UNICE ECONOMIC OUTLOOK
AUTUMN 2005

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EXECUTIVE SUMMARY

MAIN FORECASTS

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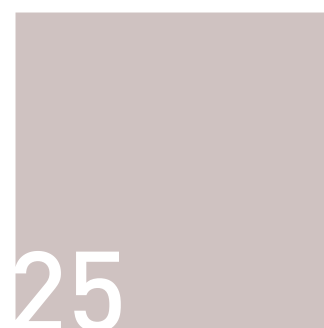
ECONOMIC SENTIMENT INDICATORS

MAIN RISKS TO THE ECONOMIC OUTLOOK

POLICY MIX



ANNEX:
COUNTRY RESULTS

UNICE
WHO ARE WE?

UNICE is the voice of more than 20 million small, medium, and large companies. UNICE's members are 39 central industrial and employers' federations from 33 countries, working together to achieve growth and competitiveness in Europe.

The UNICE Economic Outlook provides every semester a business insight into recent and projected economic developments, based on a survey of UNICE member federations in the 25 member states of the EU. Qualitative data and forecasts were established in October 2005. Aggregate values are GDP (at PPS) weighted, unless otherwise indicated.

FOR FURTHER INFORMATION, PLEASE CONTACT:

Economic and Financial Affairs Department

Marc Stocker

Tel: +32 (2) 237 65 15

Mail: m.stocker@unice.be

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UNICE FORECASTS

	2005		2006	
	EU12	EU25	EU12	EU25
GDP (annual % change)	1.3	1.6	1.8	2.1
Inflation (annual % change)	2.2	2.1	2.2	2.1
Unemployment rate	9.1	8.9	8.8	8.7
Revisions from spring				
GDP (annual % change)	-0.5	-0.6	-0.3	-0.3
Inflation (annual % change)	+0.2	0.0	+0.3	+0.1
Unemployment rate	+0.1	0.0	+0.2	+0.1

EXECUTIVE SUMMARY

- → THE RECOVERY IN EUROPE IS FACING SEVERE HEADWINDS
- → A MODEST STRENGTHENING OF GROWTH IS STILL EXPECTED IN 2006, BUT DOWNSIDE RISKS ARE DOMINATING
- → BETTER EMPLOYMENT PROSPECTS ARE KEY TO RESTORING CONSUMER CONFIDENCE
- → FISCAL DISCIPLINE IS CRUMBLING AND THE ECB IS LEANING TOWARDS TIGHTER MONETARY CONDITIONS
- → LISBON OBJECTIVES WILL HAVE TO BE RE-ACTIVATED, THERE IS NO TIME TO WASTE

THE RECOVERY IN EUROPE IS FACING SEVERE HEADWINDS ...

European businesses have become significantly less upbeat regarding economic prospects in Europe. Growth for the whole of 2005 is now estimated to be 1.6% in the EU and 1.3% in the euro area. This represents a cutback of around half a percentage point from our spring assessment.

Of course, the current disappointing pace of growth has to be viewed against the backdrop of record high oil prices. But we cannot be complacent: the under-performance of the EU in the global economy, and in particular vis-à-vis other main oil-importing economies such as the US and Asia is striking, and exposes the fact that Europe's persistent inability to generate a sustainable growth momentum also implies a heightened vulnerability to external shocks.

At country level, the most significant drawback to EU growth this year is estimated to come from Germany and Italy. The UK is also showing some signs of fatigue, although remaining somewhat more dynamic than the largest continental countries. Best performers are yet again to be found in Central European and Scandinavian countries as well as Ireland and Spain.

A MODEST STRENGTHENING OF GROWTH IS STILL EXPECTED IN 2006, BUT DOWNSIDE RISKS ARE DOMINATING ...

While it is likely that high oil prices will continue to determine the outlook in coming months, their dampening impact on growth could gradually fade. More generally, UNICE considers that conditions remain in place for a modest, but as yet insufficient, strengthening of growth next year.

In particular, past restructuring of corporate balance sheets and favourable financing conditions should, in a robust global growth environment, encourage firms to gradually raise investment plans and embark on stronger net job creation. This should help trigger a more domestically oriented pick-up in activity. In this context, it is anticipated that growth will increase slightly in 2006 to 2.1% and 1.8% in the EU and in the euro area respectively. Partial indications for 2007 show that growth is generally expected to continue at a moderate pace.

However, the European business community is showing signs of growing discomfort with the underlying performance of the European economy, and there is a sense that the recovery is now more than ever vulnerable to further adverse shocks. The main risks currently envisaged are renewed tensions on oil and other commodity markets, and potential upward pressure on the euro exchange rate related to a worsening of global imbalances.

BETTER EMPLOYMENT PROSPECTS ARE KEY TO RESTORING CONSUMER CONFIDENCE...

With anaemic consumption and the impact of high energy prices affecting households' purchasing power, there have been suggestions that higher wage growth could reinvigorate internal demand in Europe. UNICE cautions that this would come at a non-negligible cost for future growth and jobs.

The experience of the two previous oil shocks painfully illustrates that inappropriate wage-setting in response to a combination of high commodity prices and slowing trend productivity growth can have devastating and long-lasting consequences for labour market prospects.

So far, "second-round" effects of the oil shock have been largely avoided, but vigilance is of the essence. It is crucial that social partners act responsibly and keep in mind the final objective of promoting high, non-inflationary, and job-creating growth in Europe. Prudent wage-setting is a necessary condition to reach these objectives, and will ensure a rapid strengthening of employment as the recovery gathers pace. This in turn, will contribute to restoring confidence and households' willingness to spend.

FISCAL DISCIPLINE IS CRUMBLING AND THE ECB IS LEANING TOWARDS TIGHTER MONETARY CONDITIONS ...

This year's increase of fiscal deficits confirms our fears that discipline is losing ground in Europe. A more credible commitment to sound fiscal objectives is essential for the good economic governance of the euro area and is also crucial to prepare Europe for the looming challenges of an ageing population. Next year's national budgets should better reflect these challenges and help restore the credibility of the re-vamped Stability and Growth Pact.

As far as monetary policy is concerned, the ECB has left interest rates unchanged since June 2003, but current financing conditions are favourable and provide support to a strengthening of domestic demand. However, with inflation remaining moderate and risks to the outlook for growth predominantly on the downside, the ECB should keep all options open. At present, the materialisation of upside risks to price stability (i.e. excessive liquidity and risks of second-round effects of the oil shock on wages) still appear remote.

LISBON OBJECTIVES WILL HAVE TO BE RE-ACTIVATED, THERE IS NO TIME TO WASTE

In the current environment of rapid technological changes and globalisation, the cost of further delaying the necessary reforms has become too high.

Europe is currently losing export market shares and has been unable to gather more significant benefits from the remarkable upsurge in global activity and trade in the last few years. It is a matter of urgency that the EU regains its competitiveness and better asserts its role as a global economic player.

In addition, high structural unemployment and a downward trend in productivity growth have shaped a domestic environment marked by depressed income and spending expectations. A regime of stronger growth will not be reinstated unless ambitious structural reforms are launched.

In this respect, UNICE welcomes a Lisbon Strategy refocused on growth and jobs, and supports the adoption by the European Council in June of integrated guidelines, which put together in a single document the Broad Economic Policy and Employment Guidelines. At present, the overarching goal is to restore ownership of the Lisbon objectives. The National Action Plans currently being submitted by Member States are crucial to foster this ownership and we hope that these will be followed by decisive actions. UNICE's member federations should play their role to promote national initiatives for competitiveness and create reform momentum in their countries.

Finally, it is of the utmost importance that the EU budget over the next programming period becomes an effective instrument of the Lisbon Strategy, giving clear priorities to research, trans-European networks, training, education and innovative SMEs. In October, UNICE expressed to the UK presidency its concerns about the current state of negotiations, and insisted on the need to urgently re-launch discussions on the basis of a proposal capable of meeting the competitiveness objectives set out in the Lisbon agenda. We expect the UK presidency to do its best to finalise an agreement in the December council meeting and provide the EU with a budget that will help it face today's immense challenges.

