UNICE
THE VOICE OF BUSINESS IN EUROPE

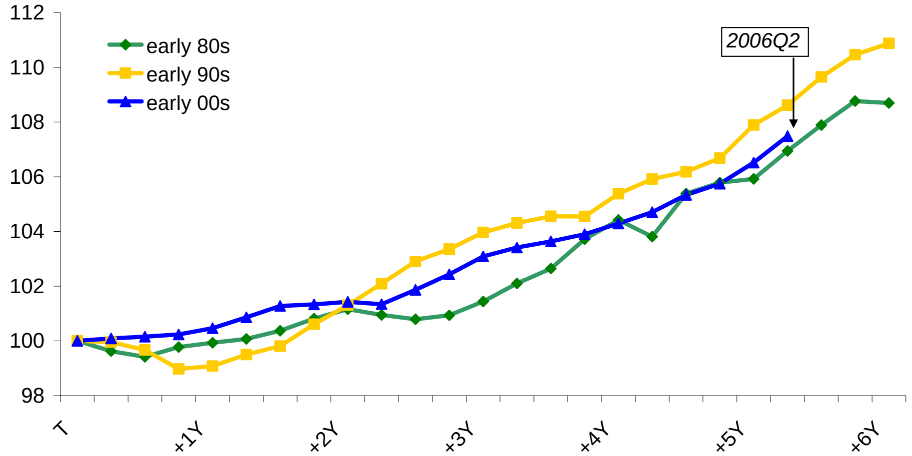
BACKGROUND MATERIAL FOR MEDTEC

SPECIAL ISSUE:
COMPARISON OF CURRENT RECOVERY WITH PAST EPISODES

1. Current upturn is comparatively modest and follows a drawn-out period of sluggish growth

Chart 1: 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)



Sources: UNICE based on OECD quarterly national account database

From the behaviour of aggregate activity, the current business cycle looks more like that the early 1980s than early 1990s, in the sense that a shallow recession was followed by several years of weak growth and two failed recoveries. During the early 1990s, the recession was more pronounced but the subsequent recovery also significantly more dynamic.

2. The external contribution to growth is the absent guest in this recovery

Chart 2: Investment

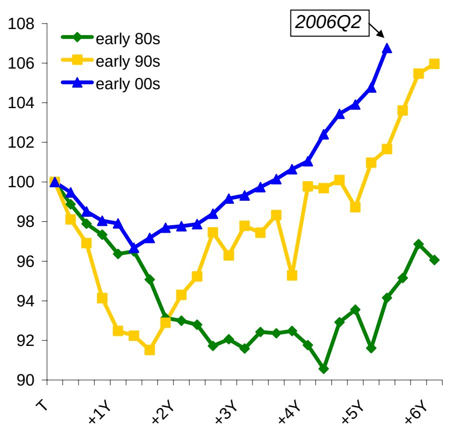


Chart 3: Private consumption

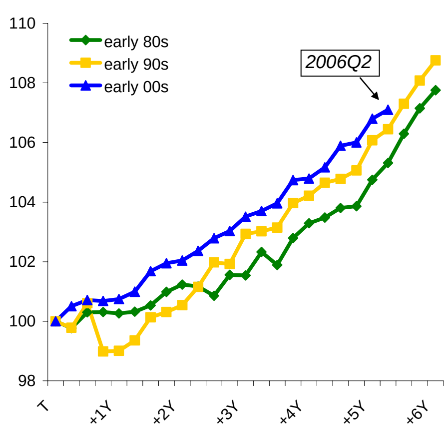
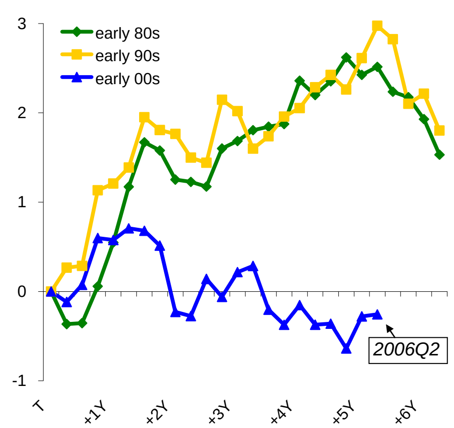


