

The Cyclical Dynamics of European Unemployment

Extended Abstract

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This paper addresses the ins and outs of European unemployment. This issue has sparked great interest in the literature, with special focus on the US (see, for instance, Shimer, 2007, Fujita and Ramey, 2009). The recent debate has not only led to new insights into the dynamics of the labor market, but also to significant methodological improvements in the treatment of sluggish labor market adjustments – a characteristic feature of European labor markets. In particular, the modified factor analysis proposed by Elsby, Michaels and Solon (2009) seems to be well-suited for this purpose. Our paper applies their approach to European data of monthly frequency.

Changes in the number of unemployed job searchers are driven by two channels. An increase in unemployment may be due to an increase in the inflow, a decline in the outflow, or both. Several studies have shown that the extent of worker flows between employment and unemployment in European labor markets is significantly smaller than in the US (see Elsby, Hobijn and Sahin, 2008). However, no paper has yet provided a convincing answer to the question which of the two channels is more important in explaining the variations in the number of unemployed job searchers.

The main aim of our paper is to explain (i) to what extent European labor markets behave differently from the US and (ii) to quantify the role of the two above-mentioned channels in explaining European unemployment variability. Existing studies on this topic either do not account for the slow adjustment dynamics in European labor markets or use low-frequency data which is subject to severe measurement errors (Elsby, Hobijn and Sahin, 2008, Gomes, 2010, and Petrongolo and Pissarides, 2008). The only study, to our knowledge, that has addressed a similar issue as that of our paper is the one by Smith (2010). Using UK data, she shows that the British labor market transition rates are lower than in the US and that the UK unemployment rate is mainly driven by changes in the inflow. But, as is well known, most continental European labor markets are still less flexible than their British counterparts. In particular, the extent of employment protection is more prevalent.

Therefore, our paper adapts a similar approach to data from Germany and Switzerland, i.e. a relative rigid and a relative flexible labor market, respectively. We first correct these data for margin errors and make them as comparable as possible. In a

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second step, we employ a modified version of a conventional factor analysis, which allows to study the slow adjustment dynamics predominant in European labor markets (see Elsby, Hobijn and Sahin, 2008).

As preliminary results of Sigrist (2009) using European Community Household Panel (ECHP) data show, job finding and job separation rates do not only differ significantly between Europe and the United States, but also between European countries. Also, the cyclicity of both job finding and job separation rates seems to follow different patterns. For example, European job finding rates tend to lead the cycle. But after a turning point, German job finding rates do not show any clear direction whereas UK job finding rates tend to increase (decrease) quickly after a recession (boom). Finally, Sigrist (2009) concludes that the contributions of European transition rates to unemployment variability differ significantly from the United States. Our present study, in contrast, extends this study by using longer time series and more carefully adjusted raw data, which allows us to derive more robust results.

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