

After its strong performance in 2017, in the first half of 2018 economic activity in the euro area slowed faster than had been expected at the end of last year, mainly as a consequence of weak exports in the current context of tightening global financial conditions, heightened global uncertainty and rising protectionism.¹ Nevertheless, GDP across the euro area as a whole continued to grow faster than potential output (which various estimates situate at rates of around 1.5%), enabling the output gap to turn increasingly positive this year (see Chart 1), after narrowing in the final months of 2017. This output gap trend can be extrapolated to the individual euro area countries (albeit to differing degrees) except in the case of Italy, where growth remains weak and the output gap is still negative.

Compared with other cycles observed since the 1970s, the process of recovering pre-recession levels of output has been slower,² particularly in those countries most affected by the sovereign debt crisis, such as Italy and Spain. Moreover, the expansion observed since the trough in early 2013 has so far been shorter and growth weaker than the average for expansionary phases in other cycles, which seems to suggest that there is still scope for it to continue.³ Underlying this weak recovery is the sluggishness of all the GDP components, in particular exports and business investment (which only returned to pre-crisis levels for the euro area as a whole after a considerable delay, at the end of 2016) (see Chart 2).

By contrast, the current phase of the cycle is strong in terms of job creation, partly as a result of wage moderation and of the comparatively large contribution to growth from sectors more labour-intensive, such as services. In this context, the European Commission's business surveys point to a growing proportion of firms having difficulty finding labour (Chart 3). Also, levels of capacity utilisation have risen to historical highs in most countries. It is therefore worth asking to what extent supply side constraints are becoming increasingly binding.

Focusing on labour, since 2017, as noted above, there has been a significant increase across the euro area in the percentage of firms considering labour shortages to be a limiting factor on activity, in

manufacturing as well as services and construction.⁴ This trend is relatively widespread across countries, although particularly marked in Germany, France and the Netherlands. Additional evidence of the possible emergence of supply side constraints in some countries and sectors comes from the job vacancy rate, which has been on an upward path since the end of 2014, suggesting hiring has become more difficult. This trend has nevertheless been compatible with persistently high levels of unemployment in certain countries, suggesting there is a problem of a mismatch between the skills required by firms and those that the unemployed can offer. In this connection, Chart 4 shows how, from a historical perspective, there is currently a higher percentage of firms reporting difficulties finding labour for the same level of unemployment.

In contrast with these signs of high levels of labour utilisation, the way other indicators have evolved points to a certain degree of slack remaining in the labour market, which would explain why until now labour shortages have been compatible with modest wage growth in the euro area. In this regard, a high level of involuntary part-time employment is observed in most countries, meaning that there is a relatively high percentage of part-time workers who would like to work more hours (Chart 5).⁵ This phenomenon would help to explain why the number of hours per worker remains at historically low levels in many countries, despite the increase in employment in terms of the number of persons employed (Chart 6).

It is therefore difficult to determine precisely the strength of possible supply side restrictions and their potential impact on growth in activity in some countries in the area. Nevertheless, although the labour supply indicator shows rising shortages across the euro area as a whole, the increase is still small: just 20% of firms say they are concerned about labour shortages, less than the percentage pointing to insufficient demand as a limiting factor on activity. Furthermore, most firms consider there to be no factor limiting their activity at the moment (Chart 3), and this is so even in those countries with low unemployment rates, such as Germany. This all suggests that the degree to which supply-side constraints are increasingly binding is subject to strong heterogeneity between countries and industries, and possibly between individual firms.

Additionally, looking ahead, the role that the recent strong migratory inflows might play in alleviating possible labour market tightness in the euro area is unclear, given the current difficulty of estimating how employable these migrants are and their possible

1 For a detailed analysis of the factors that may be behind the slowdown in the area's GDP at the start of the year, see Box 2 "Has the slowdown in economic activity in the euro area been a result of permanent or temporary factors?", *Economic Bulletin 2/2018*, Quarterly report on the Spanish economy, Banco de España.

2 The different cycles are not fully comparable. For example, after a deep recession, the recovery tends to be slow, and the subsequent expansion, longer lasting.

3 Applying a methodology similar to that used in Box 2 of ECB *Economic Bulletin 4/2018* suggests that, in the euro area, the average duration of the expansions was 31 quarters, compared with 19 quarters in the current expansion, while the average intensity was 20 pp in GDP terms (9 pp in the current phase).

4 In the third quarter of 2018, these percentages for the euro area as a whole were 16.7%, 19.2% and 20.6% in industry, services and construction, respectively.

5 In Germany and Italy, the percentage of involuntary part-time employment is fairly moderate, although the trend is heading in opposite directions: rising in Italy and decreasing in Germany.

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Chart 1
EURO AREA. GDP GROWTH AND OUTPUT GAP (a)

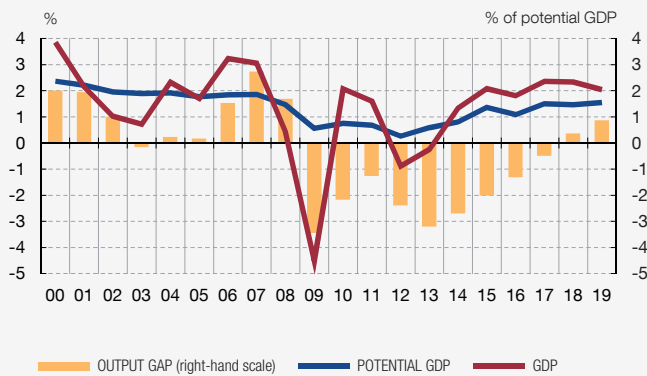


Chart 2
EURO AREA. ANNUAL AVERAGE GROWTH BETWEEN PEAKS IN THE CYCLE (b)

