Box VI-2

Is the increase of equilibrium unemployment reversing?

The Beveridge curve in Chart 1 shows the relation between demand (vacancies[1] – vertical axis) and supply (unemployment – horizontal axis). In equilibrium, unemployment and vacancies move in opposite directions over the business cycle along a negatively sloped line (NW-SE line). Changes in labour demand, reflected by the number of vacancies, generally result in changes in unemployment.

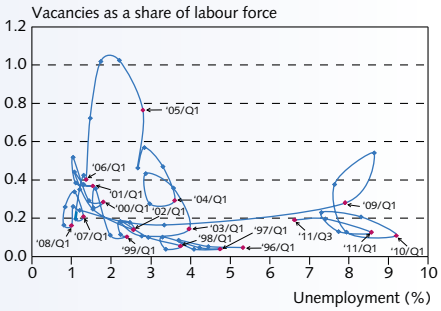
The Beveridge curve may shift due to changes in either or both, labour demand and supply. It is likely that a rightward shift of the curve stems from changes that make labour market institutions more rigid in responding to shocks. Although a rightward shift is generally interpreted as a sign of increased equilibrium unemployment, other factors can also cause the curve to shift, as was the case in Iceland in 2003-2005 (see a more detailed discussion of the reasons of increases in equilibrium unemployment in Section VI).

Chart 1 shows how unemployment and vacancies in the period 1996-2002 tracked the cycle by a NW-SE line. In 2003, there was an increase in both unemployment and vacancies, which caused the curve to shift to the right. Up until the last quarter of 2005, it seemed like a new equilibrium had been reached where more vacancies were needed than before to reduce unemployment. The reason for the curve's rightward shift is that employers wanted to import labour, but were required to post vacancies to show that they could not be filled domestically before they could apply for work permits for imported labour.[2] In 2003, vacancies for the Kárahnjúkar power station project were first advertised.

The supply of vacancies fall after nationals of the new EU accession countries (EU-8)[3] were allowed to work in Iceland without work permits, formally in May 2006, but with an agreement in autumn 2005, since it was no longer necessary to advertise vacancies to show that they could not be filled domestically. The relation between unemployment and vacancies then fell back to its previous position and stayed there until the financial crisis hit, when unemployment increased rapidly and equilibrium unemployment rose.

However, Chart 1 also suggests that the temporary rise in equilibrium unemployment has started to reverse as the unemployment rate has fallen without a significant increase in vacancies. Since the unexplained temporary increase in vacancies in the summer of 2009, the Beveridge curve has been almost horizontal.

Chart 1
Unemployment and vacancies
Q1/ 1996 - Q3/ 2011



Source: Directorate of Labour.

1. The data used here from the Directorate of Labour, compiled from employment agencies (from 1997). No reliable data are available for vacancies in Iceland before that time. Not all vacancies are advertised with agencies, but the relationship between agency vacancies and unemployment should none the less serve as a good gauge of labour market matching.
2. See Rannveig Sigurðardóttir (2005), „The enigma of the Icelandic labour market", *Monetary Bulletin* 2005/1.
3. The E-8 countries are Estonia, Latvia, Lithuania, Poland, Slovakia, Slovenia, the Czech Republic and Hungary.