BUSINESSEUROPE

REPORT

20 September 2007

Economic situation and challenges

At this juncture, BUSINESSEUROPE sees a fairly confident scenario of growth averaging around 2.7% for 2007 (more precise estimates will be published on 8 November in the Economic Outlook). However, in an increasingly challenging environment characterised by financial market turmoil, a decelerating US economy, high oil prices and a weak dollar, the resilience of growth in Europe in 2008 and beyond will rely on decisive measures to restore confidence and to implement the necessary reforms.

At the international level, the accumulation of global economic and financial risks, difficult WTO negotiations, and an intensifying political debate on foreign investment, in particular as regards the strategies of sovereign wealth funds, are also heightening the risks of protectionist pressures. Although a genuine political debate is warranted on many of these issues, it is crucial to remember that trade liberalisation and growing capital flows have been in recent years the key drivers behind the most dynamic global upturn in decades.

1. Fundamentals remain broadly supportive for the recovery in the EU

- Following a strong economic upturn for most of 2006, growth in the first semester of 2007 slightly outpaced the EU's longer-term performance. While the outlook for the second semester remains broadly positive, with business confidence still at high historical levels (*Figure 1*), the recovery momentum is losing some steam.
- Investment and exports are so far the most dynamic growth factors, and prospects in these two areas remain supportive on the whole. External demand is dynamic, especially from Asia and other developing economies, while sound corporate balance sheets and high capacity utilisation rates imply a fairly positive investment outlook. Private consumption is growing at a more moderate pace, but the remarkable improvements in the labour market, with strong job creation and declining unemployment, will provide ongoing support to consumers' confidence and purchasing power (*Figure 2*).
- Marked differences in economic performances are still noticeable at the country level. New member states continue to enjoy a very dynamic catching-up process, with growth being spurred by high productivity gains and more recently by positive employment trends. This catching-up process is to the benefit of the wider EU. Spain, Austria, Sweden and the UK are also seeing above-average growth rates, currently exceeding 3%, while Belgium, Germany, and the Netherlands hover closer to 2.5%. At the bottom of the European growth league currently lie France, Portugal, Italy, Hungary and Denmark with growth rates of around or below 1.5% (*Figure 3*).

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- A comparison between Germany and France provides a good illustration of the diversity of situations and of policy challenges in the EU. Germany's economic revival was essentially driven by strong external competitiveness and corporate restructuring, while private consumption continues to lack responsiveness. France experienced the opposite development: dynamic consumption feeding high import growth, weak exports and a subdued growth performance overall (*Figure 4*).
- Obviously the conclusion is that Germany is today in a better position to face the challenges ahead, even if important reforms still need to be undertaken, while France will need a more radical transformation towards supply side oriented policies.
- While the recovery in Europe lagged behind the global economic upturn and still has important potential looking forward, clouds are already piling up on the horizon.

2. Uncertainty has considerably increased in recent months

US Economy

- The US economy is showing signs of weakness. Although the probability of a recession is not yet a baseline scenario, US growth prospects have worsened appreciably, as the problems on the housing market are far from abating (*Figure 5*). The negative impact has been confined to the construction sector, but it cannot be excluded that highly indebted households will start to cut spending in the present environment. Europe will only escape unscathed from a US slowdown if it is able to develop stronger and sustainable domestic demand momentum and to benefit more from strong growth in Asia and other developing economies.

Credit and money markets

- Recent financial market turmoil – linked to the US sub-prime crisis – and a dramatic erosion of trust among commercial banks have also exacerbated domestic risks, in particular regarding the evolution of financing conditions for European companies.

- The ECB, which has a mandate to ensure the proper functioning of euro money markets, has acted in an exemplary manner since early August, injecting massive amounts of liquidity to alleviate a crisis in the short-term interbank market (*Figure 6*). Despite these interventions, which have helped to restore a certain degree of tranquillity, the longer-term segment of money markets is still very unsettled. It is essential that commercial banks are able to restore trust by clarifying their financial situation and by covering the assets of their troubled investment vehicles.