Chart 4: Net exports in % of GDP
Index = 0 at peak



Sources: UNICE based on OECD quarterly national account database

Domestic demand has only picked up very slowly in recent years, but the preceding slowdown was also milder than in the past. In fact, investment behaviour has proved overall more resilient and vigorous during this business cycle than during the early 1990s and certainly the early 1980s. This mirrors limited overcapacity during the 2001-03 downturn and progress in corporate restructuring and debt consolidation. Private consumption showed so far a lack of momentum, partly reflecting high household's savings despite resilient labour markets, low interest rates, and significant asset price inflation. This demonstrates a lack of confidence in longer-term income prospects, related to weak productivity growth, unsustainable public finances and globalisation pressures.

This said, the critical difference with previous recoveries relates primarily to the contribution of trade to growth. During both the early 1980s and 1990s, net exports provided a substantial stimulus to the upturn, while this positive contribution is absent in the current cyclical upturn, despite global activity and trade growing at a record pace. This largely reflects (despite the strong external performance of the German economy) a deterioration in the competitiveness position of the euro area, translating into losses of export market shares and an increased import penetration in domestic demand.

3. On the supply side, employment is picking up more strongly but productivity growth is dismal

Table 1: Euro area real GDP growth breakdown

average y-o-y growth rates – four-year recovery period

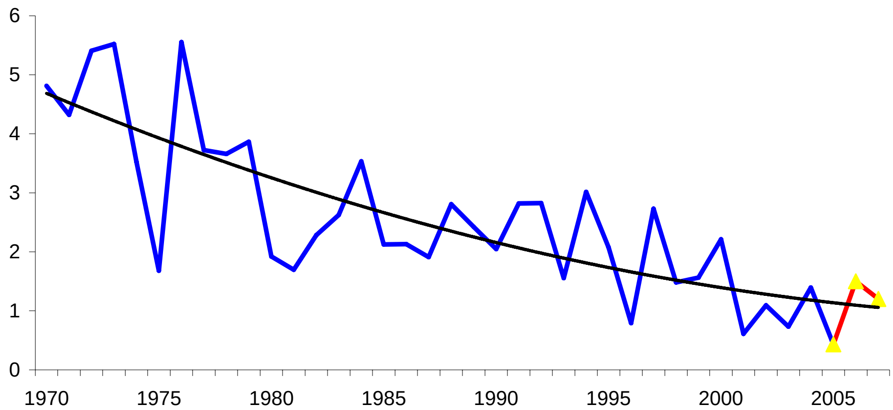
	1983-1986	1994-1997	2004-2007
Real GDP growth:	**2,1**	**2,3**	**2,0**
Contribution from			
hourly labour productivity	2,6	2,2	1,2
employment rate	-0,7	0,3	0,5
hours worked per person	-0,7	-0,4	-0,2
active age population	0,8	0,2	0,4
memo:			
unemployment rate	-0,4	-0,1	0,3
labour force participation	-0,3	0,4	0,2

Sources: UNICE based on Eurostat, Groningen Growth and Development Centre, OECD. Forecasts for 2006 and 2007 are from UNICE's forthcoming Autumn 2006 Economic Outlook

Rising labour force participation and declining unemployment are making a positive contribution to the current economic recovery. Hours worked are also declining less than in the past, reflecting the unwinding of labour underutilisation (labour hoarding) during previous years of weak economic growth.

At the same time, the productivity performance during this recovery is largely unsatisfactory, causing some doubts about the more medium-term prospects for self-sustaining growth. This slow productivity growth, in line with the poor average record over the last decade, is a major factor hampering potential output growth. A key policy challenge to uphold growth in the euro area is to put in place the conditions to avoid a negative trade-off between more inclusive labour markets and productivity growth.

