BUSINESSEUROPE

Contribution to MED at technical level

16th Meeting of the Macro-economic Dialogue at Technical Level -
25 April 2007

Question 1:

Where do participants see the major challenges for the policy-mix - in particular the direction of monetary and fiscal policies as well as wage developments?

An appropriate policy mix in the recovery would require more fiscal consolidation, wage settlements that remain fully consistent with productivity and a monetary policy stance that internalises all risks, including those of further exchange rate appreciation.

1. Use good times to consolidate public finances…

Adhering to the principle of countercyclical fiscal policies around a sustainable long-term path for public finances is a fundamental objective in general, and is particularly crucial to ensure an appropriate policy mix for countries sharing the euro.

Contrary to these requirements, public debt remains high in most countries and fiscal policies show a pro-cyclical pattern, captured by a negative correlation between changes in structural budget positions and cyclical conditions (see Chart 1). Consolidation plans for the next two years are more ambitious than they have been in previous recoveries, but they remain focused on rising tax revenues and fall short of the structural adjustments required by the new rules of the Stability and Growth Pact (more than 0.5% of GDP in good times). Moreover, there is still no cross-country consistency between prevailing cyclical conditions and fiscal consolidation efforts (see Chart 2), implying that fiscal policies will not play a "stabilising" role for cyclical divergences in the recovery.

Beyond deficit and debt concerns, the quality of public finances is also crucial. In coherence with the Growth and Jobs strategy, resources must be directed in priority towards growth-enhancing spending such as education, training, research, innovation and infrastructures.

Chart 1: correlation between structural budget changes and output gap levels – 1996 to 2006

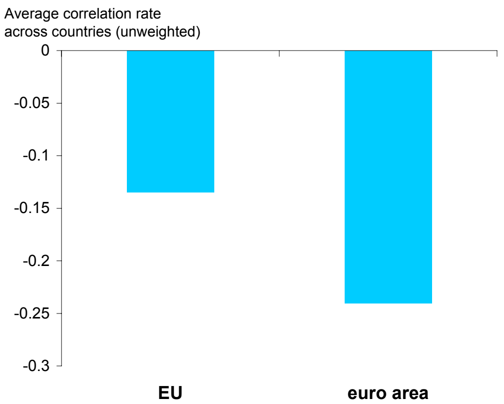
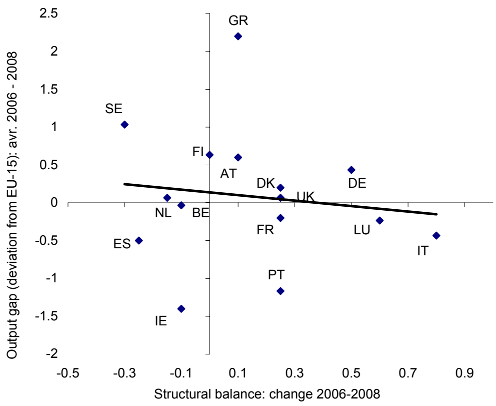


Chart 2: structural consolidation and output gap over the next two years



Source: BUSINESSEUROPE based on European Commission's AMECO database

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2. Make sure that wages remain conducive to price stability and employment creation…

The business community is vigilant of wage pressures developing, but does not see them as a substantial upside risk to price stability at EU and euro-area level. Heightened global competition and dynamic labour supply growth will continue to play a mitigating role in the recovery.

The baseline forecasts of BUSINESSEUROPE's national federations show hourly wage growth at around 2.3% in 2007 and 2008 in the euro area (see Table 1, forecast cut-off date: end-February). However, risks to this assessment are on the upside, and have increased since the forecasts were published in early March.

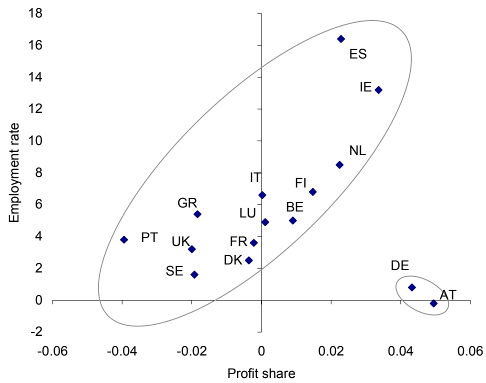
Moderate wage settlements are essential for a further consolidation of the employment recovery. Looking backwards, chart 3 illustrates a positive correlation across countries between wage moderation over the last decade (as measured by a rising profit share), and rising employment rates. Germany and Austria show a contrast, as these two countries were over the last decade in a process of regaining external competitiveness, whose effects on growth and employment have become more clearly visible in recent years.