- A re-pricing of risk on financial markets was a necessary correction from past complacency. The damage to the European economy will be contained if the crisis rapidly comes to an end. However, no one can predict at this stage how developments will unfold and how financing conditions could be affected. European companies rely on bank lending for more than 50% of their external financing. A significant tightening of banks' credit standards, which would come on top of the ECB's 200 basis point interest rate increase since November 2005, would clearly hamper investment prospects and confidence.

Stock market

- Stock markets have also experienced some losses since the start of the turmoil, affecting companies' market capitalisation negatively. It is important that investors continue to focus on the underlying fundamentals of European companies (balance sheet positions, growth/profit prospects) which remain supportive.

3. In the face of heightened risks, policy-makers must act decisively to restore confidence and support the resilience of the EU economy

ECB and Bank of England policy:

- The financial market crisis has once again underlined the importance of the ECB's independence. Independence has allowed the ECB to respond quickly and decisively to market jitters. BUSINESSEUROPE is therefore confident, that within its mandate the ECB will continue to take whatever action necessary in order to guarantee stability and the orderly functioning of the interbank market.

- Regarding its interest rate policy, the ECB must continue to be pragmatic and closely monitor all economic and financial developments. The ECB has already opted for a more subtle approach by suspending the September rate hike and by not pre-committing on further monetary tightening. BUSINESSEUROPE supports these decisions. Nevertheless, confirming that the Eurozone's monetary policy remains on the accommodative side and repeating that medium-term risks to price stability exist, suggests that the ECB could raise interest rates again.

- The ECB should carefully consider the international monetary context before considering any future decision. The US Federal Reserve has cut rates on its 18 September meeting by 50 basis points, more generally expected by market participants (*Figure 7*). Diverging monetary policies across the Atlantic have never been seen since the launch of the euro and could cause exchange rate volatility and an even more significant appreciation of the euro vis-à-vis the dollar and other currencies (such as the Chinese Yuan, which remains tightly connected to the dollar). In fact, the euro has reached a new record vis-à-vis the US dollar, at 1.40, and is reaching the pain threshold level for European companies (*Figure 8*). As long as concerns about the US economic outlook are not receding this trend will probably continue.

- In the UK, the Bank of England (BoE) has adopted a different stance from the ECB as regard the financial market crisis. Instead of injecting massive liquidity into money markets, the BoE has taken a “no-bailout” position, assuming that financial institutions should assume the consequences of their investment strategies. In the event of a systemic risk, though, the BoE will take its role as lender of last resort.

Regulatory debate:

- In addition to their impact on central bank policy, the past weeks have also revived discussions on the need to update the regulatory framework in which actors in today’s global and increasingly complex financial system operate. In general, BUSINESSEUROPE favours in this debate an approach based on self-regulation and codes of conducts decided by the financial industry. What is clear, however, is that the rising importance of complex financial instruments and the latest crisis have all increased the need for more transparency. It is also important to recognise that only global solutions can respond to global challenges (within the framework of the IMF, the Bank of International Settlements, and discussed in the G7/G8+5).

Budgetary policy and structural reforms:

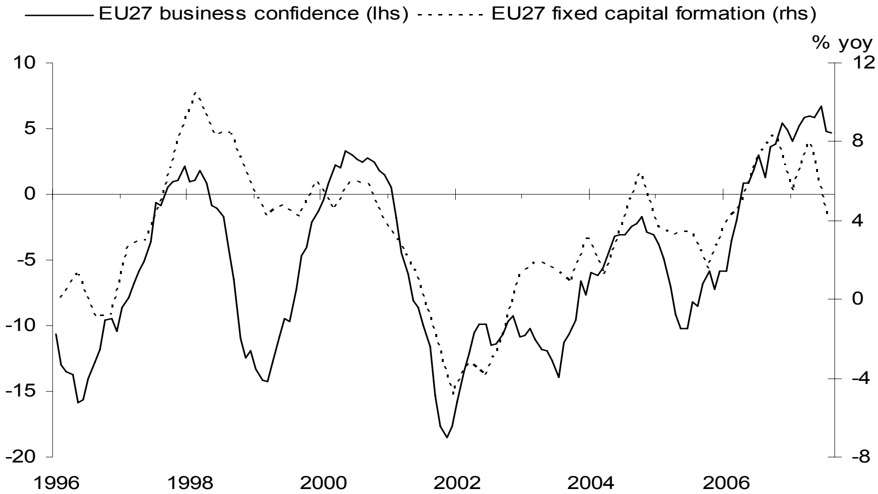
- Current turmoil emphasise the need to speed up reforms in order to strengthen the resilience of the EU economy.