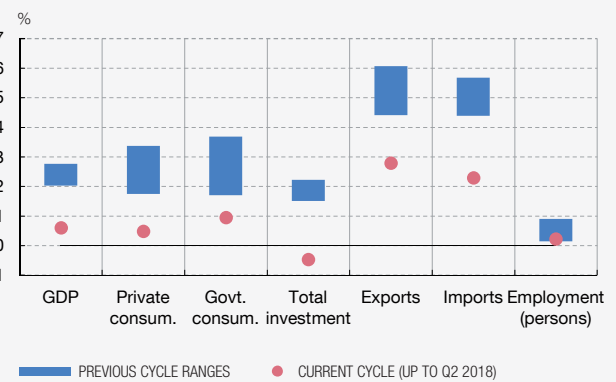


Chart 3
CAPACITY UTILISATION (EURO AREA AND COUNTRIES) AND FACTORS LIMITING ACTIVITY IN THE EURO AREA (c)

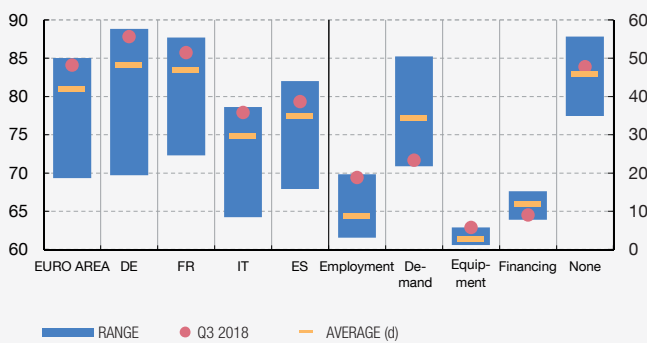


Chart 4
LABOUR SUPPLY SHORTAGES AND UNEMPLOYMENT RATE. EURO AREA COUNTRIES (2004-2018)

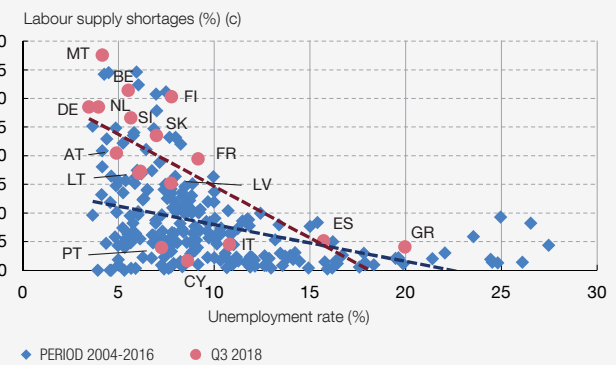


Chart 5
INVOLUNTARY PART-TIME EMPLOYMENT

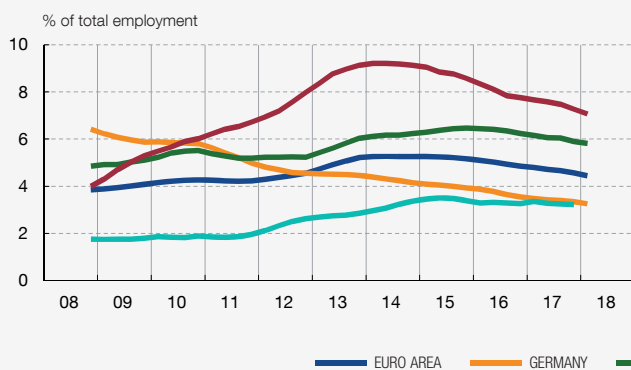
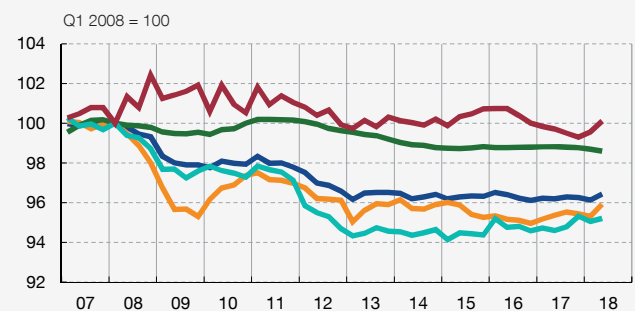


Chart 6
HOURS PER EMPLOYEE



SOURCE: European Commission.

- a European Commission data (spring 2018).
- b Cycles go from one peak to the next following the Centre for Economic Policy Research (CEPR) chronology. Specifically, the periods considered are: Q3 1974 to Q1 1980; Q1 1980 to Q2 1992; Q2 1992 to Q1 2008 and Q1 2008 to Q2 2018 (incomplete cycle).
- c Average of factors limiting activity in services, industry and construction.
- d Average since 1999 for capacity utilisation and since 2004 for factors limiting activity.

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difficulty in joining the labour force. Lastly, it is also unclear whether there is still room for the participation rate of certain population groups (such as women and young people) to rise in some countries, given that their values are still relatively low by international standards.

In short, the available evidence suggests that the possible supply side restrictions on some factors of production, particularly labour, in some sectors of certain core euro area economies are not sufficiently intense at present to explain the slowdown in the euro area economy in the first half of this year. By contrast, this

deceleration could be mainly reflecting demand factors relating to declining global demand for goods and services, and to adverse developments in agents' confidence, against the backdrop of growing geopolitical tensions. Looking ahead, however, if the euro area's growth proceeds according to current forecasts, which are consistent with growth at a pace exceeding its potential rate, supply side factors can be expected to start to play a progressively more significant role in shaping output growth. In turn, on the historical evidence, this should support a sustained rise in inflation rates towards levels compatible with the ECB's aim to maintain inflation rates below, but close to, 2% over the medium term.