Chart 4: Hourly labour productivity growth in the euro area



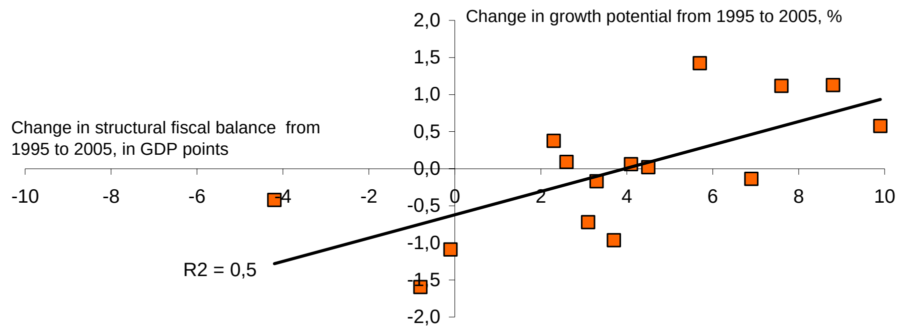
Sources: UNICE based on Groningen Growth and Development Centre. Forecasts for 2006 and 2007 are from UNICE's forthcoming Autumn 2006 Economic Outlook

PRIORITIES TO CONSOLIDATE THE CURRENT UPSWING

1. Fiscal discipline is a precondition for growth in an ageing society

The lack of competitiveness of the euro area economy and declining potential output growth became entrenched in negative expectations during the last cyclical downturn. The uncertainty about long-term prospects, reflected in rising household savings, has been reinforced by an inadequate response to globalisation and unsustainable public finances and social systems.

Chart 5: A positive correlation between potential growth and fiscal consolidation across EU15



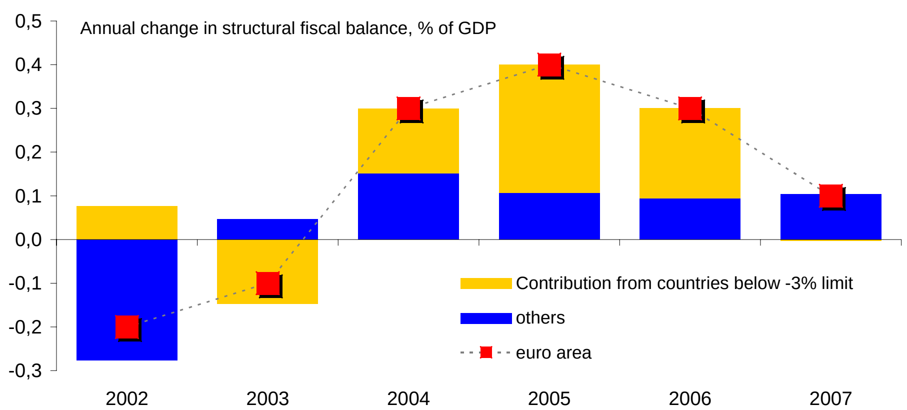
Sources: UNICE based on IMF September 2006 WEO

During this recovery, a first priority is for governments to improve their long-term budgetary positions, allowing a mutually reinforcing process of fiscal consolidation and economic growth.

Community surveillance plays a strong role here. The revised rules of the Stability and Growth Pact have induced some positive developments, notably in the area of enforcement of corrective measures for excessive deficit countries. And in effect, member states with deficits in excess of 3% have been those contributing most, and nearly exclusively, to the improvement in the euro area structural balance over the last two years. However, the new rules of the pact still need to prove their effectiveness in delivering on two other crucial objectives: (i) strengthen the commitment to fiscal discipline during good times, and (ii) ensure ambitious medium-term objectives commensurate with the challenge of demographic ageing.

On the first aspect, fiscal deficits are expected to improve this year, but mainly on account of stronger economic growth and exceptional corporate tax revenues. Notwithstanding these developments, the fiscal stance will not make sufficient progress in 2006, as captured by an only modest improvement in the euro area's structural fiscal balance expected this year. In 2007, there is also a significant risk that revenue windfalls deriving from stronger-than-expected growth this year will not be used to intensify consolidation.

Chart 6: Changes in the euro area structural fiscal balance



Sources: UNICE based on IMF September 2006 WEO

In the face of above-trend growth in 2006, governments need to set more ambitious targets for next year, and those countries already above their medium-term objectives should avoid pro-cyclical policies. A failure to reduce budget deficits significantly during good times will prove detrimental for confidence and medium-term growth, and will weaken the central bank's capacity to deliver an adequate monetary policy response.