- Regarding budgetary policy, most governments are currently in autopilot mode, counting on economic growth to reduce deficits (*Figure 9*). They need to engage in active consolidation and accumulate provisions for rainy days. Euro-area countries must stick to their pledges to balance their budgets by 2010.

- Structural reforms must also be stepped up to reinforce internal growth in Europe, supporting labour market improvements and solving the EU’s productivity challenge (*Figures 10 & 11*). The review of the Lisbon strategy should be used to foster actual reform implementation, rather than divert attention from it. As the Commission prepares the ground for the next three-year cycle of the Lisbon strategy, I have this message for president Barroso: member states have a roadmap with a concrete set of Council recommendations to implement. The number one priority is to ensure continuity, and focus on member states’ actions to fulfil their commitments.

Figures

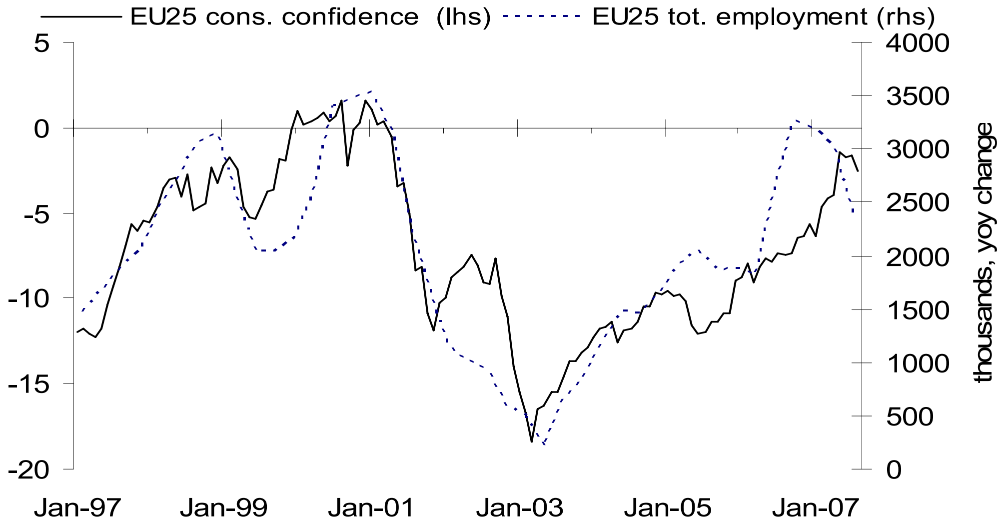
1. EU Business confidence and investment



Sources: Commission, Eurostat

Business confidence seems to have peaked but the indicator remains above its long-term average. The current level of confidence suggests further robust investment spending. The weak investment figure in 2Q2007 has to be interpreted against the background of a volatile construction investment.

