24 November 2004

MACROECONOMIC DIALOGUE AT TECHNICAL LEVEL ON 24 NOVEMBER 2004

UNICE STATEMENT

Recovery is confirmed but lacks momentum in Europe. The fragility of recovery illustrates the low capacities of the EU to participate in increasingly global competition. The moderate recovery expected in the UNICE Economic Outlook Autumn 2004 will not on its own solve structural problems and enable us to preserve our economic and social models. Actions need to be taken to release the growth potential in Europe, improve employment prospects and generate prosperity for EU citizens.

1. ECONOMIC OUTLOOK

Recovery confirmed …

According to the UNICE Economic Outlook Autumn 2004, the EU economy is expected to grow by 2.6% in 2004, which is composed of 5.1% for EU10 and 2.3% for the former EU15. UNICE and other international organisations have confirmed that recovery is taking place and have revised their growth forecasts upwards for the year 2004.

% real GDP	EU10		EU15		EU	
	2004	**2005**	**2004**	**2005**	**2004**	**2005**
UNICE[1]	4.9	5.1	2.3	2.3	2.6	2.6
Commission[2]			2.3	2.2	2.5	2.3
IMF[3]					2.6	2.5
Consensus Economics[4]					2.3	2.2

Whatever the source, the EU is lagging behind its main competitors. While the IMF expects 4.3% real GDP growth in the US, 4.4% in Japan and 2.9% in Canada in 2004, main forecasts range between 2.4% and 2.6% in the EU.

… but could level off

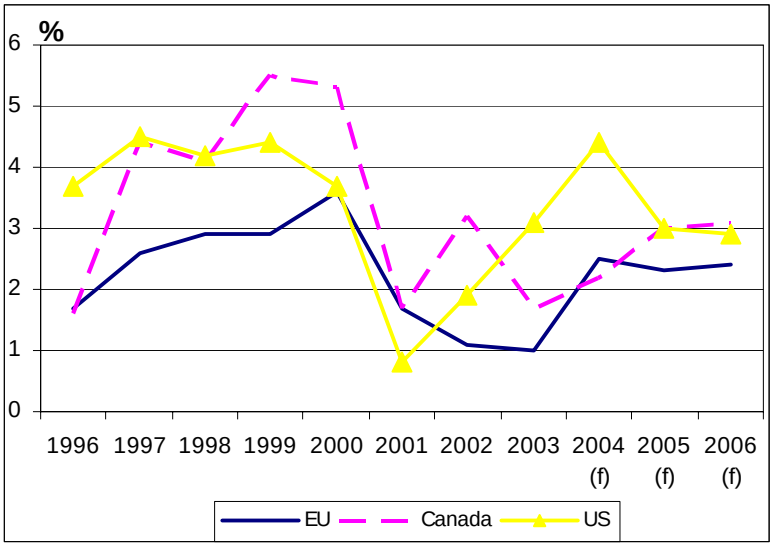
Some positive news is to be found in our Outlook notably regarding investment and consumer confidence expectations. However, expectations are being slow to materialise. Compared with the Commission Autumn Forecasts, we appeared to be slightly more optimistic for the year 2005 due to exacerbation of some downside risks by the time of the

[1] UNICE Economic Outlook Autumn 2004, based on UNICE Survey September 2004, released on 20 October 2004.
[2] European Commission, Economic Forecasts Autumn 2004, released on 26 October 2004.
[3] International Monetary Fund, World Economic Outlook, released on 29 September 2004
[4] Consensus Forecasts, 8 November 2004. Consensus Economics provides the mean of the figures provided by prominent financial and economic forecasters.

Commission's publication. Growth in advanced economies is expected by the IMF to slow down from 3.6% in 2004 to 2.9% in 2005. A slowdown is foreseen notably in the US, Japan and China. Recent Eurostat estimates confirm that the European economy could also level off. Compared with the same quarter of 2003, GDP grew by 2.1% in the EU in the third quarter of 2004, after 2.4% in the previous quarter.