This said, if wage forecasts appear consistent with price stability at euro-area level, they point at the individual country level towards further divergences in cost competitiveness. These persistent divergences are an important source of concern for the business community and must be addressed adequately and in good time (see section 2 for a more detailed assessment).

Table 1: BUSINESSEUROPE's wage inflation forecasts

	EURO AREA		
	Hourly wage	Hourly productivity	Unit labour costs
2007	2.3	1.2	1.1
2008	2.2	1.3	0.9
	EU		
	Hourly wage	Hourly productivity	Unit labour costs
2007	3.1	1.5	1.6
2008	2.9	1.6	1.3

Chart 3: profit share and employment rate - change from 1995 to 2006



Source: BUSINESSEUROPE survey spring 2007 and BUSINESSEUROPE based on Eurostat

3. Avoid pushing interest rates up too far and internalise the risk of euro appreciation…

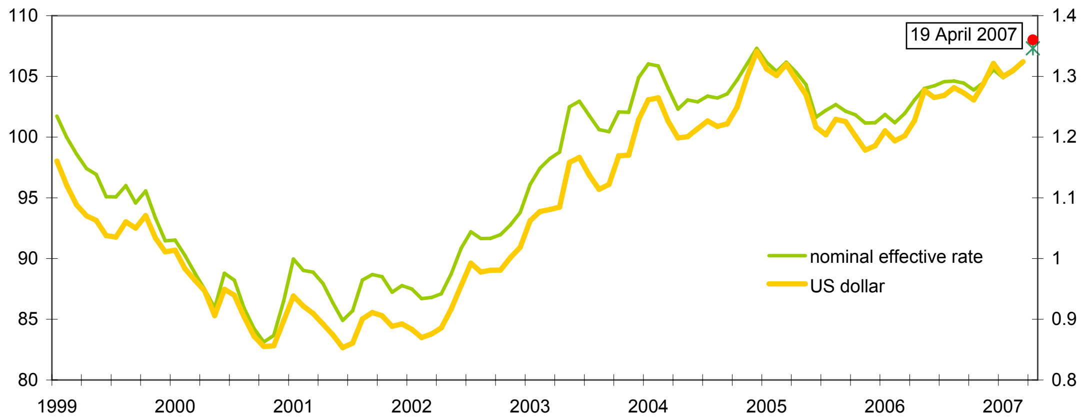
Despite the recent appreciation, the value of the euro is still in known territory, and is seen by the business community as compatible with the recovery in Europe. A relatively strong euro can even bring positive elements in the upturn, such as reduced input costs for companies, lower inflationary pressures in general and more incentives to reform.

However, the euro and other European currencies are at high historical levels against the US dollar, Japanese yen and Chinese yuan. It is worrying to envisage risks of further dollar depreciation in a context where major global currencies remains tightly linked to it (see chart 4). While European policy-makers need to encourage a decoupling of global currencies (with large current account surpluses) from the dollar, they also need to work on the assumption of a continued appreciation of the effective euro exchange rate.

This means that the ECB should keep exchange rate risks in mind when setting monetary policy, especially considering that interest rate differentials are important factor determining euro/dollar movements. Once at 4%, interest rates will be around neutral levels for the recovery and there are no obvious reasons to go into restrictive territory, unless clearer signs of inflationary pressures are emerging.

The current situation also illustrates that Europe needs to strengthen its external position with a unified voice on global economic governance issues. This is particularly important to avoid it becoming the innocent bystander in global exchange rate readjustments.

Chart 4: euro nominal effective exchange rate and euro/dollar exchange rate



Source: ECB

Question 2:

What would be appropriate to ensure a sustainable and lasting upswing with price stability and a fair participation of all?