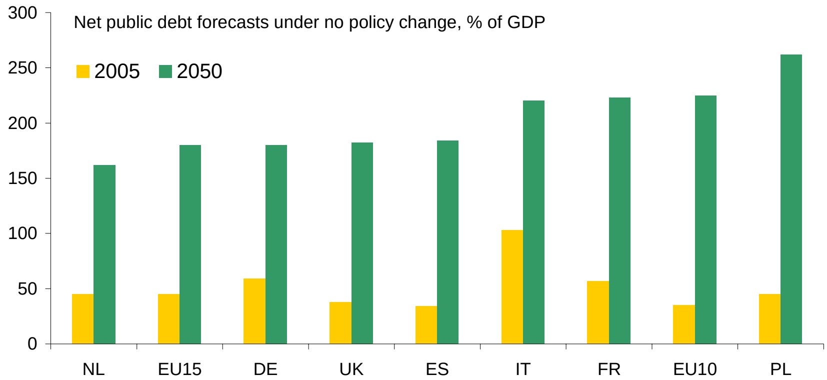
UNICE is also deeply concerned by the long-term sustainability of public finances and social systems. A rapidly ageing population is posing huge and pressing policy challenges, for which most EU countries appear inadequately prepared.

There is a reluctance to engage deep fiscal and social systems reforms, and the fact that many of the measures currently in the pipeline are based on increasing tax revenues rather than expenditure cuts is a matter of great concern. Until the end of this decade, governments have a window of opportunity to undertake the needed reforms to bail out European social models. Later on, the cost of inaction will undergo a step change.

The pressure from age-related spending will remain moderate until the start of the next decade, but thereafter the burden will increase gradually leading to deteriorating fiscal positions and a tripling of net public debt to around 150% of GDP over the next four decades.

Ensuring that governments make the most of the current recovery to put their fiscal house in order will be a critical policy objective in coming months. Progress also needs to be made towards a workable framework to ensure sustainability of public finances when determining medium-term objectives for national budgets.

Chart 7: Impact of ageing on public debt



Source: *Standard & Poor's Sovereign ratings (2006)*

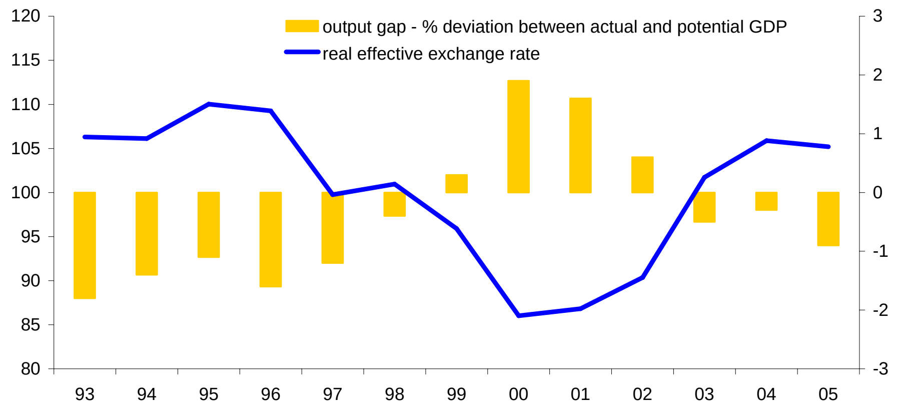
2. Enduring risks of euro appreciation should prompt ECB to exercise caution in the pace of interest rate normalisation

The business community continues to deem ECB's monetary policy stance appropriate. Past interest rate hikes have occurred against the backdrop of stronger-than-expected domestic demand in the euro area and a relatively stable euro exchange rate.

However, UNICE's Autumn 2006 Economic Outlook survey across national business federations reveals that ECB is considered to give insufficient weight to downside risks to growth but above all to the potential impact of its policy on future exchange rate developments (results of the survey will be published on 13 November).

