BUSINESSEUROPE

Contribution to MED at technical level

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Although the European economy has undergone some structural improvements in recent years, a slowdown seems inevitable in the current global economic context, combining a severe US slowdown, financial market turmoil, structurally high commodity prices and disorderly exchange rate adjustments. The extent of this slowdown will largely depend on the response of European policy-makers. For the business community, the following priorities are vital in present circumstances:

- *the ECB needs to keep its focus on anchoring inflation expectations at a low level*
- *wage moderation must be maintained, especially in the public and low productivity sectors; compensation for past inflation overruns should be avoided*
- *inflation pressures must be contained with further liberalisation of the energy and services sectors*
- *energy efficiency should be promoted, particularly in the transport and household sector*
- *higher productivity growth must be supported through better framework conditions for innovation, human capital development and SME growth, through a more adaptable workforce and by pooling public and private resources for research activities*
- *budgetary policy must allow for automatic stabilisers but avoid discretionary measures with potentially large consequence for fiscal sustainability*
- *avoid the introduction of ad hoc financial market regulations which could affect the free flow of capital on the internal market and worldwide*
- *Member States must step up the implementation of reforms, in accordance with recommendations issued in the context of the Lisbon Strategy*
- *over the period 2008 to 2010 the Lisbon coordination cycle will most likely deliver concrete results if :*
  1. *Integrated Guidelines are reconfirmed*
  2. *A certain continuity in Country-Specific Recommendations is ensured*
  3. *Member States are held accountable and are asked for clear targets and time schedules for delivery*
  4. *The profile of the Lisbon Strategy is reinforced in European capitals, for instance by involving appropriate stakeholders more and at an earlier stage*
  5. *A clear link between the use of EU cohesion funds and National Reform Programmes is established*
  6. *Evaluation criteria are improved, peer pressure is encouraged and complacency avoided, especially towards larger EU Member States*
  7. *The role of the eurogroup in the Lisbon governance for euro-area countries can be reinforced*
- *further steps must be taken to ensure an orderly realignment of global currencies, both in a bilateral dialogue (with China) and in the context of multilateral institutions (G8; IMF)*

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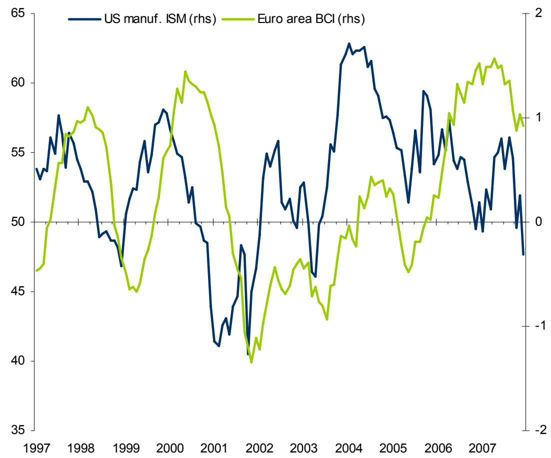
I. Assessment of the current economic situation

The European economy has undergone important changes in recent years, some of which have improved its resilience:

- companies' profitability and strong balance sheets cushioning the effect of tighter financing conditions and financial market turmoil
- a strong turnaround in EU labour markets in recent years and still positive employment prospects in coming months
- relatively balanced trade flows with the rest of the world and an overall improvement in public finances

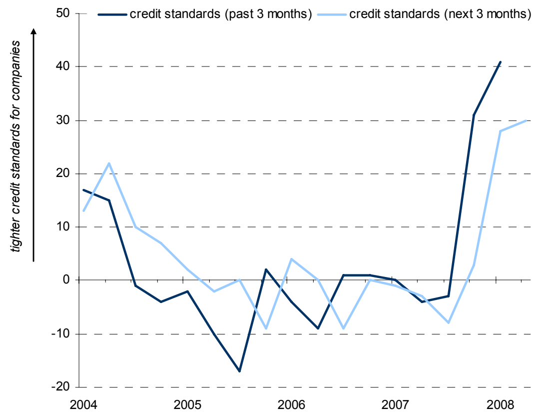
However, the rapid materialisation of risks has affected Europe's economic perspectives negatively. The fear of a US recession has become a reality over recent months (figure 1). The housing market correction is far from abating and US consumers which have been the key factor behind strong world economic growth are financially over-stretched. Monetary policy might be ineffective in the current environment. However, given the substantial US budget deficit, the room for fiscal stimuli or public investment packages is restricted.