2. Consumer confidence supported by the labour market situation



Sources: Commission, ECB

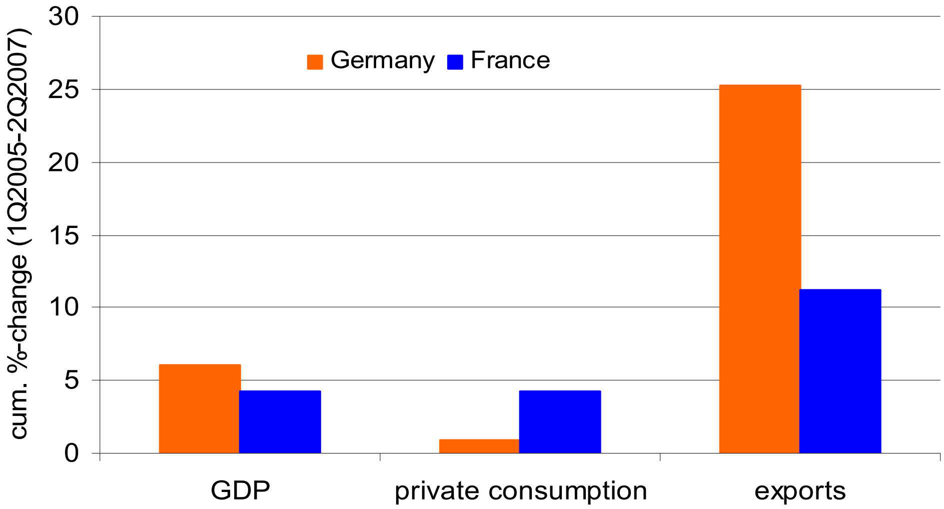
Dynamic employment growth is supporting consumer confidence. Ultimately, private consumption should benefit GDP growth.

3. Growth league table (year-on-year GDP growth in 2Q2007)

	> 4%	***4% - 3%***	***3% - 2%***	***< 2%***
	Bulgaria* Czech Republic Estonia Finland Greece Ireland* Latvia Lithuania Luxembourg* Malta* Poland Romania* Slovakia Slovenia Spain	Austria Cyprus Sweden UK	Belgium Germany Netherlands EU27 Eurozone	Denmark France Hungary Italy Portugal
% of EU 27 GDP	18%	23%	28%	31%

Sources: Eurostat
* last figure in 1Q2007

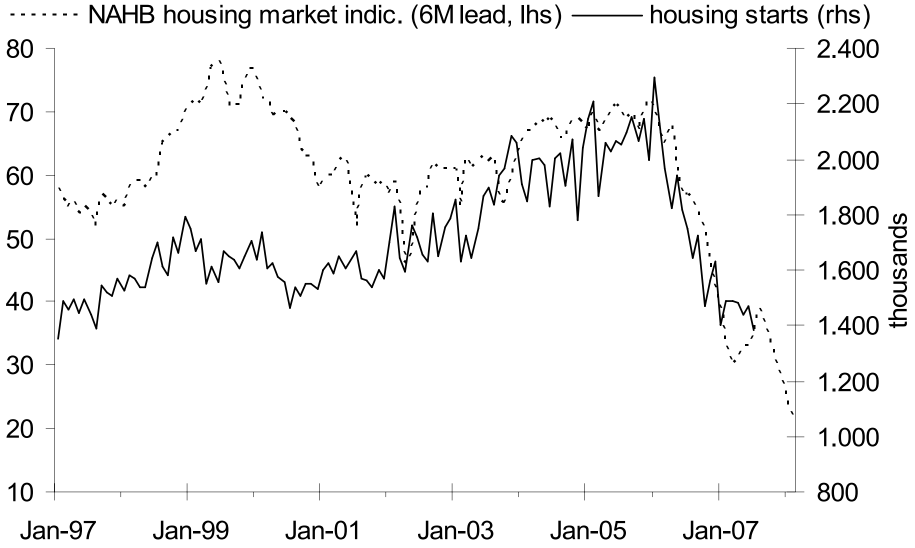
4. German and French economic performance since 2005



Source: Eurostat, BUSINESSEUROPE

The comparison of the German and French economies clearly exposes the divergent roots of growth in these two countries. Whereas Germany largely outperformed France in the export sector, private consumption was much less dynamic. But overall, the German economy is more dynamic in the recovery, and seems more able to cope with unfavourable global developments

