UNICE ECONOMIC OUTLOOK
MAY 1999 SURVEY

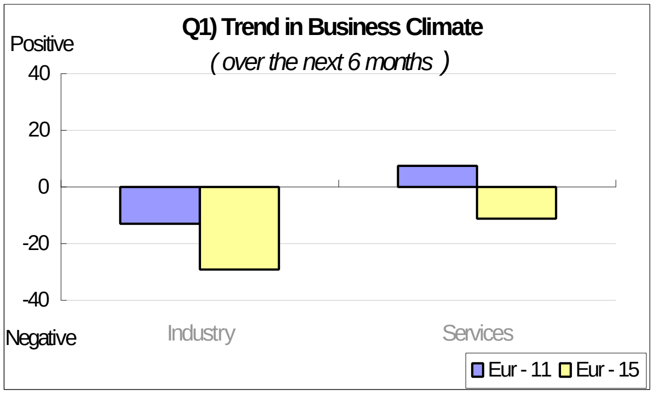
The May 1999 UNICE European Economic Outlook provides a business insight on recent economic developments, based on a survey of sixteen of UNICE's national member federations, covering EU-15 countries plus Norway.

The survey combines quantitative and qualitative indicators of business sentiment, economic and employment trends, as well as the main risks and prospects for the European economy over the next six months.

Most of the results of the survey are presented in boxes as percentage balances weighted by GDP (Eurostat figures, 1997), showing EU-15 and EU-11 values.

A) Competitiveness and business climate

- **Economic climate (questions 1-2-3)**



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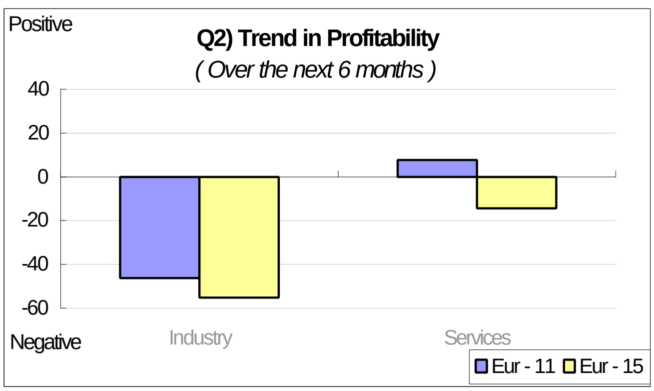

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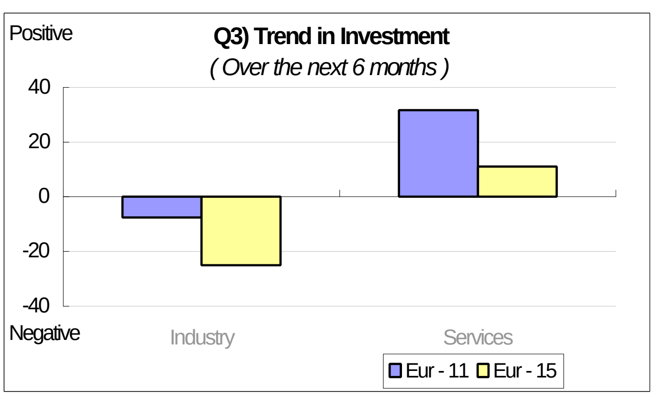

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The May 1999 UNICE survey reveals that *business confidence (chart 1)*, particularly in manufacturing industry, remains gloomy, reflecting the weakness in the European economy in the first quarter of 1999. Weakness and low confidence are not limited only to the Euro area but extend to Scandinavian countries and the United Kingdom. This situation appears to be in stark contrast with the confidence of households. Indeed, the downward convergence of inflation and the small increase in employment have increased purchasing power, consumption being now the main pillar of European growth, thus fostering service activities, mainly in Spain, France and the Netherlands.