The European economy will be particularly vulnerable to a global slowdown due to the non-self-sustaining nature of the current recovery in Europe. As stated in the UNICE Economic Outlook, European growth is recovering in 2004 thanks to the export stimulus induced by world economic growth. The robust export contribution to GDP variation results from supportive external demand, rather than a significant gain of shares in international markets. This is particularly worrying at a time when world trade is expected to slow down in 2005 as a result of price increases for oil and other commodities. Domestic demand could compensate somewhat for the slowdown in the world demand but many uncertainties remain regarding European households' and enterprises' behaviour in the near future.

GDP real growth, 1996-2006



Source: Commission and IMF, (f) = forecasts

Consumption: a mixed picture

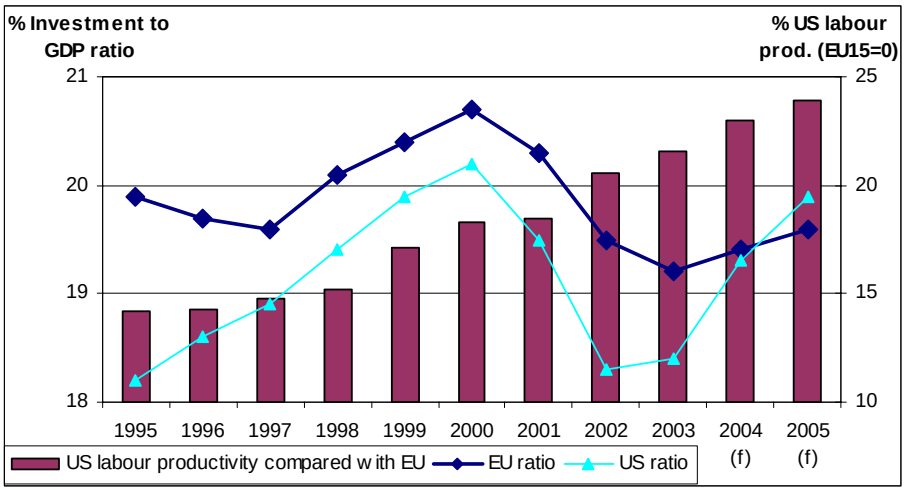
Although there is a gradual improvement in consumer confidence expectations, private consumption remains weak in Europe. Positive expectations are likely to be tempered by uncertainty, notably regarding the slow improvement on labour markets and the resulting high unemployment, or the financial sustainability of pension and health care systems. Governments and social partners could substantially reduce consumer uncertainty by better explaining the benefits that citizens can reap from structural reforms.

Needless to say, there are certainly marked differences between the Member States. Recovery appears more broad-based in countries such as France and Spain than in countries such as Germany and the Netherlands. However, it is still unclear whether improved signs in some countries will spread to the whole EU. Private consumption remains sluggish in Germany, where it only increased by 0.1% in the second quarter of 2004.

Investment: the "Achilles heel"

Recovery has not yet translated into significant renewal investments. Despite relatively high profitability expectations, favourable financial conditions and wage moderation, investment does not seem to be matching the bounce-backs experienced in the wake of previous recoveries. Investment expectations are high but do not seem to be materialising. On the one hand, investment contributes very poorly to GDP variation in Europe, compared with the situation in the US. On the other hand, the investment to GDP ratio has been relatively high in the EU over the last ten years. This puzzling situation could be explained by the fact that investment is far more productive in the US due to higher labour and capital productivity.

Investment puzzle



Source: Eurostat database: labour productivity per person employed, gross fixed capital formation/GDP ratio
(f) = forecasts

The labour productivity gap (per person employed) between the EU and the US has increased in favour of the latter from 14.2% in 1995 to 23.9% in 2005[5]. To invest more heavily, enterprises need to be convinced by determined implementation of the Lisbon Strategy that Europe is still a place where profitable investment may be made. Otherwise, and even if the most optimist scenario regarding external factors takes place, the growth gains will be lower than what could be expected at this point of the cycle. Low production capacities are indeed constraining the growth potential of the EU economy.

Employment: no turning point

On labour markets, no turning point is foreseen. Unemployment remains disappointingly high. After recording 9.1% in 2004, unemployment is only expected to fall to 8.8% in 2005. More optimistic developments cannot be expected unless major labour market rigidities are removed. From a sectoral point of view, the declining trend in industrial employment contrasts with the more positive situation in services. Paradoxically, risks of skill shortages are reported in Ireland and the UK, stressing the importance of more market-oriented education and training systems and the need for enhancing labour mobility within the EU.