The exchange rate is an important channel of transmission of monetary policy and is a crucial factor affecting domestic inflation and growth prospects. The link between interest rate policy and exchange rate developments is not straightforward and often difficult to predict. However, at the current juncture, with global imbalances posing major and relatively imminent risks of exchange rate re-adjustments, the probability of a significant real appreciation of the euro over the next two years remains elevated, which tilts medium term risks to growth and inflation on the downside. These risks should be carefully considered in monetary policy decisions.

Chart 7: Euro exchange rate and euro area output gap



Source: *UNICE based on IMF and Eurostat data*

More generally, the business community appreciates the difficulty of operating monetary policy under current circumstances. First of all, structural rigidities on both product and labour markets not only hamper the growth potential of the euro area economy but also the central bank's margin to respond to changing economic conditions. This is particularly acute in the face of slow economic growth, when inflation's lack of downward responsiveness reduces the ability to lower interest rates and thereby to boost the economy out of stagnation. The last five years have been emblematic of these difficulties, as inflation has remained flat and above 2%, despite a prolonged period of lacklustre economic activity.

The excessive inflation inertia in the euro area seems particularly strong in the services sector, where over-regulation and stifled market access hamper competition and adequate price adjustments. The lack of competition combined with inflexible labour market structures also contributes to persistent growth and inflation divergences across countries, with further negative consequences for the well-functioning of the euro area economy.

Second, as already mentioned, an inadequate fiscal policy stance combining high structural deficits and debt levels with a reluctance to consolidate public finances during good times is detrimental to the macroeconomic policy mix. The failure to adjust fiscal imbalances in the face of an ageing society raises negative expectations by financial markets and economic agents, which eventually crowd out private investment and activity.

Third, the acceleration of economic and financial integration in the global economy is having an increasing impact on the process driving domestic inflation, growth and asset prices. Globalisation therefore makes monetary policy more dependent on external conditions and renders its control over the domestic economy more uncertain.

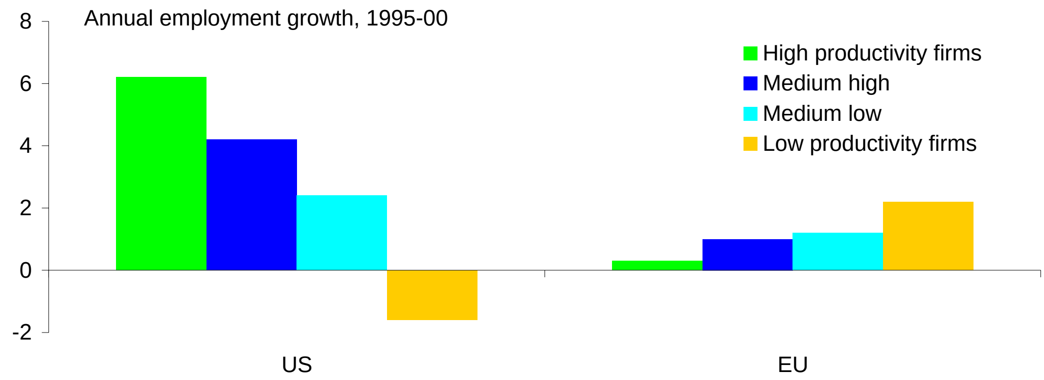
Overall, globalisation, demographic ageing and the persistence of major structural rigidities makes the conduct of monetary policy ever more challenging. In this context, the ECB's focus on anchoring inflation expectations at a low level seems appropriate, and its record in this regard is outstanding.

3. Implement the reforms on labour and product markets

The poor aggregate productivity performance in the euro area is largely related to obstacles to the entry, growth and innovation of companies. The importance of the regulatory environment for fostering productivity growth strengthens the case for less and better regulation and the removal of barriers to cross-border activity, especially in the services sector.

Regarding labour market institutions, outdated and strict labour regulations, high labour taxation and a lack of geographical and occupational mobility increase the adjustment costs associated with globalisation and technological innovations, and therefore reduce their overall benefits. This is also a factor dampening productivity growth.