On the other hand, the decline in business sentiment in industry is mainly due to sales prospects affected by a deterioration in the international environment and in a few cases by weaker domestic demand. Moreover, industrial production has fallen noticeably in Germany and Italy in recent months. Only one country, Ireland, believes that the economic climate is still favourable to industry, bearing in mind that growth there remains particularly strong. In addition, the dichotomy between industry and services in the survey follows the pattern of European activity, which remains widely divergent across sectors.

Profitability (chart 2) in the industrial sector is following the negative direction of the industrial climate, given that this sector is more particularly exposed to global competition. More than a year of weakening global demand and emerging market currency volatility has weighed heavily on exports and profits.

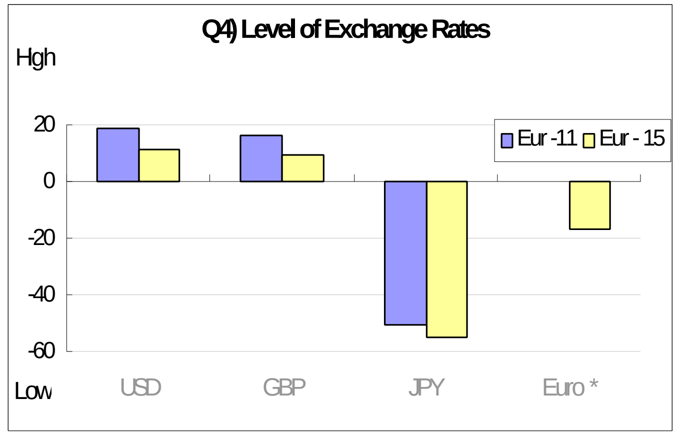
Regarding *investment* trends *(chart 3)*, the situation is more complex. Moreover, projects such as the introduction of the Euro and Year 2000 are giving some impulse to investment, even if the contribution is rather modest. However, after a peak in 1998, the investment trend in the industrial sector pursues its decline, being one of the main concerns for European growth.

The survey results show a clear dichotomy between industry and services. UNICE's federations are rather pessimistic about the business climate in industry, in line with the decline in manufacturing output in most European countries. The industrial sector was very weak at the start of 1999, and remains so during the second quarter of this year. Prospects for the first half of 1999 are fairly negative, but could improve in the second half of 1999. However, even if south east Asia is starting to climb out of the trough, Latin America is stabilising and fears about a sharp slowdown of the US economy are receding, the external environment is not expected to improve significantly enough to revive the European traded sector, gradual recovery being the most probable outcome. Moreover, this situation and persisting divergence between the confidence indices for industry and households require an appropriate response in Europe: supply-side policies should be a key priority in order to tackle remaining structural rigidities in markets, while a further stimulation of demand-side policies seems unnecessary given that European growth is being currently buoyed mainly by consumption

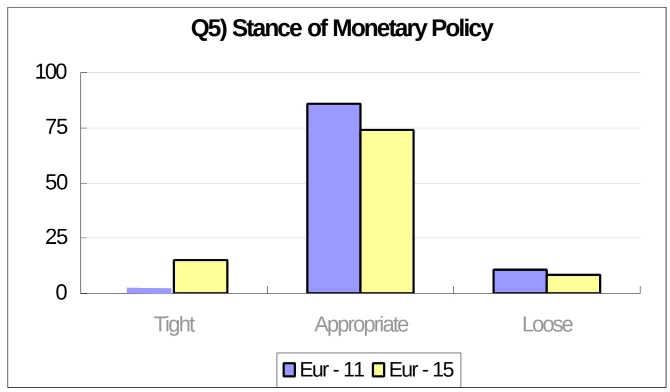
- **Monetary outlook (questions 4-5-6)**

Most federations in the Euro zone believe that the present *exchange rate* vis-à-vis the dollar and sterling is appropriate – respectively 75% and 67%- of answers *(chart 4)*, while a majority of federations consider the Japanese yen to be overvalued. The 10% depreciation of the euro against the dollar has probably stilled fears about an overvalued euro penalising the competitiveness of exposed European companies. Against that, some countries outside the euro zone complain about an unfavourable exchange rate, for instance the UK believes that sterling is overvalued and that monetary policy is somewhat restrictive.