[5] Even when expressed per hour worked, labour productivity growth has been lower in the EU than in the US. According to the Wim Kok Report, "over the period 1996-2003, the EU-15 productivity growth rate averaged 1.4%, as opposed to 2.2% recorded for the US" (p. 11).

2. RECOVERY AT RISK

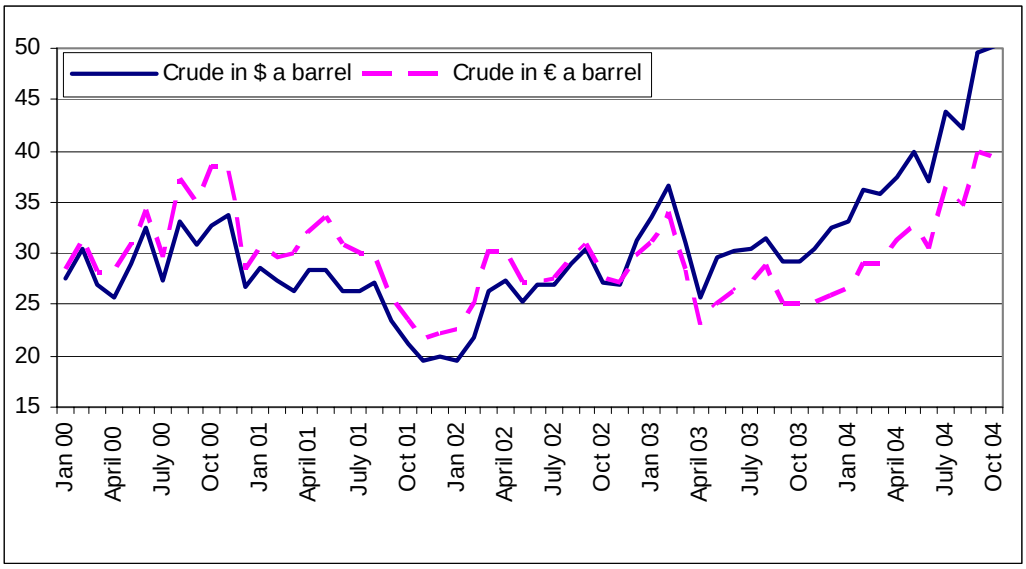
All the downside risks identified in the UNICE Economic Outlook Autumn 2004 warn us that recovery will not strengthen in Europe unless its resilience to external shocks and its competitive advantage are improved.

Is the oil price threatening the recovery?

A persistently higher and volatile oil price level could result in a growth deceleration in 2005. The 2005 oil price baseline of our forecasts stood between $35 and $40 per barrel, significantly lower than the one used by the Commission at $45.1 per barrel. Nevertheless, our analysis concludes that a sustained $10-a-barrel rise could reduce our 2005 growth forecast by up to 0.5% GDP.

The situation is clearly different from the 1970s, notably as far as the more demand-driven nature of the current tensions on oil markets (mainly generated by China), the weight of services in our economy, the energy-efficiency of industry, the inflation spillovers or the buffering effect of exchange rates are concerned. However, the virtual doubling of oil prices over the last twelve months remains a real source of concern for European firms. It can notably affect production costs, profit margins, investment decisions in business and hence reduce EU growth potential. The second-round effect on wages and inflation has so far been limited although wage moderation has still to be secured.

WTI crude oil (Jan 00-Oct 04)



Source: Bloomberg (monthly data, last day of the month)

Activities such as transport or agriculture have been particularly hurt by oil price increases. Consequently, some governments have taken fiscal measures to limit the toll taken by the sharp rise in oil prices with the risk of issuing wrong signals to consumers and producers. Even from a national point of view, the OECD has recently argued that such fiscal actions would exacerbate the vulnerability of an economy to oil price shocks[6]. First, it is "difficult ex-ante to