MAIN FORECASTS

Real GDP growth estimates for 2005 have been cut significantly downwards, to 1.6% and 1.3% in the EU and the euro area respectively (compared with 2.2% and 1.8% in our spring assessment). For the most part, these revisions reflect a disappointing pace of growth in the recent past, and expectations of further dampening effects stemming from high energy prices. Consumption and business investment growth are relatively weak at this juncture, while exports appear slightly more resilient. Inflation in both the euro area and the EU will hover around, but slightly above, 2% this year. The labour market is expected to show only limited improvements, which will be insufficient to trigger a reduction in the unemployment rate at EU aggregate level this year. On the whole, the current economic performance in Europe is yet again disappointing, particularly given the continued strong pace of global growth.

Despite recent economic setbacks, European businesses continue to expect a mild strengthening of growth in 2006. Dynamic world demand, favourable financing conditions and relatively sound corporate profitability should set the path to new investment and hiring plans. Somewhat better labour market prospects should in turn help stronger, albeit still hesitant, private consumption growth. Even based on the working assumption of continued wage moderation, inflation is unlikely to fall below 2%, as the impact of high energy prices continues to feed through the price chain.

→ OUTPUT AND DEMAND

→ UNEMPLOYMENT

→ BOX 1: THE DANISH “FLEXICURITY” MODEL

→ PRICES AND LABOUR COSTS

→ BOX 2: IS THERE AN APPROPRIATE POLICY RESPONSE TO HIGH OIL PRICES?

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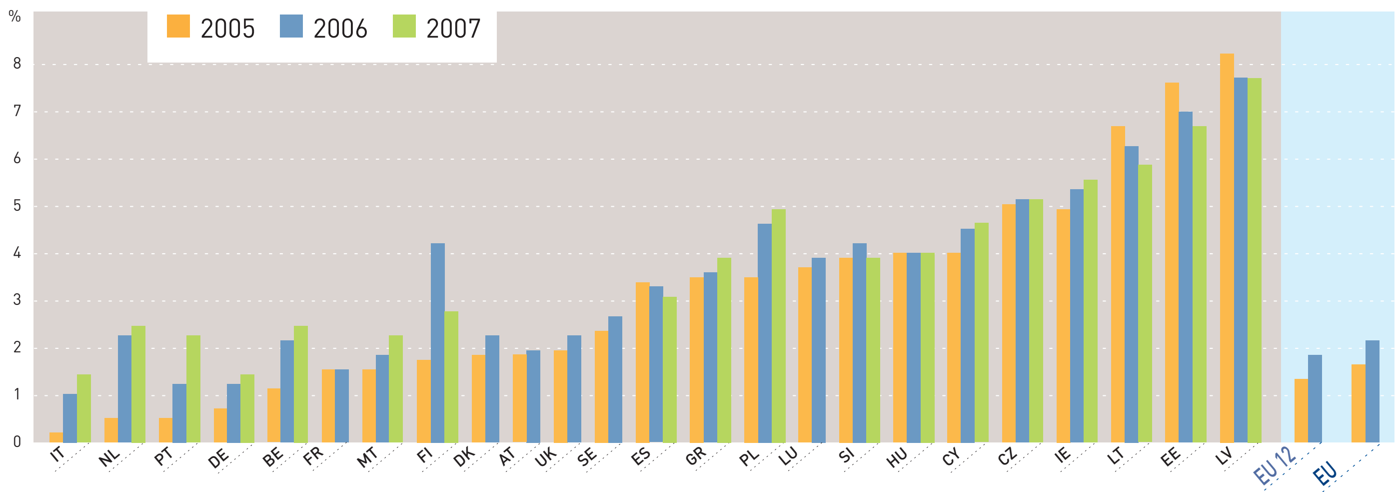
OUTPUT AND DEMAND

The Autumn 2005 UNICE Economic Outlook confirms that the European economy is currently in a soft growth patch. Our forecasts have been reduced in nearly all EU countries, with the exception of the Czech Republic, Estonia, Latvia and Lithuania. Growth in the whole of the EU is now estimated at 1.6% this year. The euro area seems set to register an even less convincing performance, with an estimate for real GDP growth of only 1.3%.

This assessment is broadly in line with other available projections. As regards the composition of demand, private consumption, investment and export growth are all expected to be more moderate this year than in 2004. Exports will continue to grow at a stronger pace than other components of demand, but the net trade contribution should be negative or at best neutral, due to significant import growth.

Chart 1 **Growth forecasts for 2005, 2006 and 2007**



Source: *UNICE survey October 2005*

The outlook for next year has also deteriorated markedly. In 2006, real GDP growth is foreseen at 2.1% and 1.8% in the EU and the euro area respectively. UNICE considers that beyond the more immediate effects of record high oil prices, conditions for a modest strengthening and broadening of growth remain in place in Europe. In particular, persistently strong global growth, restored corporate profitability and favourable financing conditions should encourage firms to raise investment plans and embark on stronger net job creation. However, investment and employment expectations have become more uncertain since the spring, and therefore also the chance of a significant strengthening of private consumption.

From a global perspective, the EU continues to lag significantly behind, as world GDP growth is estimated to remain robust and largely unaffected by the oil price hike. Europe's under-performance vis-à-vis other main oil-importing economies such as the US and Asia is particularly striking, and illustrates that our structural weaknesses and inability to create a self-sustained pick-up also implies a heightened vulnerability to global shocks.

At national level, the most significant drawback to the overall performance of the European economy this year again comes from Germany and Italy.

Germany has gradually regained its competitiveness, leading to an impressive export performance in the recent past. However, the transmission from this external stimulus to domestic demand has failed to materialise for the moment. Consumer spending has been particularly unresponsive, largely reflecting high structural unemployment and the negative impact of health care reforms on confidence. Political uncertainty in the aftermath of the general elections in September is not helping to restore confidence. It is crucial that the new government coalition rapidly launches an ambitious programme of reforms to let Germany become again Europe's economic driving force.

The situation in Italy is quite worrying. Structural shortcomings accumulated in previous years still remain, and the macroeconomic fundamentals are weak, with low growth potential, weak competitiveness, excessive deficit and an unsustainable level of public debt. Following a technical recession at the start of the year, Italy's GDP growth will be close to zero for the year as a whole, and is only expected to post a modest performance in 2006.

The best performing countries are still to be found in Central European and Scandinavian countries as well as Ireland, Spain and the UK. However, the UK economy has also shown signs of fatigue this year. More specifically, private consumption decelerated significantly reflecting the combined impact of the oil shock, higher interest rates and a relative cooling of the housing market.