The recent easing of monetary policy by the ECB is a response to concern about weak growth and low business indicators in the context of a weak external environment, sharp inventory corrections and low inflation. A large majority of euro zone federations welcome the ECB decision and consider the cost of capital and the *stance of monetary policy* to be appropriate *(chart 5)*. However, the larger than expected cut in the refinancing rate from 3 to 2.5% might not be sufficient to revive growth and employment, considering the structural nature of Europe's unemployment problems.



*% balance, * for non euro countries*



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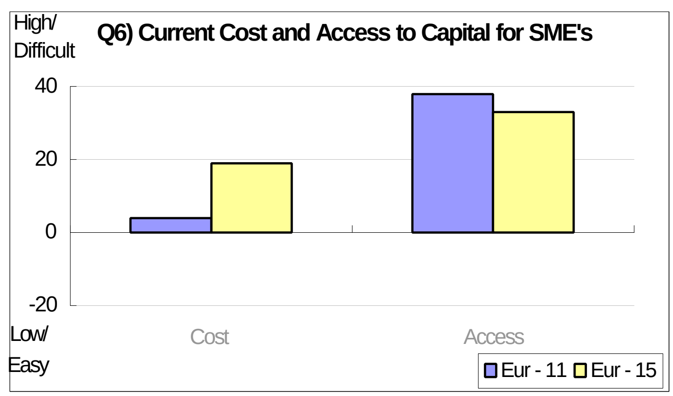

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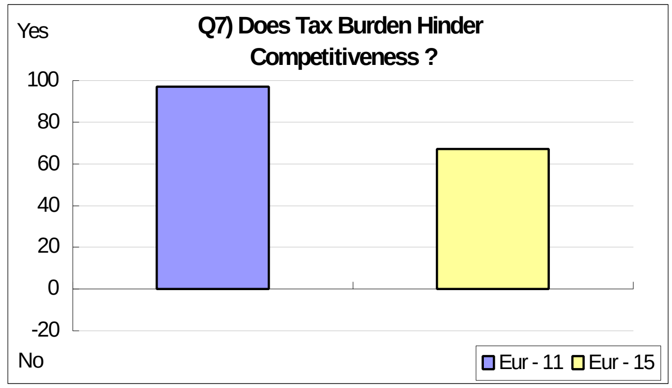
The difficult tasks facing the new European Central Bank will be to cope with regional diversities and buoyant countries such as Ireland, or even Spain, Portugal and the Netherlands -Irish and Spanish federations consider monetary policy to be too loose – (*Chart 5*) whose business cycles are not synchronised with the largest European economies of the euro zone.

The positive assessment of ECB policy diverges from federations' opinions on the difficulty that SMEs have in raising capital *(chart 6)*. Europe's financial markets and services still suffer from rigidities and a lack of integration, as some federations (Austria, Belgium, Portugal, Spain, Greece) consider access to capital too difficult. Even if progress has been made in recent years, there remains a great deal to do before the advantages of the Single Market are enjoyed to the full. Access to equity financing and risk capital in particular, should be fostered in order to allow SMEs to exploit their growth and employment potential

Recent cuts in interest rates should remove part of the risk of future political interference in ECB's conduct of monetary policy. Although the debate on ECB transparency (publication of minutes, voting records, etc) is still alive, it remains essential to safeguard ECB's independence. The impact on growth of the recent change in the stance of monetary policy must be enhanced by appropriate structural reforms in order to be effective. Moreover, the new monetary framework must not be jeopardised by unduly expansive budgetary policies or by inappropriate wage developments. If the cost of capital has fallen in Europe, access to capital is not always smooth, impeding an optimal allocation of resources. At European level, integration of financial services must be fostered, in line with the Cardiff proposals, in order to allow a combination of capital cost/access which encourages the creation and development of European companies. It is now urgent and crucial to remove obstacles to SME growth such as poor access to financing, but also cumbersome regulatory frameworks and tax systems.