1. Foster productivity growth…

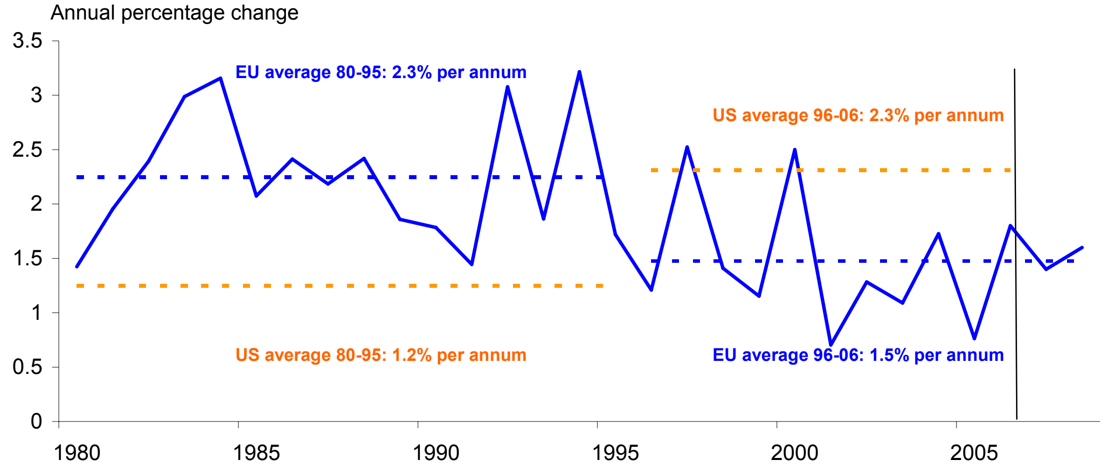
Rising employment rates have made a positive contribution to growth over the last decade, and is an important factor supporting the ongoing recovery. However, growth has been constrained by disappointing productivity trends, which are again trailing behind in the present upturn.

Hourly productivity growth in the EU is estimated to have peaked already in 2006, at 1.9%, and should stabilise over the next two years at around 1.5% according to our spring forecasts (see Chart 5). This is putting a cap on income developments and reinforces negative expectations regarding future economic trends and the sustainability of social systems.

The poor aggregate productivity performance is the result of complex interactions but can be linked back to unnecessary obstacles to the entry, growth and innovation of companies, which reduce the benefits of technological progress and fast globalisation. In a similar vein, flexible forms of labour regulations and efficient active labour market policies facilitating transitions on the labour market are needed to allow more innovative and competitive companies to grow and absorb a larger proportion of the available workforce.

Recommendations: heightened competition (EU and national level), fewer regulatory burdens, better technological infrastructures, better education and training, more labour market flexibility and adaptability

Chart 5: Hourly labour productivity growth in the EU-15



Source: BUSINESSEUROPE survey spring 2007 and GGDC

2. Address competitiveness imbalances…

Current account imbalances in the euro area have steadily increased since the start of monetary union. Today, among the five OECD countries with the largest current account deficits (as a % of GDP), three are in the euro area – Spain, Portugal and Greece – mainly compensated by large surpluses in Germany, the Netherlands or Finland.

Those imbalances are not an immediate threat in the absence of country-specific exchange rate risks and relatively uniform risk premia. However, these imbalances are nevertheless worrying as they indicate that the workings of competitiveness and growth re-adjustments between euro-area countries are very slow.

In fact, growing external deficits in Spain, Portugal, Greece, but also France and Italy are intimately connected with drifting competitiveness (see Chart 6), unabated by either market forces or national policies. On the other hand, the accumulation of considerable current account surpluses, in particular in Germany, reflects not only rising competitiveness but also the slow dissemination of these gains to domestic demand.

The main reasons for the slow rebalancing of competitiveness positions in monetary union are associated with two groups of factors. First, at microeconomic level, they are the consequence of structural rigidities dampening productivity and leading to excessive price and wage inertia. Second, imbalances tend to be reinforced by an inadequate (pro-cyclical) macroeconomic policy mix at the individual country level.