UNEMPLOYMENT

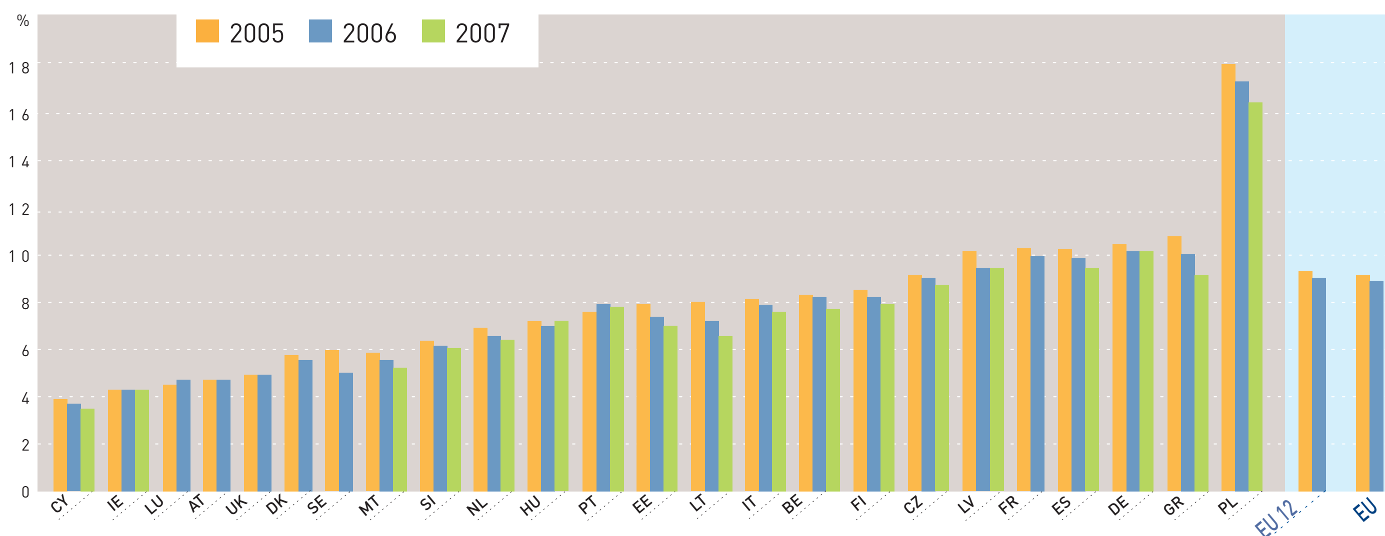
In a morose domestic environment, the labour market situation is unlikely to improve very significantly in the short term. This year, the unemployment rate is expected to stand at 8.9% in the EU and at 9.1% in the euro area. In 2006, it is expected to reduce slightly to 8.7% in the EU and 8.8% in the euro area.

At the current juncture, high unemployment appears to be the main concern for households, weighing on their confidence and spending decisions. This is notably clear from the latest Commission Eurobarometer survey which shows that European citizens consider that the most pressing issue facing Europe is a better functioning labour market.

Although unemployment in Europe remains unacceptably high, the labour market performance has improved significantly over the last decade. A gradual rise in the employment rate has been an important source of economic growth since the mid-1990s, and net job creation has continued at a significant pace during the most recent years of weaker growth. This is primarily the outcome of cautious wage-setting and targeted employment policies, which have allowed firms to embark on more employment-intensive processes and activities. This trend has to continue in the future. It is the key to restoring confidence and households' propensity to spend.

While Europe as a whole is characterised by high unemployment, the situation is very diverse across member states. In 2005, the unemployment rate should average around 10% in Germany, France and Spain, between 4% and 8% in other euro area countries and around 5% to 6% in the UK, Sweden and Denmark. Among new EU member states, the situation is also mixed with the unemployment rate ranging from 4% in Cyprus to 17% in Poland. The persistence of massive unemployment in some countries while others have attained near-full employment demonstrates the importance of an appropriate design of labour market institutions and social benefit systems. Best practices should inspire the institutional changes needed in countries with high structural unemployment. In this respect, the acclaimed successes of the Danish model are described in box 1, which also briefly discusses the applicability of this system to other countries in Europe.

Chart 2 **Unemployment rate forecasts for 2005, 2006 and 2007**



Source: *UNICE survey October 2005*

BOX 1: THE DANISH "FLEXICURITY" MODEL

The Danish labour market has performed particularly well during the last decade and is one of the few EU countries fulfilling the Lisbon goal of raising the employment rate above 70%.

Rapid progress has been achieved through labour market policies focusing on incentives and activation strategies for unemployed people, as well as flexible but comprehensive employment regulations in collective agreements and labour legislation. The latter implies limited hiring and firing costs and more generally a strong ability to cope with changes. This has created a very liquid labour market. Another aspect of the "Danish model" has been a decentralisation of wage-setting institutions, which have allowed appropriate account to be taken of relative productivity developments across sectors and firms.

The high degree of flexibility entailed by labour market institutions concentrating on job creation rather than job protection does not cause employees to feel particularly anxious about their employment situation. To the contrary, Danish employees are among those in the EU who show the strongest feeling of job security.

Reasons for this job security are manifold. First, the probability of finding a job when falling unemployed is relatively high. Second, unemployment benefits are generous as laid-off workers receive allowances of up to 90% of their previous income (for a period of maximum four years, including the period of active programmes). Third, social partners have included many security aspects in the collective agreements, e.g. sickness payments, payment during maternity and paternity leave, pensions, education, etc.

This security in the transition between jobs goes along with responsibilities. To avoid disincentives to work, unemployed people have to follow programmes of activation (public and private job training, support for job searching, etc.) and demonstrate that they are actively seeking a job.

The Danish labour market system has performed well so far but one should not underestimate its shortcomings. In particular, it provides insufficient work incentives among the lowest qualified and requires strong public spending for its financing, and is consequently associated with high taxation. With an unemployment rate below 5%, Denmark spends almost 1fi % of its GDP in unemployment benefits (financial and non-financial forms), i.e. four times more than the US with a similar unemployment rate and almost as much as France, with a rate twice higher. This high-cost system requires a well functioning economy and could be particularly vulnerable to adverse economic shocks.

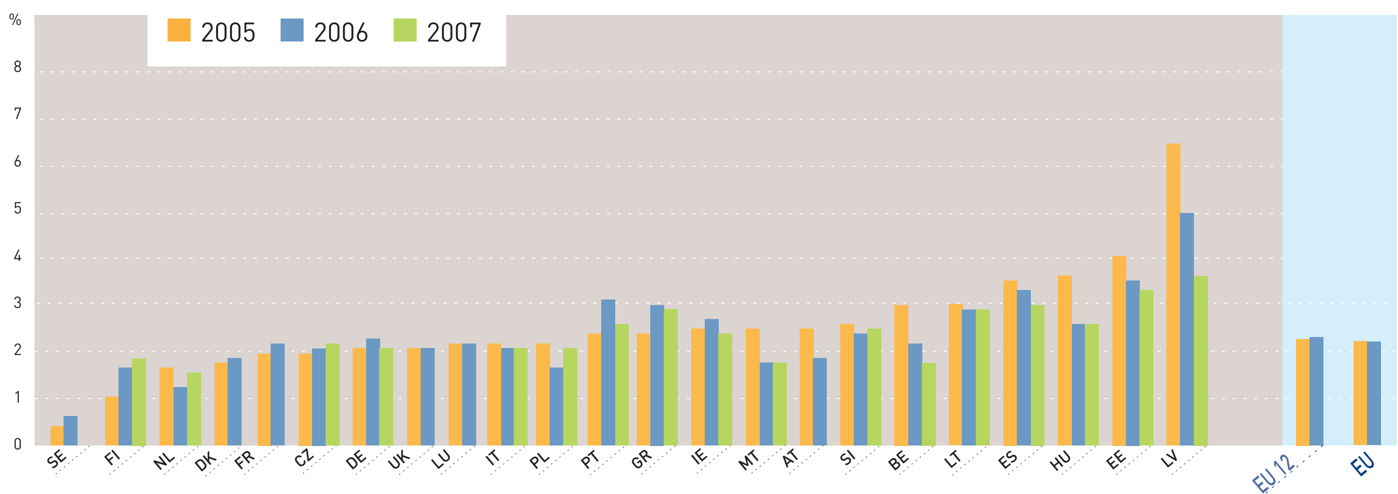
Despite the drawbacks, certain aspects of the Danish "flexicurity" model could potentially inspire institutional changes in other European countries. However, what works in a small, rich and relatively homogenous country, could have only limited applicability for larger, more diverse and less consensual societies. Including for countries with already generous social systems such as Germany and France, the Danish model would hardly prove sustainable. EU member states cannot spare the effort of finding their own specific reform package, obviously giving due consideration to best practices in other countries.

PRICES AND LABOUR COSTS

This year's inflation developments are characterised by two important trends. On the one hand, high commodity prices are adding considerable inflationary pressures compared with last year. Their effects on producer price and consumer price inflation have already been quite noticeable and the impact is likely to continue in the coming months. On the other hand, stable inflation expectations, subdued domestic demand and prudent wage-setting are keeping "core" inflation at a relatively low level. Against this background, headline inflation is expected to remain broadly stable this year, slightly above 2% in both the EU and the euro area. In 2006, the direct impact of high energy prices will wane but "core" inflation is expected to increase, resulting in an overall inflation rate remaining again marginally above 2%.