- **Taxation (questions 7-7a-7b)**

Continental Europe is unanimous: the *level of the tax burden* is no longer a factor of competitiveness but a hurdle to growth *(chart 7)*, and has even increased in a number of countries during the last few months *(chart 7a)*, reaching levels which are a disincentive to investment and employment (public spending accounts for 43.4% of GDP in the euro zone). Among the "pre-ins", only the UK stands out, with Ireland and Luxembourg in the euro zone, and does not regard the tax burden as an obstacle to corporate competitiveness. Furthermore, the UK and Ireland have managed to adapt their tax regimes in a way that encourages job creation.



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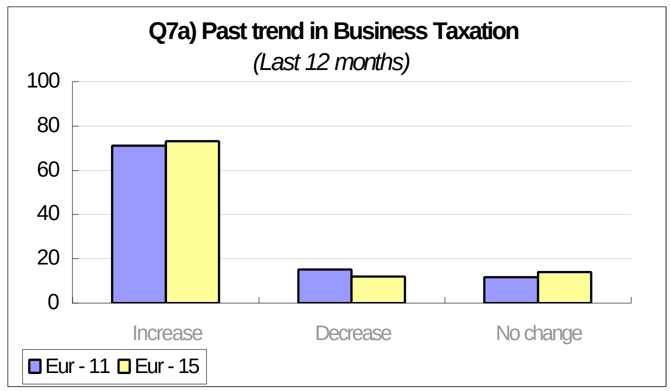

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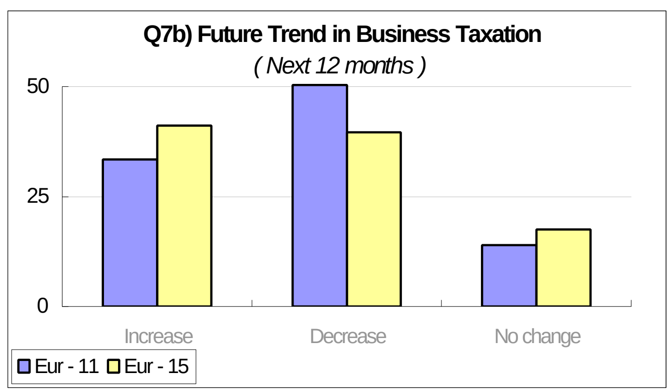

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The *direction of taxation* remains fairly disparate *(chart 7a-b)*. In Germany, political events have raised hopes that changes in corporate taxation will be less unfavourable than expected in 2000 (a committee on tax reform has issued a report recommending a cut in the main rate of corporate tax), while the tax burden will increase in 1999 (ecological taxation).

A slight increase in taxation is also expected to continue this year in the UK. In Ireland, social insurance contributions have increased in industry, as they have in the Netherlands, but corporation tax has fallen from 32% to 28%, and from 32% to 30% in Luxembourg. In Norway, a reduction in taxes for petroleum related activities is also expected. In Belgium, the total burden should fall by a small amount, thanks largely to lower social contributions. Finland expects an increase from 28% to 29% on corporate tax and interest earnings.