Chart 8: Most productive EU companies are not creating enough jobs



Sources: McKinsey Quarterly (2005)

A comprehensive set of policy action across a broad front is needed to alleviate the negative trade-off between employment and productivity growth. The detailed measures must take account of the specificities of each country and can only be decided in the Member States. However, there are common priority actions:

- Fewer regulatory obstacles to job and business growth
- Coherent innovation policy
- More tertiary education and lifelong learning
- Increased geographical and occupational mobility
- Contained labour costs
- Sustainable and employment-friendly social systems

The ongoing screening of national reform progress by the Commission and Council will be crucial to show a real resolve to fill the reform gap.

4. Ensure that wage levels maximise labour demand

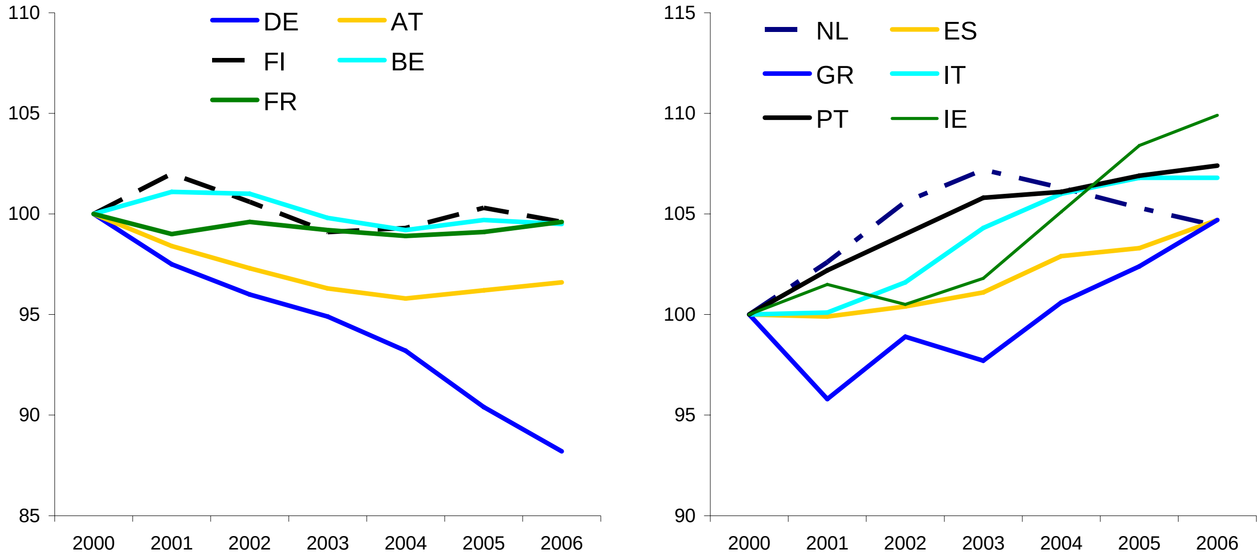
At this juncture, underlying inflationary pressures remain contained, primarily as a result of moderate wage growth. Hourly wage growth in the euro area is expected to average 2.4% this year and 2.0% in 2007.

Continued wage moderation is essential to ensure that the recovery consolidates both internally, with strong employment growth and declining unemployment rates, and externally, with increased competitiveness supporting exports and investment.

In general, in aiming at increasing employment levels in the economy, wages must be aligned with medium-term productivity developments, not only at aggregate level but also across various segments of the labour market. Hence the importance of ensuring sufficient wage differentiation to reduce wage inertia and the impact of negative economic shocks. It is also important that wage-setting is responsive to the aim of restoring competitiveness; particularly in those countries which have accumulated significant imbalances in recent years.

Indeed, based on the evolution of relative unit labour costs, Italy, Portugal, Ireland, Spain and Greece are seeing a significant loss of competitiveness against their main trading partners, leading to declining market shares. At euro area level, this has been partly offset by a significant decline in relative unit labour costs in Germany. Overcoming these imbalances in an orderly manner will be a major policy challenge, requiring rapid progress in the reform agenda backed by an effective system of economic governance at European level.

Chart 9: Unit labour cost developments in comparison with 23 main trading partners



Sources: EC AMECO Database (Spring 2006)

****