At country level, inflation rates will continue to vary significantly, ranging in 2005 from 0.4% in Sweden to 6.5% in Latvia. In the largest euro area countries, inflation is expected to reach 1.9% in France, 2.0% in Germany, 2.1% in Italy and 3.4% in Spain. While the issue of inflation differentials in a single currency area should not be exaggerated, persistent differences are nevertheless a cause for concern. For instance,

Chart 3 **Inflation rate forecasts for 2005, 2006 and 2007**



Source: *UNICE survey October 2005*

inflation expectations are significantly higher in Spain than in Germany, although being suitably around 2% at euro area level. Differences in inflation expectations are leading to non-negligible gaps in real interest rates across euro area countries, which can sometimes contribute to maintaining imbalances at the national level (excessively supportive monetary conditions in some parts of the euro area, and stricter than necessary conditions in other parts). Addressing these imbalances when they emerge is a key challenge for the good economic governance of the euro area.

As far as wage developments are concerned, they remain moderate overall. This year and next, hourly labour costs are expected to remain broadly constant at 2.7% and 2.3% in the EU and in the euro area respectively. This mainly reflects the impact of persistent slack in the labour market and low trend productivity growth.

These price and cost projections rely on the assumption of a continuation of prudent wage-setting as observed in recent years. However, the support for wage moderation is waning in the face of persistently low consumption growth and high oil prices, and there are some upward risks to our forecasts. Box 2 discusses the appropriate policy response to the ongoing oil shock.

BOX 2: IS THERE AN APPROPRIATE POLICY RESPONSE TO HIGH OIL PRICES?

Oil prices have been hovering in recent months above $ 60 a barrel, and oil futures predict that they will remain high for the foreseeable future.

Despite these record levels, today's situation is very different from the previous two oil shocks. In fact, the oil dependency of the economy has decreased over the last 3 decades, notably resulting from a gradual shift to a more services-oriented economy, but also from a more energy-efficient industry. Moreover, the latest oil shock, unlike previous ones, was triggered in the first place by strong global demand, not least from the US and Asia. High oil prices are therefore to a large extent a by-product of an exceptionally strong global upturn, which also helps explain why the world economy appears less disturbed this time.

However, the EU is in a less enviable position and appears relatively more affected than other major oil-importing economies. It is as if Europe was currently paying twice for its lack of external competitiveness: while losing export market shares and missing the opportunities of strong global growth, internal demand is now also hurt by the resulting tensions on commodity markets.

Against this background, can or should policy-makers try to minimise the dampening effects of high oil prices? The answer is: not in the short term.

First of all, some EU countries have planned to reduce the oil bill for consumers and for some exposed sectors like transport. Public subsidies and artificial price caps should be avoided: they distort necessary adjustments and might in fact exacerbate the vulnerability of an economy to future oil price increases.

Second, as far as wage policies are concerned, the experience from the 1970s and early 1980s shows that trying to compensate for loss of purchasing power with higher wage settlements can have devastating effects on medium-term employment prospects. This calls for particular vigilance with current wage-, but also price-setting decisions.

Overall, it is difficult and could be largely counterproductive to take short-term actions to offset the loss of income currently being borne by households and firms in Europe.

Appropriate policies should seek to increase the resilience of our economy to oil price fluctuations, by improving further energy efficiency, reducing oil intensity, diversifying energy and oil supplies and ensuring a better functioning of the markets for all energy providers and consumers. Energy diversification could notably be promoted through the removal of barriers and disincentives to risky investment in new energy sources.

ECONOMIC SENTIMENT INDICATORS

While expecting some moderate improvements, businesses generally remain cautious regarding the overall economic climate in Europe. The outlook for corporate profitability, investment and employment remains positive, but is not expected to improve significantly over the next six months against the backdrop of high oil prices and weak domestic demand.

→ BUSINESS CLIMATE

→ PROFITABILITY

→ INVESTMENT

→ EMPLOYMENT

→ SME FINANCING

→ BOX 3: COSTS AND BENEFITS OF RELOCATION

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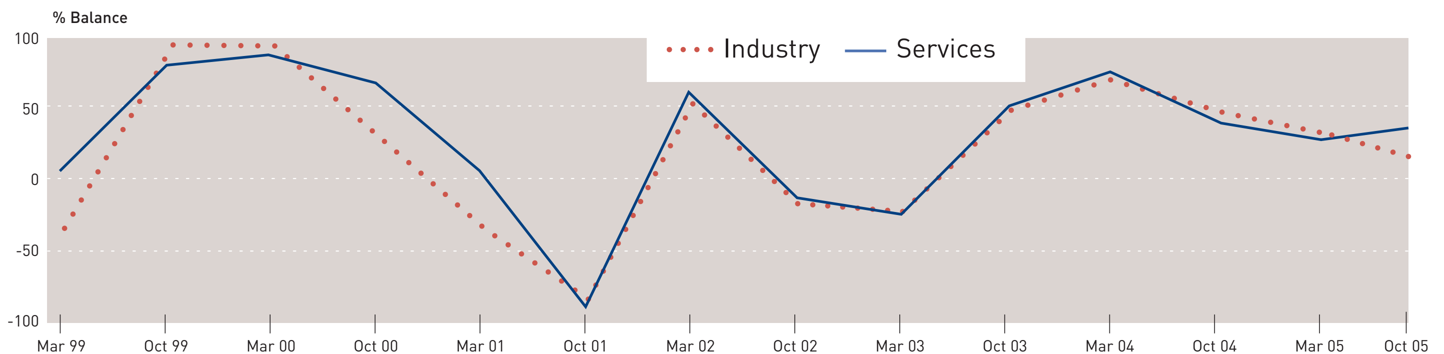
BUSINESS CLIMATE

The business climate at EU aggregate level is still projected to improve gradually over the next semester, thanks to a relatively positive outlook in the services sector. On the other hand, conditions in industry remain uncertain and indicate only hesitant growth in the near future.

At the country level, earlier hopes of better economic conditions in Germany have been disappointed, and the political uncertainty following the September general elections has also affected entrepreneurs' confidence. However, most recent indicators have been encouraging and show that a modest recovery could finally be under way in Germany. In the UK, conditions in industry are predicted to worsen, but a positive trend in services is still forecast. In a number of other countries such as France, Italy, the Netherlands, Finland and Sweden, the outlook in industry has improved following relatively weak developments in the recent past.

Chart 4 **Trend in business climate - EU15**



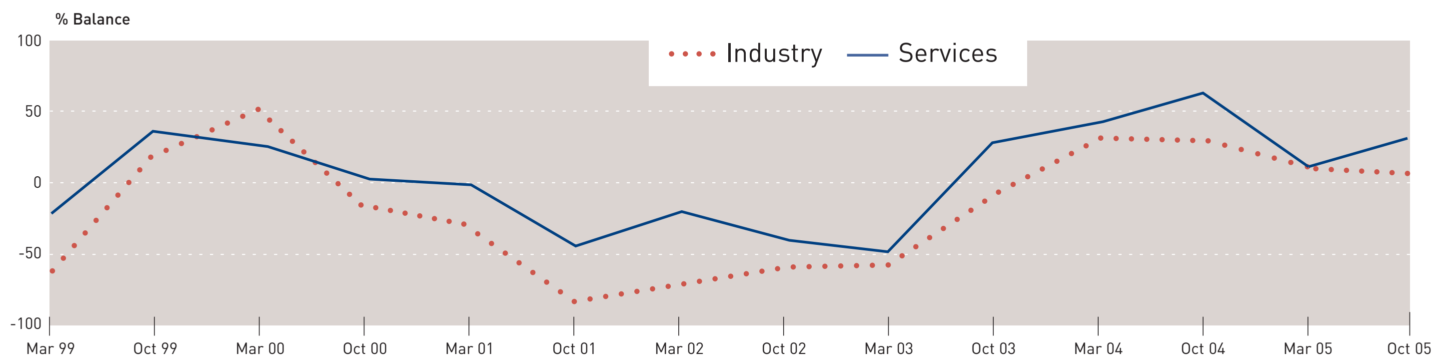
Source: *UNICE surveys 1999-2005*

PROFITABILITY

The outlook for corporate profitability remains positive overall but should not improve significantly in coming months. The depreciation of the euro since the beginning of the year has released some pressure on profit margins, but this has been largely offset by high commodity prices and the recent deceleration in labour productivity which will lead this year to higher, albeit still moderate, unit labour cost growth.

