Press points for Chapter 3: ***Unemployment Dynamics during Recessions and Recoveries: Okun's Law and Beyond***

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Prepared by Ravi Balakrishnan, Mitali Das and Prakash Kannan

Key points

- **Unemployment responses differed markedly across advanced economies during the Great Recession. The sharp increases in Spain and the United States can be explained largely by the effect of output declines, as well as the impact of financial stress and house price busts. In other countries, the rise in unemployment was less than predicted, partly reflecting large short-time work programs (Germany, Italy, Japan, and Netherlands).**

- **Given the sluggish recovery in output and the lingering effects of financial stress, the average unemployment rate in advanced economies is forecast to remain high through 2011, although employment is expected to turn positive in many countries in 2010.**

- **Conventional monetary and fiscal policies remain the primary tools for boosting employment through their impact on economic activity. Financial sector repair is also essential, given that labor-intensive sectors rely heavily on bank credit. Beyond this, there is a need to encourage wage flexibility and improve labor market institutions. Depending on individual country circumstances, designing exit strategies from short time work programs and tackling the problems of two-tiered labor markets are further issues for consideration to foster employment creation.**

During the Great Recession, output and unemployment responses differed markedly across advanced economies (figure). For example, in Ireland and Spain the unemployment rate increased by about 7½ percentage points, despite the fact that output dropped by more than 8 percent in Ireland but by only half as much in Spain. Moreover, although Germany suffered an output drop of about 7 percent, the unemployment rate actually *decreased* during its recession.

To shed light on this and near-term prospects, this chapter provides a systematic analysis of unemployment developments, for a sample of advanced economies, during

recessions and recoveries over the past 30 years.[1] Because unemployment is largely driven by output fluctuations, the chapter uses Okun's law—the relationship between changes in the unemployment rate and changes in output—as an organizing framework. The different responses during the Great Recession suggest that, apart from the varying impact of output fluctuations because of differences in employment protection and the share of temporary workers, changes in unemployment were also driven by policies and shocks, which the chapter also analyzes.

The decline in output, institutional differences, the nature of the crisis, and the policies implemented explain the unemployment responses in several economies. During the Great Recession, the sharp increases in unemployment in Spain and the United States can be explained largely by the impact of output declines as predicted using Okun's law, by financial stress, and by the impact of house price busts. High financial stress prompts larger layoffs by firms that rely more on external financing than during recessions without such stress. Recessions that are accompanied by housing busts also tend to feature more job losses than normal recessions as the shocks affect employment-intensive sectors, such as construction. In countries that implemented large short-time work programs (Germany, Italy, Japan, and the Netherlands), the rise in unemployment caused by these factors was less than predicted. Other countries that experienced less unemployment than expected remain more of a puzzle (Canada and the United Kingdom).

Overall, the analysis in the chapter presages sluggish employment growth during the recovery. Beyond the potentially slow recovery in output, the nature of the recent recession—financial crises combined with house price busts—in several advanced economies weigh against unemployment moderating any time soon (figure). Indeed, based on the current path of policies, the forecasts presented in this chapter suggest that although employment growth will turn positive in many advanced economies in 2010, the unemployment rate will remain high through 2011.

Given the potential for high short-term unemployment to become entrenched over the medium term, combating unemployment is a key policy challenge. The standard macroeconomic policy levers—monetary policy and fiscal policy—remain the primary tools for boosting employment through their impact on economic activity. Financial sector repair is also essential, given that labor-intensive sectors rely heavily on bank credit.