[6] "While fiscal policy does not have an active role to play in stabilising the oil price, energy taxes reduce oil dependence and increase the resilience to oil price shocks. A high tax component of the final price reduces oil intensity and hence the terms-of-trade and inflation impacts of oil price shocks. Using taxes to stabilize end-use prices would run contrary to these long-run goals, while also possibly jeopardizing the attainment of budget

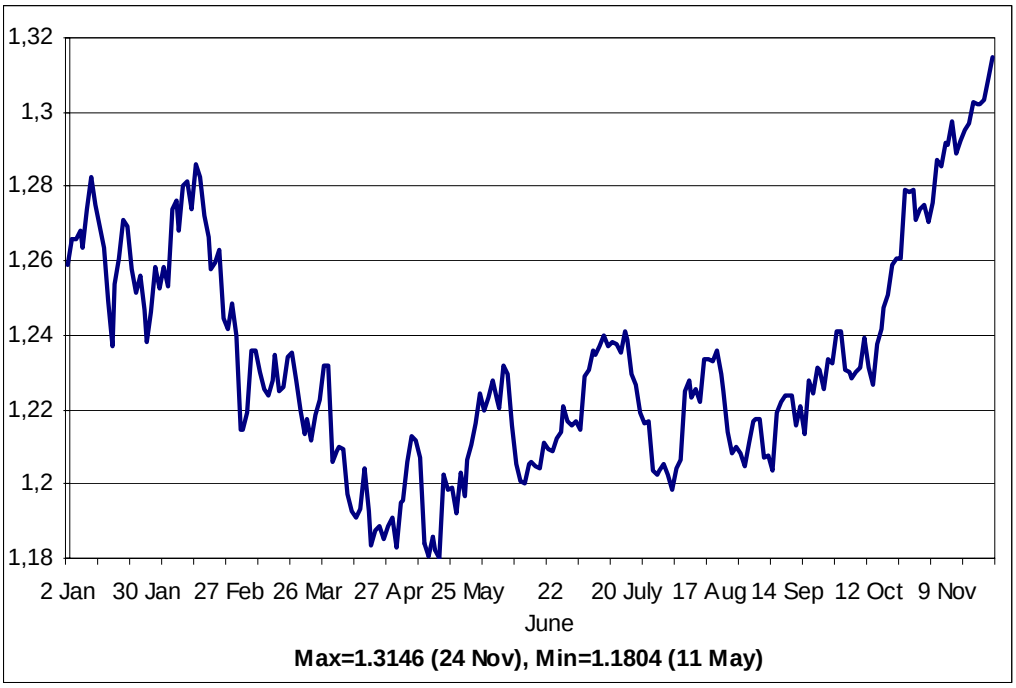
determine whether a change in the oil price is a temporary shock or a more permanent response to changes in market fundamentals". If all countries coordinate such an action, this will reduce the demand elasticity to any OPEC decision.

Policies should seek to increase the EU resilience to oil price fluctuations, by improving energy efficiency, reducing oil intensity, diversifying energy supplies and ensuring a better functioning of the markets for all energy providers and consumers. Oil stocks function in the framework of the IEA crisis mechanism.

Is the exchange rate worrying?

A level of the euro of around 1.23$/€ was considered in the UNICE Economic Outlook manageable as it has limited the detrimental effect of oil price increases. Since then, the euro has appreciated further and is harming the competitiveness of European enterprises doing business in international markets, thus cutting away the sole leg on which the recovery is firmly based. The UK firms are slightly better off since the pound sterling has appreciated less sharply than the euro against the dollar. The current peg of the Chinese renminbi to the US dollar is also exacerbating the potential harmful effect resulting from a lower US exchange rate.

Euro Foreign Exchange Rate: USD (2 Jan – 24 Nov)



Source: European Central Bank

objectives.", in OECD (2004), *Oil price developments: drivers, economic consequences and policy responses*, 29 September 2004, p. 5.

3. POLICY CHALLENGES

Fiscal policy: recovery, an opportunity to consolidate public finances more forcefully

The Commission expects deficits around or in excess of the 3% of GDP threshold in Germany, Greece, France, Italy and Portugal unless additional consolidation measures are adopted. "Debt ratios in these countries are in excess of the 60% of GDP threshold and would either rise or fail to decrease significantly". The demographic challenge makes more relevant than ever the need for fiscal discipline to preserve macroeconomic stability and allow sustainable growth. As stated in the Kok report, the working-age population is projected to be 18% smaller than the current one and the number of people over 65 years will have increased by 60% by 2050..