Chart 6: real exchange rate developments in the euro area since 1999

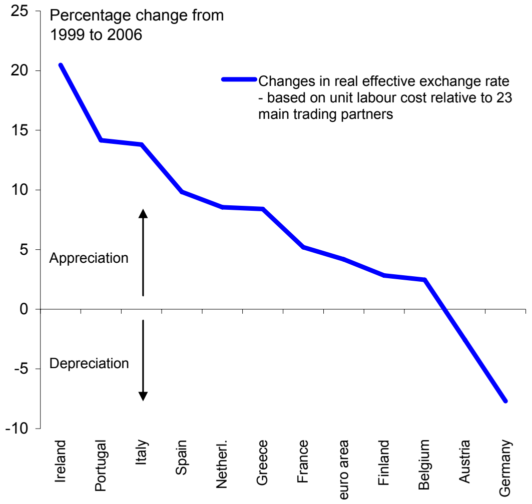


Table 2: explaining competitiveness divergences in the euro area

Panel data model[1] Dependent variable: Explanatory variable	Unit labour cost inflation[2] 1999-2006
	Coefficient value and significance [5]
Lagged ULC inflation	0.37***
Cyclical conditions [3]	0.49***
GDP per capita [4]	-0.01***
R-square	81%
Durbin Watson	2.13

Source: BUSINESSEUROPE based on AMECO, IMF, OECD and Eurostat

Note:

(1) *Estimates are based on a pooled model combining 15 years of observation across 11 euro-area countries (15*11=165 observation). The estimation method allows for cross-section heteroskedasticity and contemporaneous correlation between country residuals*

(2) *Unit labour cost of each country relative to 23 main trading partners – annual percentage change*

(3) *Output gap - i.e. deviation between actual and potential output levels – deviation from euro-area average*

(4) *Level of GDP per capita – deviation from euro-area average*

(5) *Probability of coefficient being insignificant: *** less than 1%, ** between 1% and 5%, * between 5-10%*

To illustrate this point, Table 2 presents regression results explaining relative unit labour cost inflation across the euro area by three factors: inertia, cyclical conditions, and the level of GDP per capita. The first factor, inertia, should capture the effect of product and labour market rigidities leading to slow price and wage adjustments; the second, cyclical conditions, the fact that countries with above-trend growth generally face more inflationary pressures; and finally, GDP per capita controls for the fact that catching-up economies could have higher inflation, but without this necessarily being a problem for their competitiveness if it reflects a process of price convergence in the non-tradable sector.

All three factors accounts together for 80% of unit labour cost trends in the euro area, but in quantitative terms, the most significant element is inertia, and this effect seems to have amplified since the start of monetary union.

Obviously, wage formation takes a central role in determining competitiveness. An overarching priority to avoid any long-lasting drift is to ensure that real wage developments are consistent with trend productivity growth, not only at the aggregate level but also across various segments of the labour market and at the company level. Wage differentiation reduces wage inertia and hence the impact of asymmetric shocks on competitiveness, growth and employment. In a context where competitiveness imbalances have grown steadily over the last decade, it is also crucial that countries lagging behind put in place a coherent adjustment scenario, combining wage moderation with reforms aimed at boosting productivity.

Policies aimed at raising price and wage flexibility would have pervasive positive consequences for the functioning of monetary union, including by giving more margins for the ECB to respond to changing economic conditions.

Persistent cyclical divergences also contribute to slow country adjustments in monetary union, and both monetary and fiscal policy seem to have played a role in this regard. At the national level, the asymmetrical effect of the single monetary policy is a rather natural outcome in the presence of heterogeneous conditions across euro area countries (although the effect of credit constraints and housing market channels might have been initially underestimated). What is more worrying is that fiscal policies are also pushing in the same pro-cyclical direction (see Chart 1 and previous comments on it). This clearly emphasises the importance of a strict enforcement and enhanced ownership of the preventive arm of the Stability and Growth Pact, in order to overcome the current pro-cyclical bias of national fiscal policies.

Recommendations: More competition, particularly in the services sector, more financial integration, in particular in retail credit and mortgage markets, more wage responsiveness, faster budgetary consolidation in good times.

