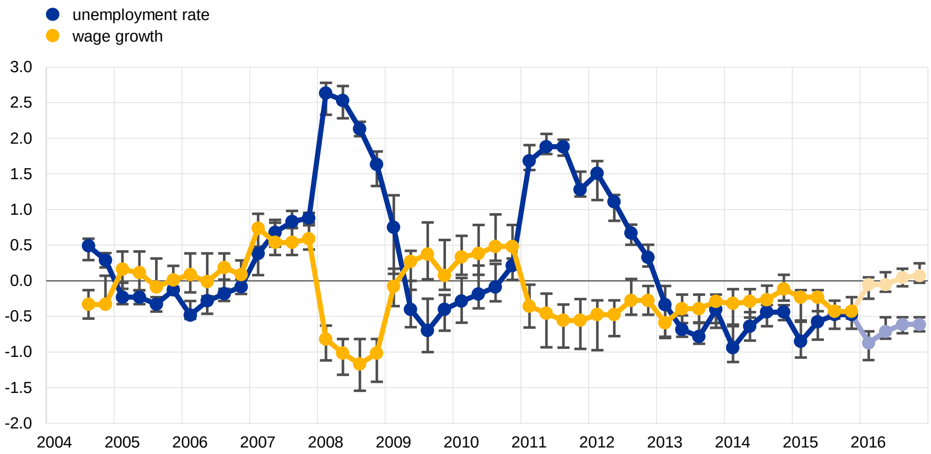
Up until 2013, SPF projection errors tended to mirror those for unemployment: episodes of weaker-than-expected wage growth coincided with a higher-than-expected unemployment rate and vice versa (see Chart C).[12] After 2013, however, not only did the pattern of revisions to unemployment and wage growth forecasts change, but so did the pattern of projection errors. Both wage growth and the unemployment rate were jointly overestimated by the SPF over the period 2013-15, a constellation of errors which seems unusual relative to the survey's earlier history. Moreover, this pattern was not only seen in the average forecasts reported by the SPF, but also for the large majority of individual forecasters. The whiskers on Chart C illustrate the spread of individual forecast errors (calculated as the interquartile range). Over the period 2013-15 these whiskers lie mostly below the zero line, which indicates that a large majority of respondents overestimated both wage growth and unemployment.

[12] The SPF has collected expected annual growth rates (for fixed-calendar-year horizons) for compensation per employee (i.e. wage growth) since 2004.

Chart C

SPF near-term projection errors for the unemployment rate and wage growth

(percentage points)



Sources: SPF and ECB staff calculations.
Notes: The projection horizon is the next calendar year; the date indicated refers to the survey date. The chart shows the median and interquartile range of the SPF forecast microdata. Projection errors are defined as the outturn, according to the most recent data, minus the expectation. The latest compensation per employee data refer to the third quarter of 2017. The latest SPF expectations for the next-calendar-year horizon which can be definitively evaluated are those for the year 2016, from surveys carried out in 2015. However, this chart also presents an indicative assessment of expectations from 2016 surveys for 2017, on the assumption that the data for the final quarter are in line with the Eurosystem staff macroeconomic projections for December. The pattern of unemployment and wage growth projection errors for the calendar-year-after-next horizon (collected only in third and fourth quarter surveys until 2013) is similar.

This historically unusual pattern of forecast errors since 2013 may suggest a structural break in labour market dynamics in the euro area. Specifically, the pattern suggests that even though the amount of slack in the labour market (as measured by unemployment) turned out to be less than expected, other factors were keeping wage growth subdued. Such factors could include: increased wage flexibility, in view of the depth of the crisis and following structural reforms in labour markets; a larger increase in low productivity jobs; and effects arising from the low inflation environment.[13] This pattern may also signal that, at the current juncture, the unemployment rate underestimates the total amount of slack in the labour market. For example, an elevated proportion of part-time workers who want to increase their hours or of marginally attached workers may have allowed employment to expand without generating significant wage inflation. This is consistent with the findings of the survey for the second quarter of 2017: when posed a question on perceived risks to wage developments, respondents emphasised the uncertainty around the response of wages to slack, and the risk that wage growth could turn out weaker than expected, if marginally attached workers re-entered the labour market as the economic recovery progressed.

However, the influence of factors behind recent unusual labour market developments may already be waning. Expectations for wage growth have been picking up in 2017 at all forecast horizons. In particular, the latest SPF (for the fourth quarter of 2017) shows that expectations for wage growth in the longer term have now recovered over half of the decline experienced over the period 2013-16 (see Chart B). This in turn may suggest that the factors which have been holding down wage growth are now perceived to be weakening.

[13] See the box entitled "Recent wage trends in the euro area", *Economic Bulletin*, Issue 3, ECB, 2016.