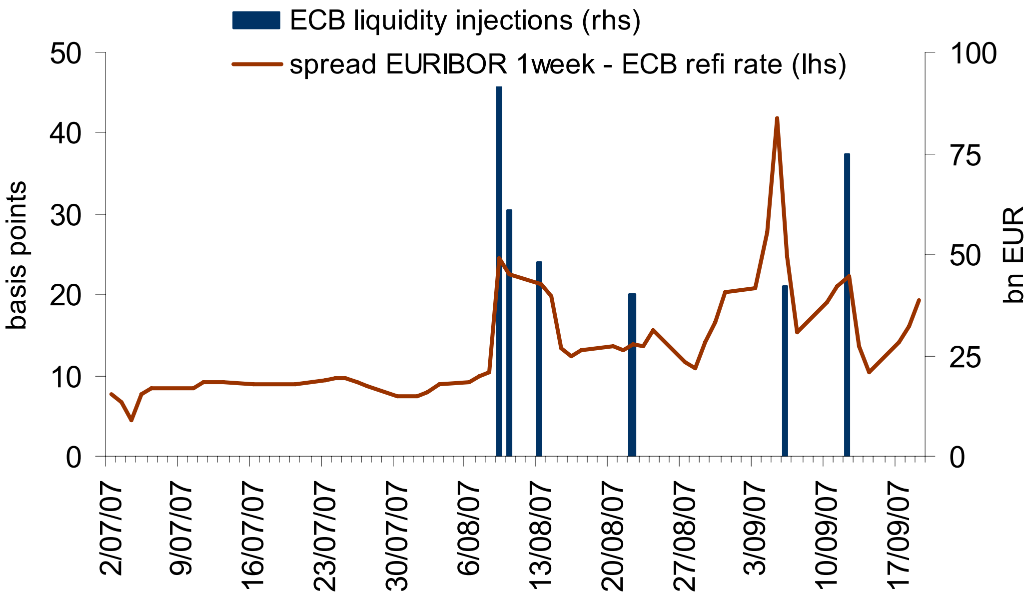
5. US housing market – no light at the end of the tunnel



Sources: NAHB, US Census Bureau

Housing starts and builders' confidence have hit the lowest level in more than ten years. The correction is still far from over.

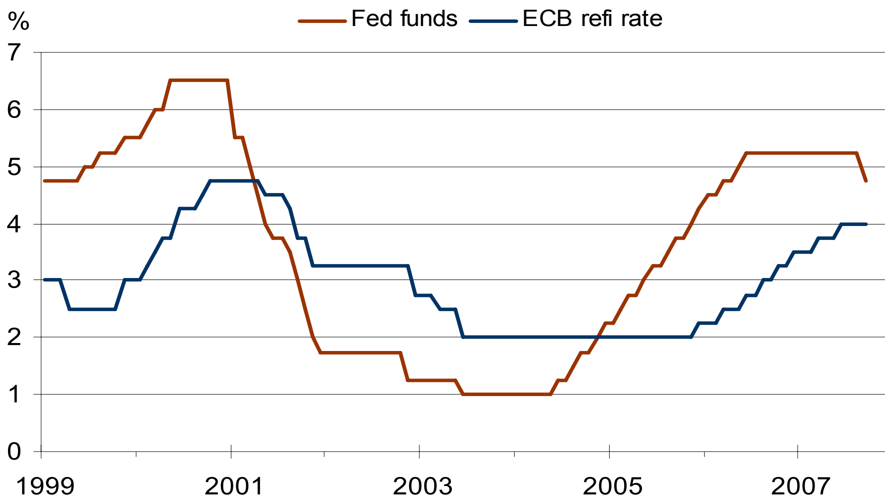
6. Money market turbulence



Source: EURIBOR, BUSINESSEUROPE

Financial market turmoil causing distrust among commercial banks has led to significant increases in the spread of short term interbank rates vis-à-vis the ECB's refinancing rate. Massive ECB liquidity injections have helped to restore confidence temporarily.