Looking at individual countries, a significant improvement in profitability is expected in Germany, as restructuring efforts, and to a lesser extent a reduction in non-wage labour costs, should largely compensate for the impact of high commodity prices. In Italy and the Netherlands, an improvement in profitability indicates a consolidation period following weak developments in the recent past. In the UK and in France, profitability trends remain generally negative, reflecting high oil prices, moderate demand and limited pricing power.

Chart 5 **Trend in profitability expectations - EU15**



Source: *UNICE surveys 1999-2005*

INVESTMENT

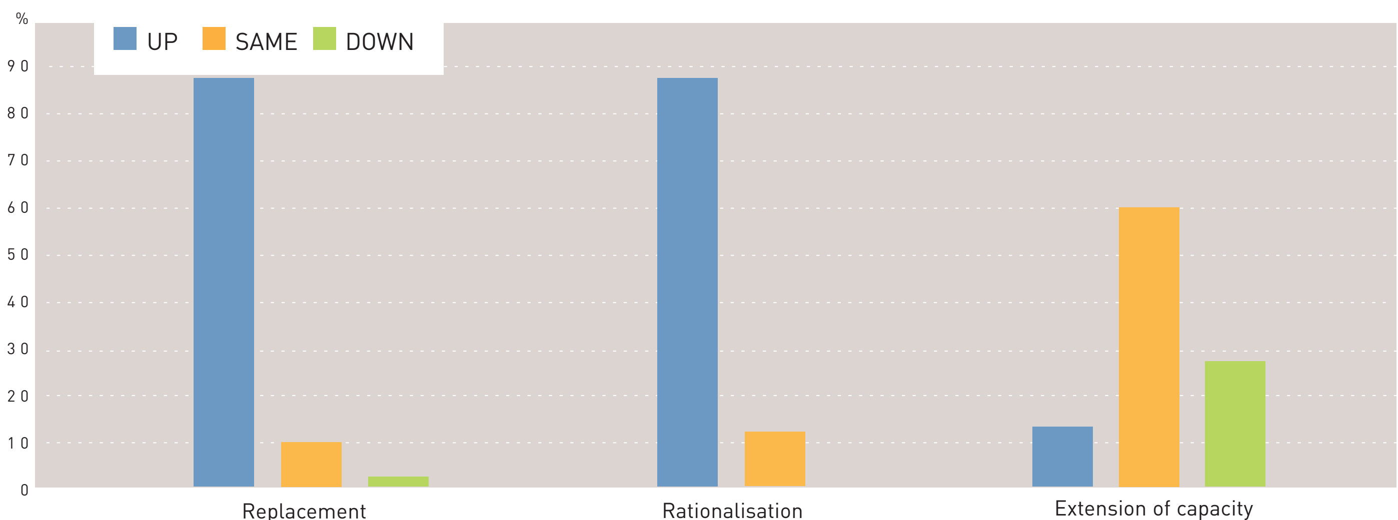
Past restructuring of corporate balance sheets and favourable financing conditions are conducive to stronger investment growth in Europe. However, expectations remain prudent, reflecting the mounting discomfort of European businesses with the underlying performance of the European economy.

Replacement and rationalisation currently represent the key factors supporting a positive investment outlook, while the extension of capacity remains a secondary objective. From a sectoral perspective, conditions for investment in the services sector have recently deteriorated, while prospects in industry have brightened following a significant worsening in the spring.

In Germany, the weakness in capital spending is only slowly passing. Persistent difficulties in the construction business, the tendency towards foreign investment and the decrease in the value-added to gross production ratio remain a burden. Another restraining factor in the short term is ongoing low capacity utilisation, uncertain sales perspectives as well as the unsatisfactory discussion about economic reforms in Germany. In Italy, due to improved profitability conditions and better demand prospects, investment should gradually pick up albeit at contained rates. In the Netherlands, investment geared towards extending productive capacities should be stepped up significantly. In contrast, developments in the UK point to a deterioration in the conditions for gross fixed capital formation.

In view of the growing attention and concern in the general public about relocation, Box 3 discusses its potential costs and benefits in Europe.

Chart 6 **Trend in investment by purposes - EU15**



Source: *UNICE survey October 2005*

EMPLOYMENT

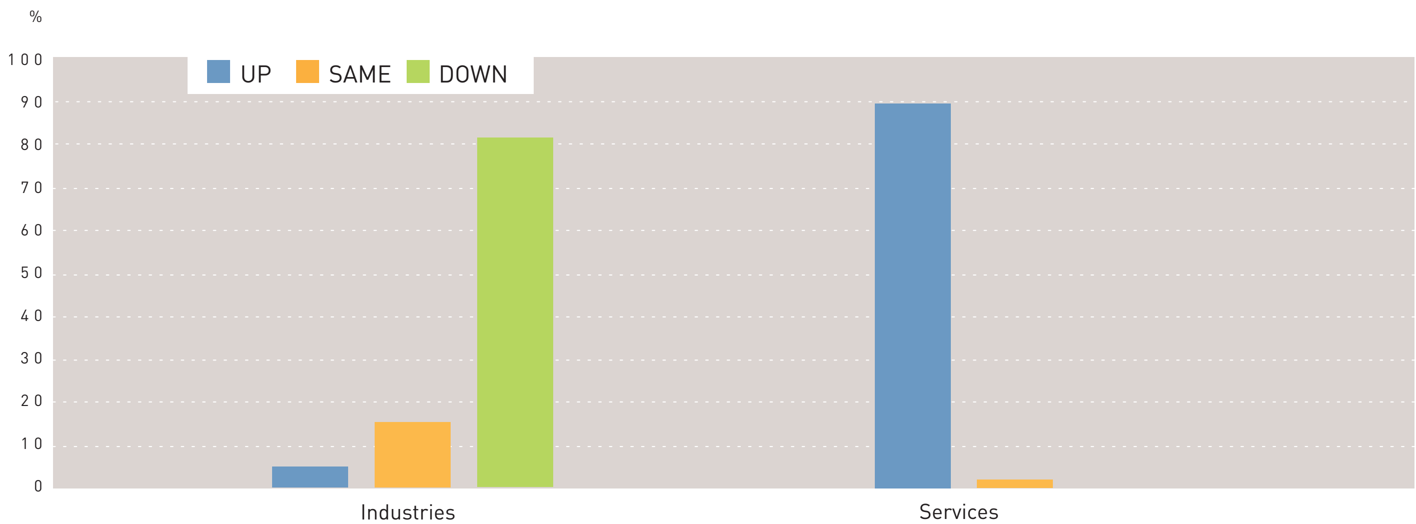
On average, employment expectations remain positive and consistent with net job creation in coming months. However, conditions have deteriorated somewhat since the spring, reflecting weaker-than-expected economic growth in the first half of 2005 and heightened uncertainty regarding the outlook.

Developments in industry and services continue to follow opposite trends. Industrial employment is forecast to shrink further in the near future, and at a more significant pace than expected six months ago. This deterioration results mainly from the downgraded outlook in Germany and from less optimistic prospects in Spain, Sweden and Portugal.

On the other hand, services employment is trending upwards and conditions in this sector have improved slightly from our previous assessment. At the country level, this is mainly accounted for by better prospects Italy, the Netherlands, Finland and Sweden.

This diverging trend between industrial and services employment is a long-lasting phenomenon, resulting from the growing importance of services activity and from more efficient production processes in industry. This is not per se a damaging development but it represents a crucial test for the functioning of labour markets. It imposes flexible institutions and appropriate training so that workers and skills can match the demand from sectors that are integrating a growing share of the workforce. This requires, first, labour market policies focused on incentives and activation strategies and, second, less strict employment regulations which impose large hiring and firing costs.