The European Commission has recently proposed to revise the Stability and Growth Pact. The proposal to exempt from the Excessive Deficit Procedure countries with a "protracted period of sluggish growth" is questionable as it would give the wrong incentives for bad performers which slow down the necessary reform process. It would also penalise the good performers that have successfully implemented the growth-enhancing Lisbon reforms. They would support the detrimental spillovers from higher (allowed) budget deficits in other countries through higher interest rates.

Regarding the economically more sensible proposal to focus further on debt sustainability to determine the medium-term objective for the budget balance, this proposal should not unduly soften the SGP for low-debt countries. But, stricter rules must be implemented for high-debt countries, particularly when this goes hand in hand with excessive budget deficits.

Recovery should be regarded as an opportunity to speed up the consolidation of public finances and even generate budget surpluses to reduce the debt burden for the sake of future generations. In that sense, the Commission's attempt to promote contra-cyclicality of fiscal policy is a valuable objective, even if the way to make peer pressure and early warnings more effective remains unclear.

Monetary policy: an increasingly difficult task

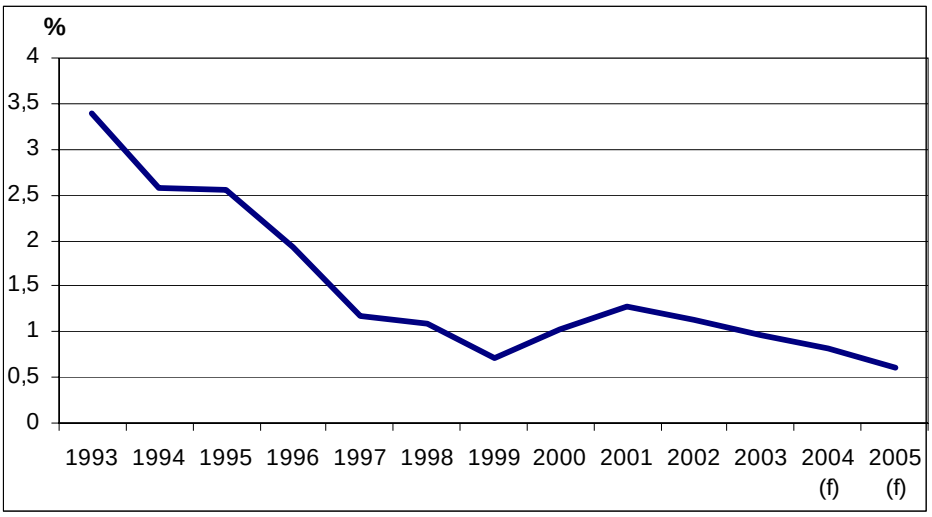
Monetary policy has been fairly accommodative. Real short-term interest rates are close to zero while long-term rates are only expected to moderately increase in the coming months. According to our survey, many federations whose countries belong to the Eurozone consider it necessary to keep interest rates unchanged given the fragile state of the economy and as long as the mandate of the ECB is met.

The ECB has achieved its objective of keeping core inflation under control while expected inflation has only been slightly revised upwards to 2.1% in the UNICE Economic Outlook compared with the Spring exercise. Particular attention should be paid to potential secondary effects of commodity prices on wages and salaries, as well as on increased inflationary expectations. Housing prices should also be scrutinised, particularly in countries such as Ireland, the Netherlands, Spain and the UK. Despite its buffering effect on imported inflation, the recent exchange rate development do not support any change in the monetary policy.

Despite an increase between 1999 and 2001, inflation differentials are historically modest but structural rigidities in product, capital or labour markets could still hinder further price convergence. Nevertheless, significant inflation differentials especially due to Southern Member States (Greece, Spain, Portugal) could complicate further the task of the ECB. Only

in Spain is ECB monetary policy considered to be too loose, setting the conditions for negative real interest rates.