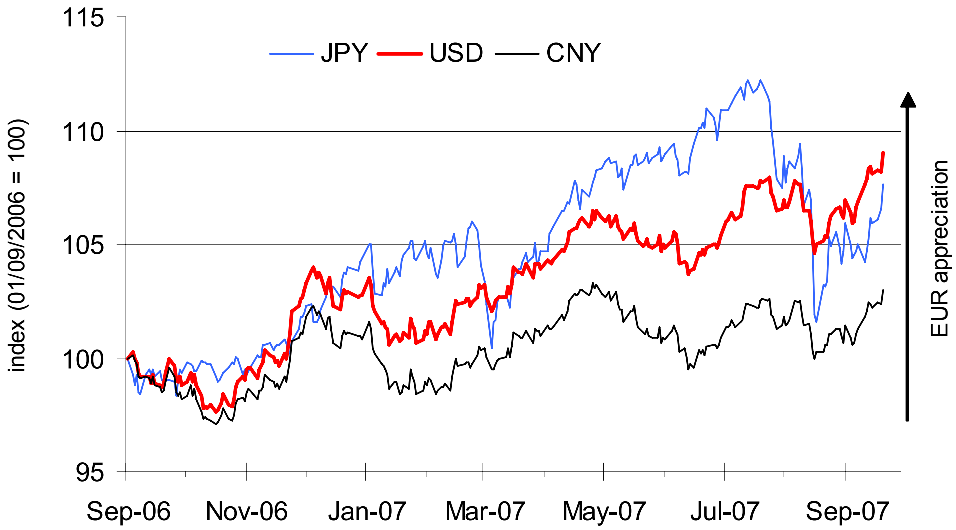
7. Fed and ECB interest rates



Sources: ECB, Federal Reserve

Although mutually independent, Eurozone and US interest rates have moved in tandem since the creation of EMU. ECB rate hikes when the Fed is cutting rates would be unprecedented and could lead to unwelcome FX volatility.

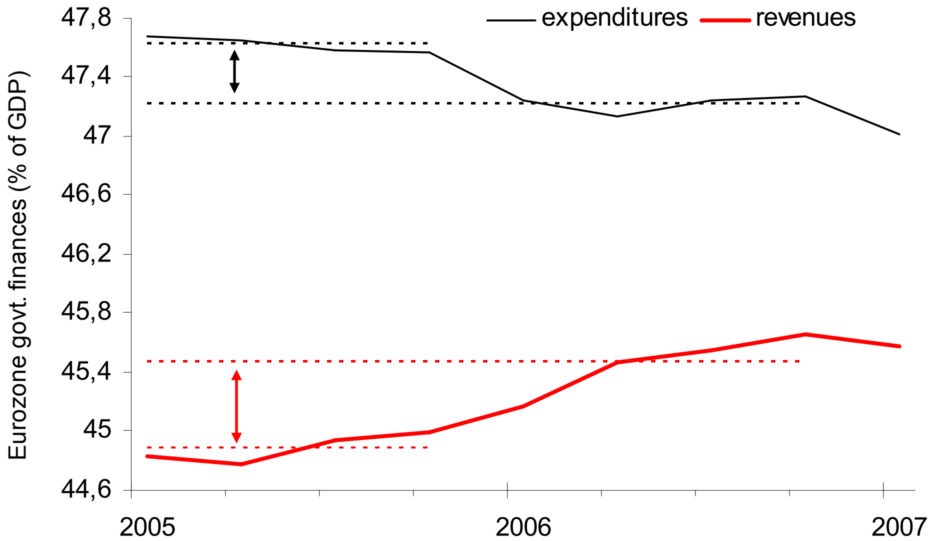
8. Exchange rate developments



Source: ECB

The EUR has established new record highs vis-à-vis the USD, at 1.40 on 20 September. Whereas financial market turmoil has caused an initial retreat of the euro, diverging growth and monetary policy prospects on both sides of the Atlantic have fuelled again the euro's appreciation against the USD and Japanese yen. The euro is also appreciating against the Chinese renminbi.