Chart 7 **Expected trend in employment over the next six months - EU15**



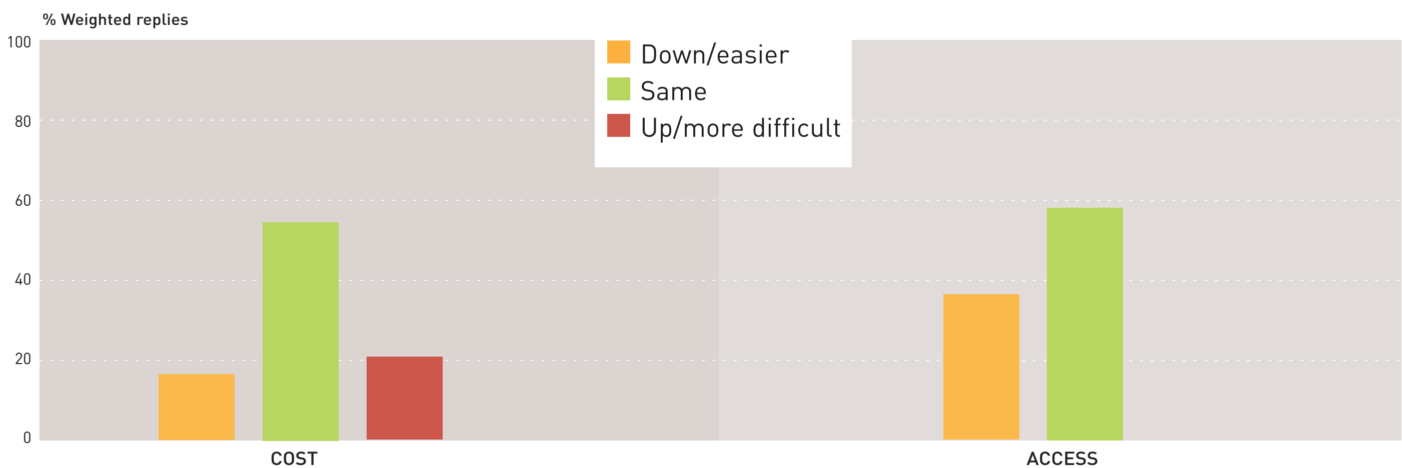
Source: *UNICE surveys October 2005*

SME FINANCING

The cost of financing for SMEs is expected to remain favourable in the short term. This stems from low bank lending rates across the maturity spectrum, narrow corporate bond yield spreads and declining cost of equity issuance. The cost of financing is assessed to remain unchanged in the largest majority of EU countries. However, it is expected to deteriorate slightly in Germany. In contrast, lower costs are reported in the UK, Poland and in Slovenia.

Regarding access to financing, conditions are set to remain broadly unchanged or to improve slightly. In particular, bank lending policies are becoming more supportive in Germany and Italy, while access to financing is also easing in Estonia, Lithuania, Poland and Slovenia.

Chart 8 **Trends in SME cost and access to finance - EU15**



Source: *UNICE surveys October 2005*

BOX 3: COSTS AND BENEFITS OF RELOCATION

Western European companies relocating some of their activities to other places in the world have recently received a great deal of media attention and stirred up anxieties. Relocation, defined as the transfer of production or services to other countries, only accounts for a minor proportion of job losses in European enterprises. Nevertheless, relocation is part of a wider phenomenon of accelerated globalisation and structural change with momentous consequences for European society.

A European company's decision to develop a global business strategy is motivated by cost advantages, but also more often than not by the will to secure access to growing foreign markets. A 2003 survey by the Observatory of European SMEs shows that the main reason why SMEs are going global is access to new and larger markets, outweighing reasons such as access to cheaper labour.

Economic theory and empirical analysis suggest that relocation is generally beneficial for the host as well as for the relocating country. In the latter, the freed economic resources should over time create more jobs than those originally displaced. How much time will depend on the flexibility of economic structures and how the skills of the displaced workers will match new vacancies. Unfortunately, Europe is lagging behind in this respect. For instance, re-employment rates for displaced workers in manufacturing industries are significantly lower than in the US.

In any event, the transition costs of relocation are always more visible than its benefits (i.e. cheaper products and services for consumers). The current danger is that the crucial elements which turn relocation into a win-win situation - flexibility and openness – will be undermined by protectionist pressures. Giving in to protectionism will only increase the social costs of relocation.

MAIN RISKS TO THE ECONOMIC OUTLOOK

With domestic demand in Europe so far failing to gain momentum, the recovery is more vulnerable than ever to further adverse shocks. The main risks currently envisaged are those related to further tensions on oil and other commodity markets and to renewed upward pressures on the euro exchange rate.

→ ENERGY PRICES

→ EXCHANGE RATE

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ENERGY PRICES

Since our Spring Economic Outlook the worst fears about developments on commodity markets have materialised. Contrary to our expectation six months ago oil prices have increased dramatically and are currently fluctuating above $ 60 / barrel.

While the main driver of the past upward trend in oil prices was the strength of global demand, most recent tensions have been related also to supply constraints caused by political instability in some producing countries, weather-related disruptions and past under-investments in oil-refining capacity. Looking forward, our member federations generally expect oil prices over the next six months to subside slightly but to remain above $ 50 /barrel. However, there remain considerable upward risks to this assessment. Limited spare capacity implies that any changes in the supply-demand balance will have significant effects on the market. With continued robust global demand, oil prices are set to remain high but also very volatile in the coming months.

Further oil price increases from current high levels could have disproportionate effects on the economy. Additional cost pressures on European businesses could have larger effects on investment and employment prospects. In turn, consumers whose sentiment is already at a low level could become even more cautious if the labour market outlook deteriorates, trapping the economy in a dangerously weak domestic demand regime. These risks would be heightened if second-round effects on wages and prices are allowed to happen.

EXCHANGE RATE

The euro exchange rate has weakened since the record levels reached at the end of 2004, and currently stands in a range of about $ 1.20-1.23. At least in the short run, the burden has decreased for European exporters.

The slight depreciation of the euro so far this year is partly explained by interest rate and growth differentials between the euro area and the US, but also by a crisis of confidence in EU governance following the rejection of the European constitutional treaty in France and the Netherlands and by the failure to reach an agreement on the next EU budget.

From a more medium-term perspective, a stabilisation of the euro will only be possible if fundamental measures are taken to address the widening global imbalances, the most visible expression of which is a US current account deficit now reaching an astounding 6% of GDP. This situation continues to imply significant risks of dollar depreciation. In the absence of more flexible exchange rate regimes in areas with large current account surpluses (mostly Asia and OPEC countries), the weight of the adjustment could fall on Europe with a significant euro appreciation. The revaluation of the Chinese Renminbi in July and the additional flexibility introduced at the end of September is a positive signal, but it will not result in the necessary adjustments. The Chinese currency will have to appreciate significantly to contribute to the unwinding of global current account imbalances.

Renewed pressure on the euro would put businesses in significant difficulties. Our survey suggests that an exchange rate above $ 1.3 would hurt the European economy considerably.

(*) Only 8 member federations gave a numerical answer to the related question.

POLICY MIX

The policy mix is currently deemed inadequate in a majority of European countries. This mainly stems from an unsatisfactory pace of fiscal consolidation, with most Member States failing to take appropriate actions to prepare for the forthcoming demographic shock. The malaise is particularly clear in the euro area, where most countries lack the political commitment, solidarity and fiscal discipline required for the good governance of the monetary union.

→ FISCAL POLICY
→ MONETARY POLICY

FISCAL POLICY

The pace of consolidation is slowing down in Europe. The budget deficit of the euro area is likely to reach the limit of 3% of GDP in 2005, following a deficit of 2.7% last year. This deterioration could largely be associated with a weaker pace of economic growth, but structural deficits (corrected for the position in the cycle) have also stopped improving this year. Germany, France, Italy, Greece and Portugal are all expected to exceed the limit of 3% by a significant margin. In these countries, consolidation efforts are assessed to be either slower than needed or non-existent by our member federations. More generally, fiscal policies are generally considered to be inadequate in a majority of countries, representing more than 90% of the euro area but also of the EU.