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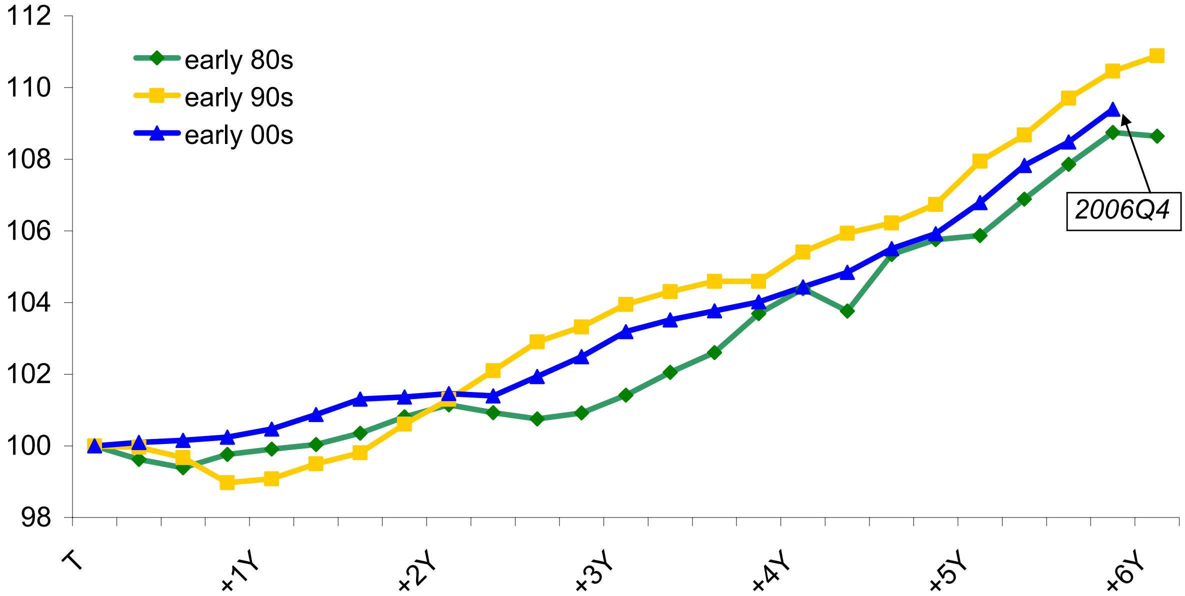
Additional material:

I. Employment is more dynamic than in the past but productivity is trailing behind

Chart A1: Euro area GDP level comparison across three business cycles

Index =100 at the peak of the previous upturn
Early 1980s: 1980Q1 (CEPR Business Cycle Dating Committee)
Early 1990s: 1992Q1 (CEPR Business Cycle Dating Committee)
Early 2000: 2001Q1 (own estimate)



Source: BUSINESSEUROPE based on OECD quarterly national account database

Chart A2: Employment

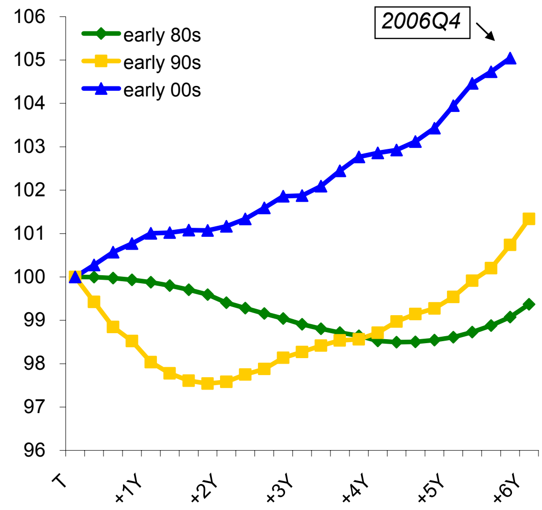
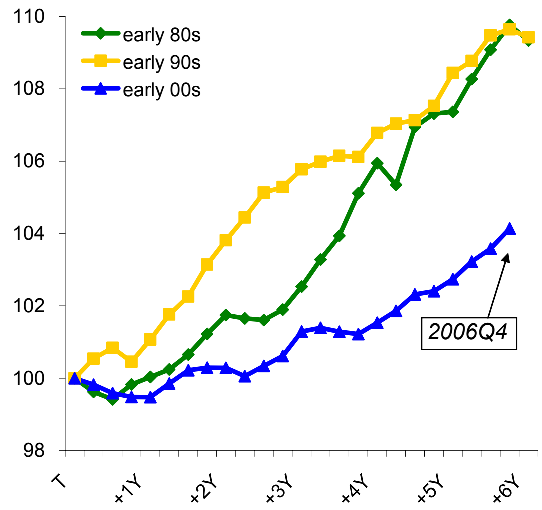