Inflation differentials in EU12: unweighted standard deviation



Source: Eurostat 1993-2003, UNICE forecasts 2004-2005

Labour costs, wage moderation still to be secured

The European Trade Union Confederation agrees with the need to keep wage claims moderate. This should help European enterprises to defend their market shares, increase investment and provide new and better jobs. However, wage moderation still has to be secured at national and sectoral levels. Close attention should be paid to wage developments, particularly in the new Member States. Inflationary pressures are particularly high in these countries, where higher productivity and wages in tradable goods sectors could generate wage pressure in other low-productivity sectors (so-called Balassa-Samuelson effect).

Nominal employee compensation is expected to increase by 3% in 2004 and 2.9% in 2005. However, expectations indicate that real labour costs are unlikely to increase faster than productivity growth. Only Luxembourg, Denmark (for services), Estonia, Cyprus, Greece, Latvia and Slovakia expect the reverse scenario. However, our panellists also stress modest productivity growth per hour compared with what could be expected from the phase of the cycle.

Employees work on average approximately 160 hours less a year than in the US and 230 hours less than in Japan. The secular decline in working time is not so much reflecting a preference for leisure but results rather from persistent disincentives to work in Europe. The gap in working time is even not matched by higher productivity per hour. Stronger productivity gains and optional increased working time will be needed to face the challenge of an ageing population for the sustainability of our social protection systems.

4. STRUCTURAL REFORMS: RELEASE GROWTH POTENTIAL!

The expected cyclical upturn will not on its own solve structural problems in Europe. Signs of reform fatigue indicate that we could repeat the experience of 1999-2000 when a fairly good growth performance was not used to consolidate public finance and implement structural reforms. Action is needed to release the growth potential in Europe and improve employment prospects. As projected by the European Commission, , the aging population is expected to reduce the growth potential from the current 2-2.25 % to 1.5% in 2015, and to 1.25% in 2040 if the present use of the labour potential remains unchanged.

We all agree that the performances of the EU have been unsatisfactory in terms of growth and employment. The Wim Kok report on the mid-term review of the Lisbon Strategy provides an excellent analysis of the current bottlenecks to economic growth and employment. The report also rightly calls on EU countries to draw up national actions plans to make governments accountable for their implementation in national parliaments and in a multilateral surveillance framework. Nevertheless, we would have liked to see more concrete and focused recommendations to get back, as a matter of urgency, to a much higher growth rate which is the prerequisite of sustainable development strategy.

Furthermore, the Lisbon Strategy should provide greater incentives to overcome their inertia in implementing structural reforms in labour, financial and product markets:

- Research and development is key to improve the long-term prospects of productivity growth. This is not only a question of increasing the resources allocated to research but also to set a research agenda fitted to the needs of industry. One should also overcome the 'European paradox' whereby the quality and quantity of European research is good yet it does not make the transition to commercially viable products. This is especially true on the future markets for bio- and nano-technologies.

- Increasing labour mobility and flexibility will also help to foster productivity growth. Making education and training systems respond better to labour market needs will also improve the skills of the workforce. This must be accompanied by a far-reaching reform of pension systems and health care, that will contribute to consolidate the public finance framework and to strengthen households' and investors' confidence.

- A renewed industrial policy should aim at enhancing the competitiveness of manufacturing industry by combining and adjusting for this purpose all the Community instruments available.

- The Internal Market has been one of the most successful projects with obvious mutual benefits in the European Union. However, indicators in terms of growth in trade and inflation convergence underline that the process of integrating markets further has slowed down and the transposition deficit has widened. As shown by the EU Economy 2004 Review[7], this trend has hindered productivity growth in the EU and downsizes the benefits that further product market reforms should deliver. It is time to create a truly internal market for the services sector.

- Better regulation has been rightly identified as an important priority by the Dutch Presidency. On the national as well as on the EU level, efforts to simplify existing red tape should be now intensified, and all new proposals must be assessed for their potential impact on Europe's competitiveness. In this context, reducing administrative

[7] European Commission (2004), The EU Economy: 2004 Review, Directorate General Economic and Financial Affairs, 26 October 2004.

burden is an essential channel to support the Lisbon agenda. Following the Netherlands Bureau for Policy Analysis, coordinated action of all Member States and the European Commission could lead to a structural GDP increase of 1.7%.

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