The level of the tax burden on business and more particularly social security contributions, is such as to discourage development of activities and employment in most European countries. A certain level of tax competition is necessary to avoid high levels of taxation which hinder business competitiveness and represent a major obstacle for employment. European initiatives should also aim to simplify tax compliance and administrative rules for cross-border activities. Moreover, on the budgetary side, a decrease in tax burden must be followed by improvements in the efficiency of the public sector

B) Labour market indicators and wage trends:

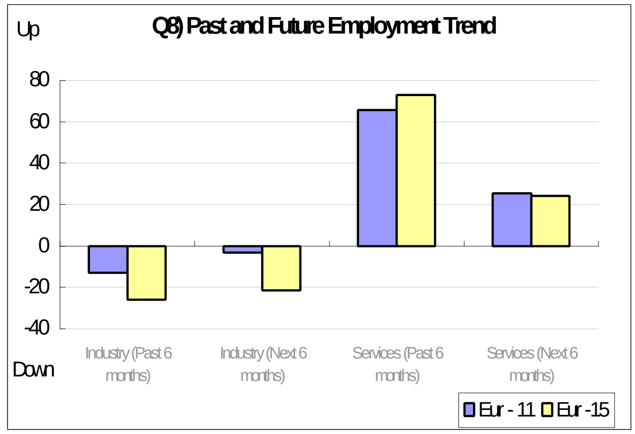
- **Employment trends (questions 8-9)**

The survey shows that *employment developments* have been positive in most countries in recent months *(chart 8)* reflecting solid growth in 1998 (around 3% of GDP), in services. However, prospects are fairly disparate when considering past trends in industry: Germany and Italy have seen a downward trend where countries such as France or Spain had an upward trend in employment. Moreover, prospects are negative for industry over the next six months, in contrast with services where employment should continue to grow in most European countries, but at a slower pace. Countries such as France are benefiting from structural change with the economy geared increasingly to services.

A few countries are experiencing *recruitment difficulties (chart 9)* in some high-tech or growth sectors such as information technology (Finland), or a general tightening on the labour market (Ireland), with employment growing strongly.

- **Productivity and wage trends (questions 10-11)**

Most federations regard *productivity* as average *(chart 10)* - but still weaker than in the United States when compared with average EU - or even high in industry where productivity gains have been considerable in recent years (Austria, Belgium, Ireland, Sweden, etc.). However, it is still less pronounced in services – but this sector is difficult to quantify.



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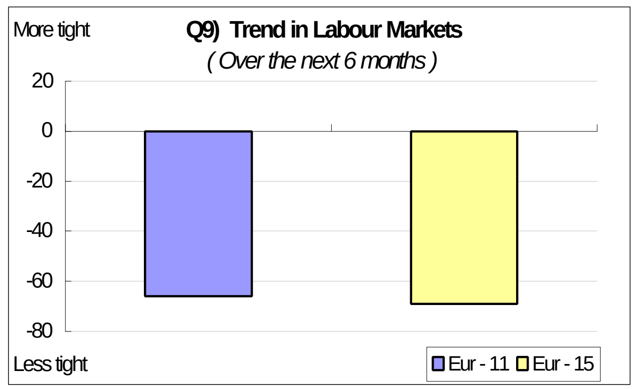

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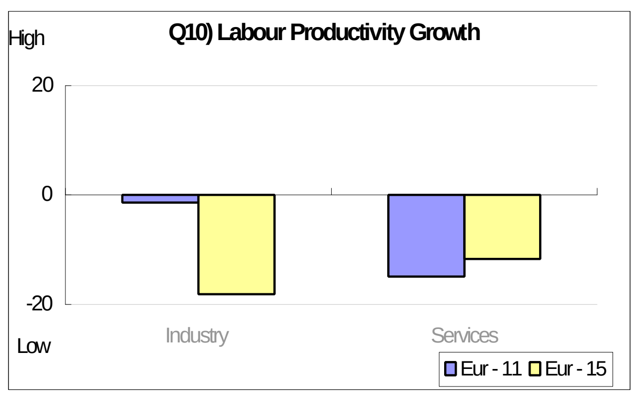