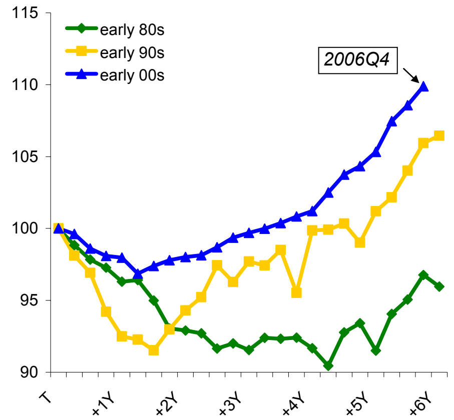
Chart A3: Productivity

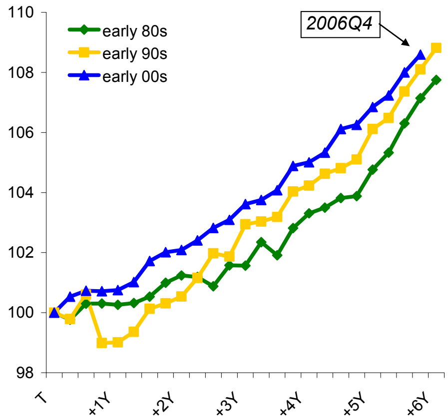


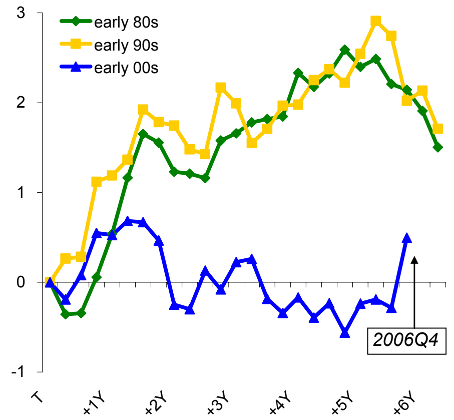
Source: BUSINESSEUROPE based on OECD quarterly national account database

Chart A4: Investment **Chart A5: Private consumption** **Chart A6: Net exports in % of GDP**

Index = 0 at peak







Source: BUSINESSEUROPE based on OECD quarterly national account database

II. IMF forecasts for 2007 are relatively cautious, in line with BUSINESSEUROPE's spring 2007 Economic Outlook

BUSINESSEUROPE FORECAST, March 2007

	Euro area			EU		
	2006	2007	2008	2006	2007	2008
Real GDP (annual % growth)	2.7	2.2	2.0	3.0	2.6	2.4
Inflation (%)	2.1	2.0	1.9	2.2	2.2	2.0
Unemployment (%)	7.8	7.4	7.2	7.9	7.3	7.0
Employment (%)	1.3	1.2	1.0	1.5	1.3	1.2
Hourly wage growth (%)	2.6	2.3	2.2	3.1	3.1	2.9
Hourly productivity growth (%)	1.6	1.2	1.4	1.9	1.5	1.6
Private consumption (%)	2.1	1.9	1.8	2.4	2.2	2.1
Public consumption (%)	2.1	1.4	1.4	2.1	1.6	1.6
Gross fixed capital formation (%)	4.4	4.0	3.6	5.3	4.7	4.2
Exports (%)	8.1	5.4	5.0	8.4	5.9	5.9
Imports (%)	8.2	5.6	5.0	8.4	6.2	5.9

IMF FORECAST, April 2007

	Euro area			EU		
	2006	2007	2008	2006	2007	2008
GDP (annual % growth)	2.6	2.3	2.3	3.2	2.8	2.7
Inflation (%)	2.2	2.0	2.0	2.3	2.2	2.2
Unemployment (%)	7.7	7.3	7.1			
Exports (%)	8.2	5.7	5.3			
Imports (%)	7.6	5.6	5.5			

Sources: IMF April 2007 WEO