Several specific labor market policies could help reduce unemployment, in addition to generally encouraging wage flexibility and improving labor market institutions. For

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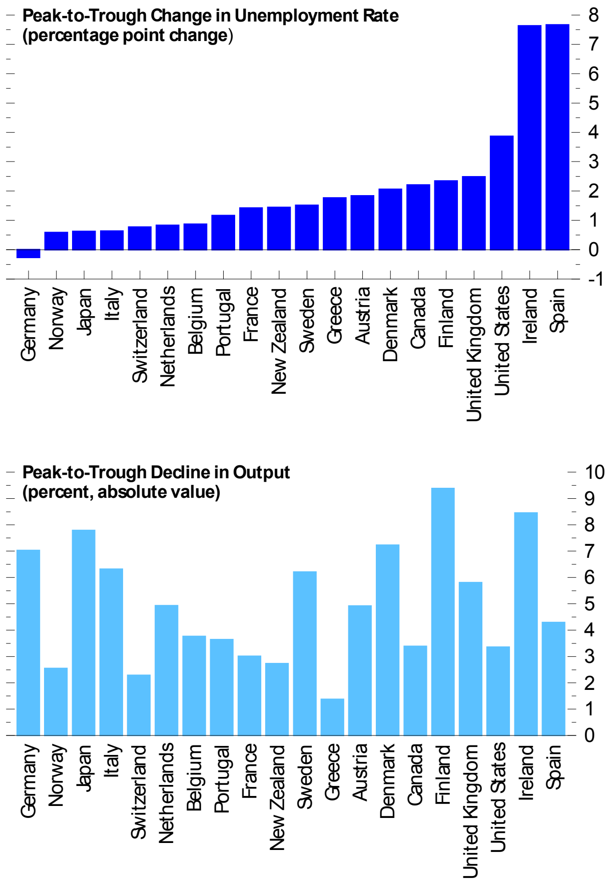
[1]The sample includes Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom, and United States.

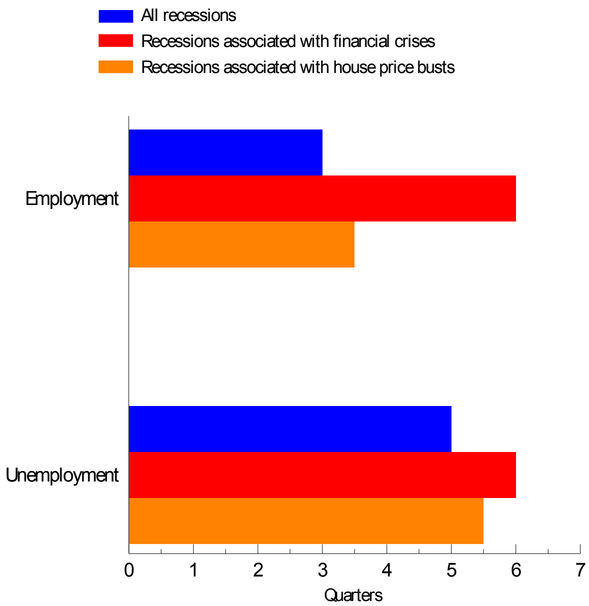
economies with lingering macroeconomic uncertainty, but where labor productivity remains strong, targeted and temporary hiring subsidies may help advance employment creation. Evidence suggests that the success of these schemes depends on how well they are targeted, designed, and enforced. In countries with large short-time work programs, phasing them out as the economy recovers combined with carefully designed wage-loss insurance programs could help facilitate movement of labor across sectors. Finally, in countries with two-tier labor markets—where employment protection legislation is strict for permanent contracts and the share of temporary workers is high—transitioning to a system of open-ended labor contracts under which employment security gradually increases with tenure could help reduce the negative impact of temporary employment contracts on human capital formation and the lack of unemployment benefit coverage for such workers.

Figure 3.1. Change in the Unemployment Rates and Output Declines during the Great Recession[1]



Source: IMF staff calculations.
[1] Because GDP in Greece and Spain has not yet reached a trough according to official data, the change in unemployment and decline in output are taken from the peak to the latest data point.

Figure 3.10. How Long before Employment Recovers?
(Median number of quarters before employment (unemployment) reaches its trough (peak) after the end of the recession)



Source: IMF staff calculations.