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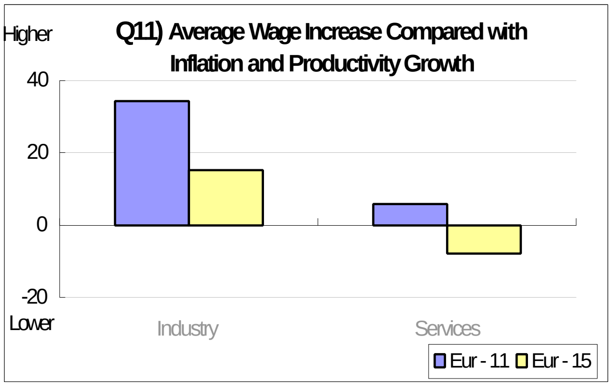

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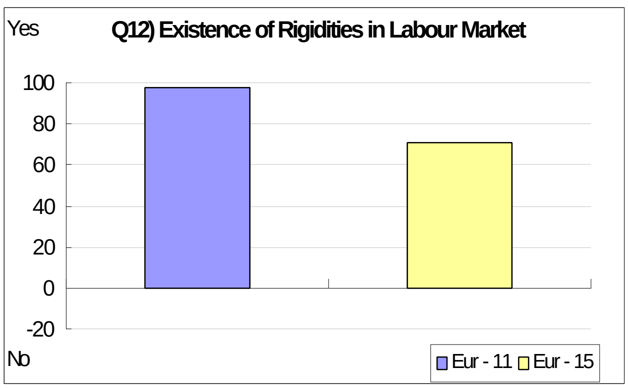

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Lastly, for most federations *wage settlements* are in line with inflation and productivity *(chart 11)*, especially in services. Germany, however, believes that wage expectations are too high, reflecting the recent wage negotiations in the metalworking sector. Wage settlements in this sector, which serve as a reference for the wage negotiations of other trade unions, may wipe out some of Germany's recent competitiveness gains vis-à-vis its trading partners, just at the time when the employment situation was starting to improve. It should be noted that the 35-hour week is likely to have negative effects on *productivity* in France.

- **Functioning of labour markets (question 12)**

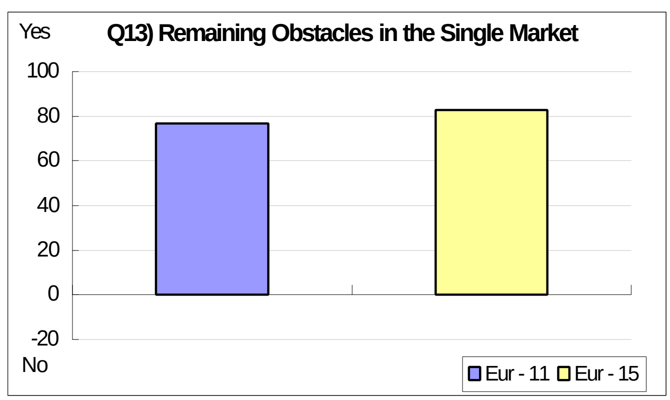
There is wide consensus about poor functioning of the labour market *(chart 12)* which is still marred by rigidities.
Only the UK federation believes that its labour market functions well, being much more flexible than on the continent.

Among the various factors hampering the smooth operation of the labour market are administrative barriers (legal framework for dismissals, rigidity of minimum wages, etc.) and tax barriers (labour costs, especially social charges).

Despite some improvements, in industry and services since 1998, the high level of unemployment remains a major problem in Europe especially among the countries which entered monetary union in 1999. Most European labour markets are subject to extensive legislation and other forms of rigidities and suffering from limitations widely considered by federations to be a factor behind Europe's dismal record of job creation over the past two decades. The future trend in employment is negative in industry, prospects being better in services. However, federations fear that the high level of structural unemployment in some European countries together with a slowdown expected in the first half of 1999 provide a picture which is not favourable for employment within the next 6 months. Structural reforms in labour markets and a sound macroeconomic framework are essential to promote and foster economic activity and development of companies (more particularly innovative and high-growth firms) in order to tackle unemployment. Also, tax and welfare reforms must enhance incentives to work, particularly for unskilled workers.