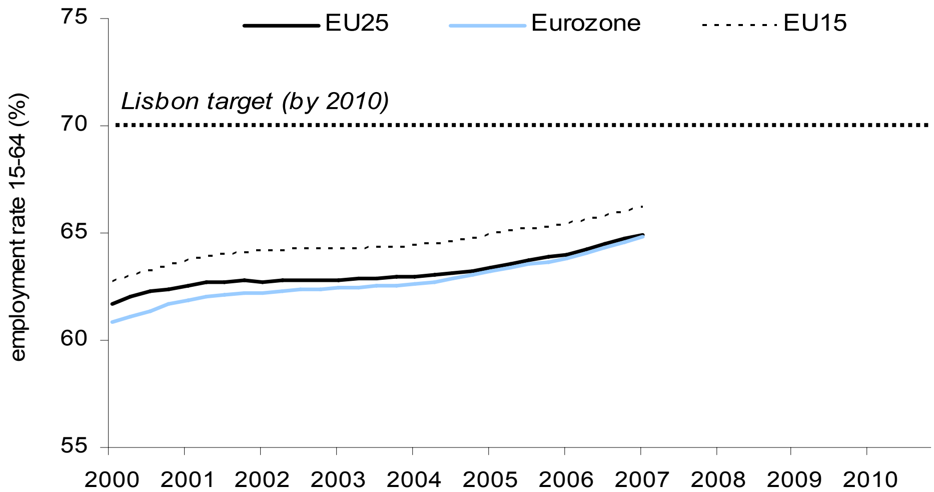
9. Public spending not under control in the euro area



Source: Eurostat

Cuts in government expenditure could have been more decisive. The rise in government revenues can be attributed to the strong economic momentum and better-than-expected tax receipts.

10. The Lisbon goals: Employment rates are rising but still a long way to go



Sources: Eurostat

The European employment rate still falls short of the Lisbon target. Productivity growth has also decelerated, especially in the Eurozone.

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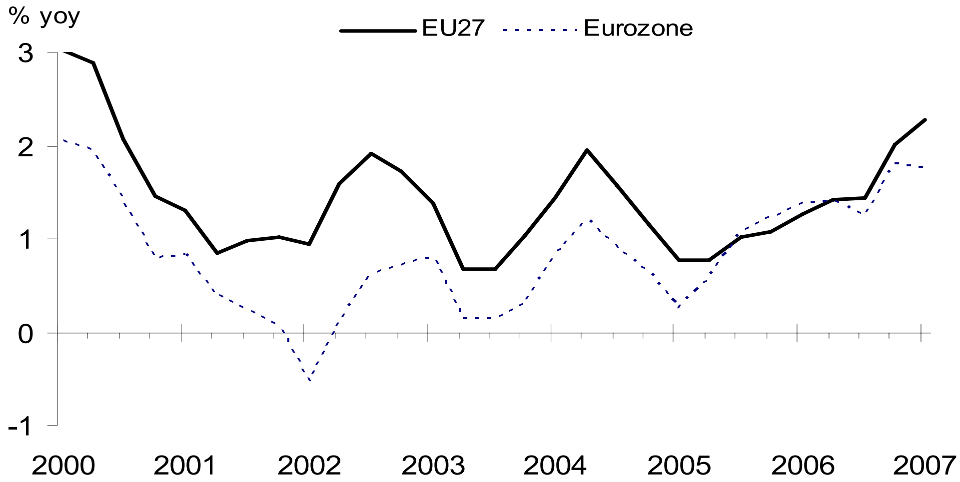
11. The Lisbon goals: Productivity growth remains lacklustre



Source: Eurostat

Productivity growth is dynamic in New Member States, fuelled by their catching-up process, but is generally insufficient in more mature EU economies. This increases the necessity for member states to implement important reforms now if they want to improve their competitiveness in a global environment.