With pressures from an ageing population looming ahead, it is crucial to ensure credible commitments to bring fiscal budgets close to balance before the end of the decade. Imposing such a process of consolidation will be an important test for the reformed Stability and Growth Pact. Developments so far are not encouraging. UNICE is concerned to see the new rules so rapidly used by high-deficit countries to justify a postponement of the necessary adjustments. The room for manoeuvre provided by the new SGP should be used with greater care.

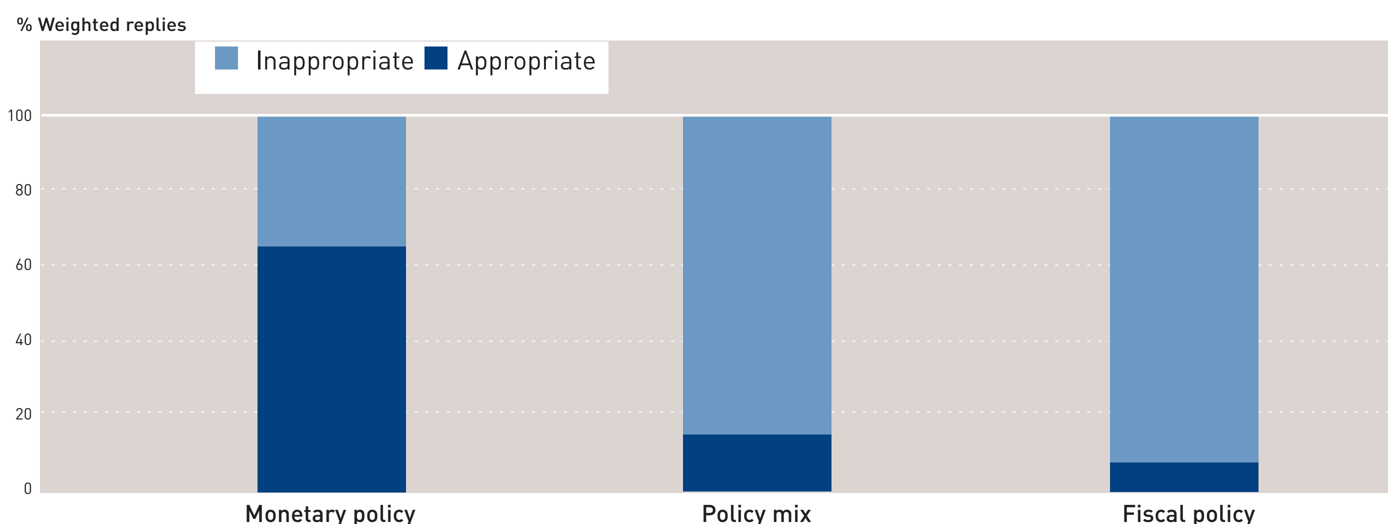
MONETARY POLICY

The ECB continues to have a steadfast policy, as it has left interest rates unchanged since June 2003. This policy is deemed appropriate by the widest majority of employer federations which see current financing conditions as favourable for investment and more generally to sustain a recovery in Europe.

Yet, with inflation remaining relatively moderate (below 2% excluding energy prices) and risks to the outlook for growth predominantly on the downside, it appears unnecessary to adopt a tightening bias at this juncture. Upside risks to price stability, such as excessive liquidity and risks of second-round effects of the oil shock on wages still appear remote in the current environment of weak domestic demand.

Finally, as the ECB rightly insists on the need to launch ambitious structural reforms to unleash the euro area's growth potential, it might also indicate more clearly that supply-side policies, if sufficiently widespread, will be supported by a low interest-rate environment.

Chart 9 **Assessment of fiscal and monetary policy in the euro area**



Source: *UNICE survey October 2005*

ANNEX
COUNTRY RESULTS

COUNTRIES

AT	Austria
BE	Belgium
CY	Cyprus
CZ	Czech Republic
DK	Denmark
EE	Estonia
FI	Finland
FR	France
DE	Germany
GR	Greece
HU	Hungary
IE	Ireland
IT	Italy
LV	Latvia
LT	Lithuania
LU	Luxembourg
MT	Malta
NL	Netherlands
NO	Norway
PL	Poland
PT	Portugal
SK	Slovakia
SI	Slovenia
ES	Spain
SE	Sweden
TR	Turkey
UK	United Kingdom

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UNICE ECONOMIC OUTLOOK AUTUMN 2005

MAIN FORECASTS

	BE	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI
2005												
Real GDP (annual % growth)	1.1	0.7	3.4	3.3	1.5	4.8	0.2	3.6	0.5	1.8	0.5	1.7
Inflation (annual % growth)	2.9	2.0	2.3	3.4	1.9	2.4	2.1	2.1	1.6	2.4	2.3	1.0
Unemployment rate	8.1	10.2	10.5	10.0	10.0	4.2	7.9	4.4	6.8	4.6	7.4	8.3
Nominal hourly compensation (annual % growth)												
2006												
Real GDP (annual % growth)	2.1	1.2	3.5	3.2	1.5	5.2	1.0	3.8	2.2	1.9	1.2	4.1
Inflation (annual % growth)	2.1	2.2	2.9	3.2	2.1	2.6	2.0	2.1	1.2	1.8	3.0	1.6
Unemployment rate	8.0	9.9	9.8	9.6	9.7	4.2	7.7	4.6	6.4	4.6	7.7	8.0
Nominal hourly compensation (annual % growth)												
2007												
Real GDP (annual % growth)	2.4	1.4	3.8	3.0	na	5.4	1.4	na	2.4	na	2.2	2.7
Inflation (%)	1.7	2.0	2.8	2.9	na	2.3	2.0	na	1.5	na	2.5	1.8
Unemployment rate	7.5	9.6	8.9	9.2	na	4.2	7.4	na	6.3	na	7.6	7.7
Nominal hourly compensation (annual % growth)												

ECONOMIC SENTIMENT

	BE	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI
Question 1 — **Trend in business climate over the next six months**												
Positive	Ser		Ind Ser		Ind Ser	Ser	Ind	Ser	Ind			Ind
Negative				Ind		Ind						
Unchanged	Ind	Ind Ser		Ser			Ser	Ind	Ser	Ind Ser	Ind Ser	Ser
Question 2 — **Trend in profitability over the next six months**												
Positive	Ser	Ind Ser				Ser	Ind Ser	Ser	Ind Ser			
Negative				Ind	Ind			Ind		Ind		
Unchanged	Ind		Ind Ser	Ser	Ser	Ind				Ser	Ind Ser	Ind Ser
Question 3 — **Trend in investment over the next six months (compared to the last 12 months)**												
Increase (faster pace)		Ind Ser	Ind Ser						Ind Ser			
Increase (lower pace)	Ind Ser			Ser		Ser	Ind Ser	Ser		Ind Ser	Ser	Ind
Unchanged				Ind	Ind Ser	Ind		Ind			Ind	Ser
Decrease (faster pace)												
Decrease (lower pace)												
Question 4 — **Trend in consumer confidence over the next six months**												
Positive							Yes					
Negative		Yes	Yes						Yes		Yes	
Unchanged	Yes			Yes	Yes	Yes		Yes		Yes		Yes
Question 5 — **Overall trend in employment**												
Ind: past6 months	Down	Down	Same	Down	Down	Down	Up	Same	Down	Down	Same	Same
Ind: next 6 months	Down	Down	Same	Same	Down	Down	Down	Same	Up	Same	Down	Same
Ser: past 6 months	Same	Up	Up	na	Up	Up	Up	Up	Down	Same	Up	Up
Ser: next 6 months	Up	Up	Up	na	Up	Up	Up	Up	Up	Up	Same	Up
Question 6 — **Compared to six months ago. SMEs cost/access to capital for business development**												
Higher / more difficult	C	C										
Same	A		C A	C A	CA	C	C	C A	CA	CA	C A	C A
Lower / less difficult		A				A	A					