C) Functioning of the single market:

- **Question 13**



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A large majority of federations mention a range of obstacles which impede the smooth operation of the single market *(chart 13)*. These include lack of openness in public procurement, and in transport, energy, telecommunications and financial services (pension funds,etc.). Some federations highlight the absence of mutual recognition of standards. In addition, tax obstacles and state aid represent distortions of competition which should be removed.

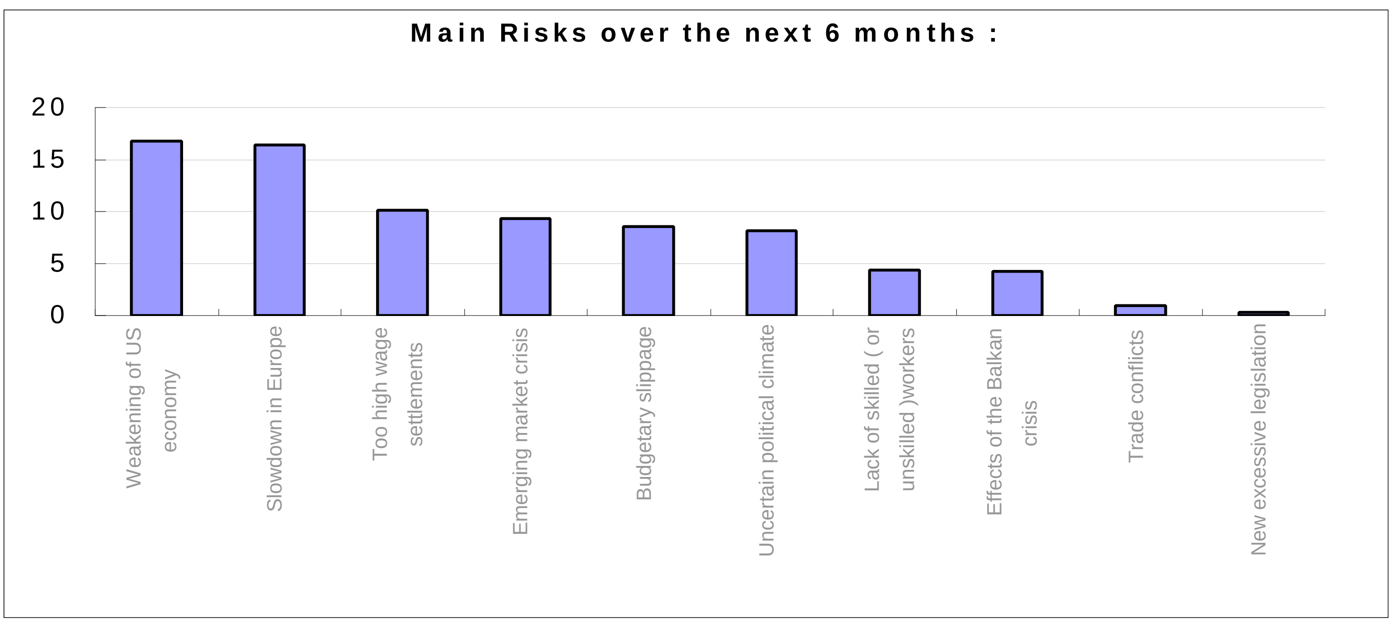
If the Single Market is one of the most important achievements of the European Union, obstacles are still impeding its smooth functioning. Priority must be given now to tackling these obstacles by improving the functioning of labour, product, services and capital markets and having the right balance of regulations. The removal of obstacles and rigidities in each of these markets will make it possible to take advantage of the Single Market and increase healthy competition which will create a more dynamic economy.

D) Main Risks for the European economy:

- **Question 14**

UNICE federations are particularly worried about the external situation: renewed market volatility and a slowdown of the US economy (will it be a soft landing?) could lead to a strong equity correction in the US as well as a debt default in emerging markets with spill-over effects on Europe. Moreover, there is concern about an increase in protectionism when trade flows are weak, trade imbalances high and trade disputes gaining prominence.

Internal risks are also a source of concern, the first being a slowdown of the European economy, followed by excessively high wage settlements and budgetary slippage which could interfere with the stance of monetary policy. Federations in countries with tighter labour markets also fear difficulties in the recruitment of skilled (in some case unskilled) workers.



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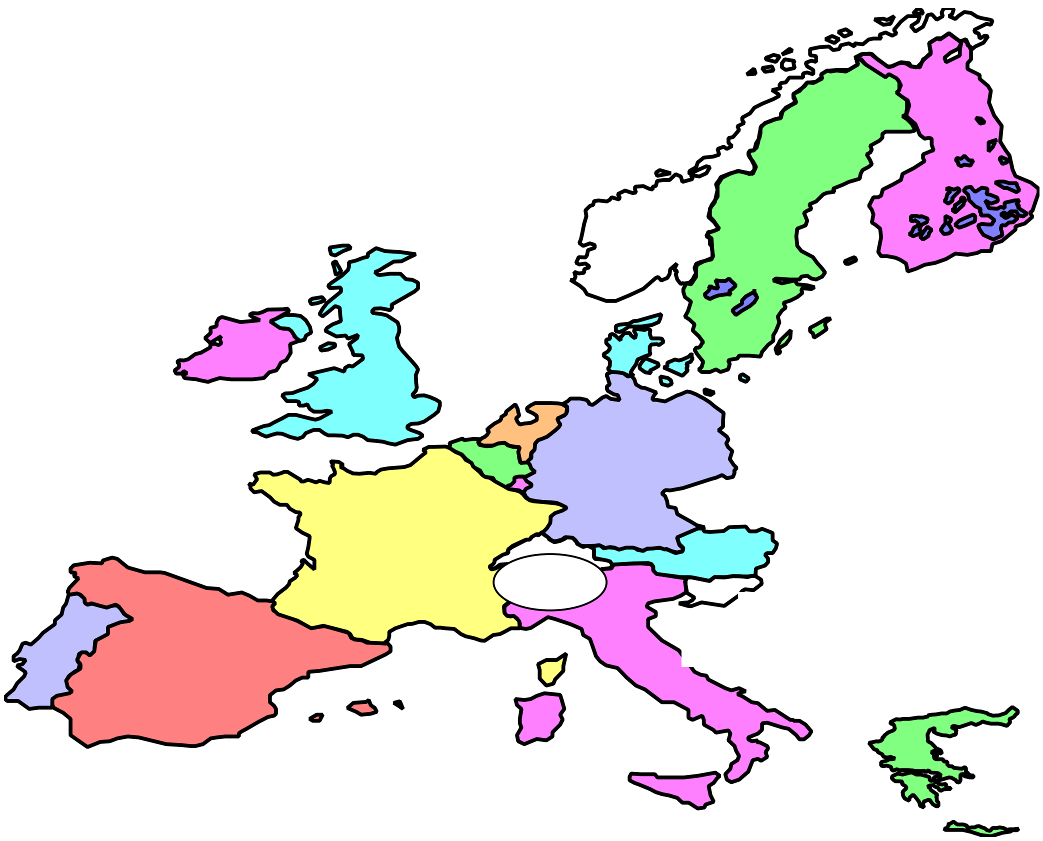

List of UNICE federations participating in the May 1999 Survey:

AUSTRIA	VÖI
BELGIUM	VBO-FEB
GERMANY	BDI
DENMARK	DI
SPAIN	CEOE
FRANCE	MEDEF
FINLAND	TT
UNITED KINGDOM	CBI
GREECE	SEV
ITALY	CONFINDUSTRIA
IRELAND	IBEC
LUXEMBOURG	FEDIL

NETHERLANDS	VNO-NCW
PORTUGAL	AIP
PORTUGAL	CIP
SWEDEN	SAF
SWEDEN	SI
NORWAY	NHO