MAIN RISKS

	BE	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI
Question 7 — **Above which level of dollar/euro will the European economy be significantly hurt?**												
Dollar per euro	na	1.30	1.20	1.40	1.10/1.15	1.40	1.30	na	1.30-1.35	1.30	na	1.30
Question 8 — **According to you where will the dollar/euro stand in March 2006?**												
Dollar per euro	na	1.20	1.20	1.20	na	1.28	1.22	na	1.25	1.18	1.20	1.25
Question 9 — **Impact of an increase of 0.10 in the dollar/euro on your country growth?**												
GDP	na	-0.20	0.00	-0.10	na	na	-0.40	na	-0.50	-0.25	na	-0.30
Question 10 — **Above which level of US crude oil will European economy be significantly hurt?**												
US dollar a barrel	50	50	50	na	na	70	60	na	70-75	→70	na	65
Question 11 — **According to you where will the US crude oil price stand in March 2006?**												
US dollar a barrel	55	60	50	63	na	62	57	na	60-65	55	50	58
Question 12 — **How many GDP percentage points could your economy lose as a result of a $10 increase in oil prices?**												
GDP	na	0.20	0.2-0.3	0.20	na	0.20	0.50	na	0.50	0.40	na	0.20

POLICY MIX

	BE	DE	GR	ES	FR	IE	IT	LU	NL	AT	PT	FI
Question 13 — **Fiscal policy: Pace of fiscal consolidation**												
Faster than needed												
Adequate						yes			yes			
Slower than needed	yes	yes	yes	yes			yes			yes	yes	yes
Non existent but not needed					yes							
Non existent and needed												
Question 14 — **Monetary policy (ECB policy for the euro area members)**												
Tight but appropriate for the euro							yes					
Tight												
Appropriate	yes	yes	yes		yes			yes	yes	yes	yes	
Loose				yes								
Loose but appropriate for the euro are						yes						yes
Question 15 — **Consistency between the fiscal and the monetary policies**												
Adequate	yes		yes					yes	yes		yes	
Unadequate		yes		yes	yes	yes	yes			yes		yes

EU-12	DK	SE	UK	EU-15	CZ	EE	CY	LV	LT	HU	MT	PL	SI	SK	EU	NO	TR
1.3	1.8	2.3	1.9	1.4	4.9	7.4	4.0	8.0	6.5	3.9	1.5	3.4	3.8	na	1.6	3.8	5.0
2.2	1.7	0.4	2.0	2.1	1.9	4.0	na	6.5	2.9	3.5	2.4	2.1	2.5	na	2.1	1.3	8.0
9.1	5.6	5.8	4.8	8.2	8.9	7.7	3.8	9.9	7.8	7.0	5.7	17.6	6.2	na	8.9	4.4	10.0
2.3				2.7											2.7		
1.8	2.2	2.6	2.2	1.9	5.0	6.8	4.4	7.5	6.1	4.0	1.8	4.5	4.1	na	2.1	3.0	5.0
2.2	1.8	0.6	2.0	2.1	2.0	3.4	na	5.0	2.8	2.5	1.9	1.6	2.3	na	2.1	1.8	5.0
8.8	5.4	4.9	4.8	8.0	8.8	7.2	3.6	9.2	7.0	6.8	5.4	16.9	6.0	na	8.7	4.0	10.0
2.3				2.8											2.7		
na	na	na	na	na	5.0	6.5	4.5	7.5	5.7	4.0	2.2	4.8	3.8	na	na	2.5	5.0
na	na	na	na	na	2.1	3.2	na	3.5	2.8	2.5	1.9	2.0	2.4	na	na	2.0	4.0
na	na	na	na	na	8.5	6.8	3.4	9.2	6.4	7.0	5.1	16.0	5.9	na	na	3.8	9.8
na				na										na	na		

EU-12	DK	SE	UK	EU-15	CZ	EE	CY	LV	LT	HU	MT	PL	SI	SK	EU	NO	TR
Ind/Ser				**Ind/Ser**											**Ind/Ser**		
52 44	Ind	Ind Ser	Ser	45 44	Ind Ser	Ind Ser	Ind Ser	Ser	Ser			Ind Ser			47 46	Ind Ser	Ind Ser
14 2	Ser		Ind	28 2							Ind		Ind		26 1		
34 55				27 55				Ind	Ind	Ind Ser	Ser		Ser		26 51		
Ind/Ser				**Ind/Ser**											**Ind/Ser**		
53 59	Ind	Ser		44 49	Ind Ser	Ind Ser		Ind Ser	Ser	Ind Ser		Ind Ser	Ind		48 52	Ind Ser	
34 0	Ser		Ind Ser	44 19					Ind						41 17		Ind Ser
12 41		Ind		12 32			Ind Ser				Ind		Ser		11 30		
Ind/Ser				**Ind/Ser**											**Ind/Ser**		
37 37		Ser		29 31		Ser	Ind Ser	Ser	Ser			Ind Ser			30 34	Ser	
25 40		Ind		22 31	Ind Ser	Ind				Ind	Ind Ser		Ind Ser		24 33	Ind	Ind Ser
38 24				30 19				Ind	Ind Ser						28 17		
0 0			Ind Ser	17 17											16 16		
0 0				0 0											0 0		
19		Yes		18	Yes	Yes		Yes							19	Yes	Yes
39			Yes	48					Yes	Yes					45		
41	Yes			34			Yes				Yes		Yes		32		
U/S/D				**U/S/D**											**U/S/D**		
19/7/74	Down	Down	Down	15/6/79	Up	Up	Same	Up	Down	Down	Down	Up	Up	na	20/5/74	Same	Same
6/17/77	Same	Down	Down	5/15/80	Same	Up	Same	Up	Down	Down	Down	Up	Up	na	9/16/75	Up	Same
78/4/6	Up	Down	Up	80/3/7	Up	Up	na	Up	Up	Same	Same	Up	Up	na	80/4/7	Up	Same
85/2/0	Up	Up	Up	88/2/0	Up	Up	na	Up	Up	Same	Same	Up	na	na	87/3/0	Up	Same
C A				**C A**											**CA**		
28 0				22 0				C							20 0	C	
68 51	CA	CA	A	58 62	CA	C	CA	A	C		CA				55 58	A	
0 49			C	17 38		A			A	CA		CA	CA		21 41		
	na	1.30	na		1.40	1.40	na	na	1.40	na	na	na	na	na		na	na
	1.23	1.24	na		1.24	1.25	1.27	1.20	1.25	na	na	na	na	na		na	na
	-0.20	-0.40	-0.10		na	-0.30	na	-0.20	na	-0.30	na	na	na	na		na	na
	na	50	45		60	73	na	80	60	70	na	na	na	na		50	na
	na	55	67		55	65	na	na	72	65	60	na	na	na		50-60	na
	0.20	0.20	0.70		0.10	1.5-2	0.10	na	na	na	na	na	na	na			na
Ind/Ser				**Ind/Ser**											**Ind/Ser**		
0				0											0		
8	yes			8	yes		yes				yes				9		
70			yes	72								yes	yes		70		
22				17		yes		yes	yes						16		
0		yes		3											2		
Ind/Ser				**Ind/Ser**											**Ind/Ser**		
19				15											14		
0				0											0		
65	yes	yes	yes	73			yes		yes		yes				66		
12				10								yes			13		
3				3											2		
Ind/Ser				**Ind/Ser**											**Ind/Ser**		
15				12	yes		yes	yes	yes		yes				14		
85	yes	yes	yes	88		yes						yes			84		

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168 AVENUE DE CORTENBERGH 1000 BRUSSELS BELGIUM

T +32 (0)2 237 65 11 F +32 (0)2 231 14 45 MAIN@UNICE.BE

WWW.UNICE.ORG

Graphisme Mandragore - michel@mandragore.be