Figure 1: No decoupling expected between US and EU



Sources: BUSINESSEUROPE, www.econstats.com

Figure 2: Deteriorating borrowing conditions



Sources: BUSINESSEUROPE, ECB Bank Lending Survey

In addition to trade flows, the deterioration in the US outlook affects Europe through further channels:

1. *Knock-on effects of financial market turmoil*

   Although the situation on the interbank money market has stabilised, banks have significantly tightened their credit standards (figure 2), according to the ECB's latest bank lending survey. The credit crisis has also induced rapidly tightening credit standards for private house purchase loans.

   Stock markets have undergone a sharp correction since the beginning of 2008 with leading indices losing between 10 and 15%. The direct effect on capital investment decisions should be rather limited, though, in view of companies' sound balance sheet situations, but confidence effects could play a significant role.

2. *Sharp euro appreciation*

   Since end-October, the euro has appreciated by 2.2% in nominal effective terms (12 trading partners), providing further evidence that the euro remains an important variable of adjustment for present global imbalances.

Although the impact on aggregate EU and euro area trade performances is limited for the time being, the sensitivity across Member States or sectors varies greatly. Current exchange rate developments and the risk of further and prolonged US dollar depreciation on the back of recession fears in the US and planned bank diversification out of US dollar assets in countries with a sizeable current account surplus (e.g. oil producers) are adding to the uncertainty of Europe's growth outlook for the years ahead.

3. *Uncertain compensation for slowing US demand*

   With recession looming in the US, Europe must rely to a larger extent on emerging markets putting additional pressure on the need for European business to reinforce their competitiveness.

4. *Housing market correction within the EU*

   In relation to the global credit crisis triggered by the US sub-prime problems, the likelihood of a housing market correction has increased significantly in some EU Member States (Spain, Ireland, UK). Spain in particular is experiencing concrete signs of a market correction, which will weigh on overall GDP growth.

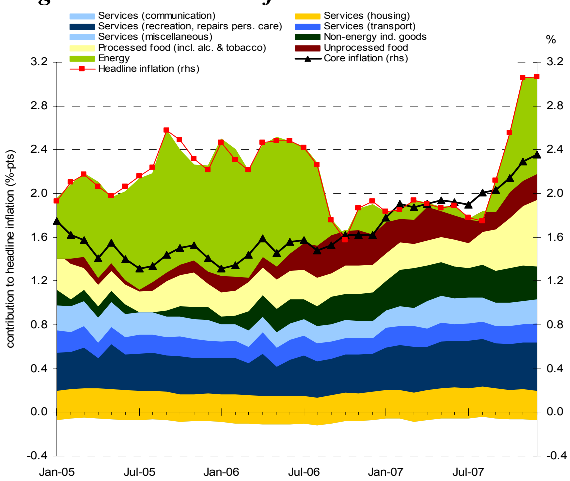
Against the background of these developments, a slowdown in the EU's and the euro area's economic performance is inevitable. 2008 real GDP growth estimates will be revised significantly downwards, to below 2% in the euro area.

II. Soaring euro area inflation – a worrying outlook

1. *Recent inflation trends*

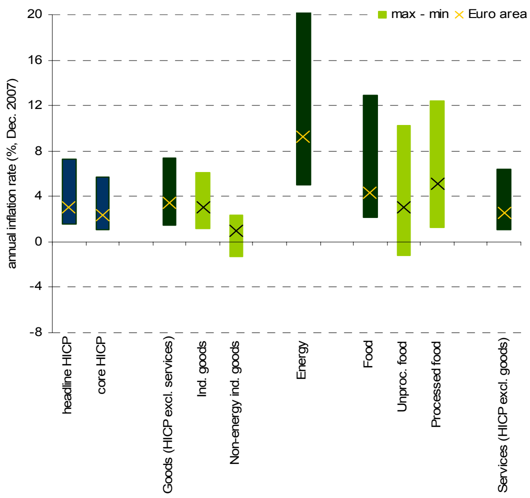
Since September, euro area headline inflation has remained above the ECB's inflation threshold and exceeded 3% in November and December. Although a hump-shaped inflation profile around the turn of the year was expected, the recent upsurge has been significantly stronger than anticipated. Especially energy and unprocessed food prices have contributed to the latest inflation surge as the contribution of other components has remained more stable in recent months (figure 3).

Figure 3: Euro area inflation and contributions



Source: BUSINESSEUROPE, Eurostat

Figure 4: Inflation dispersion in the euro area



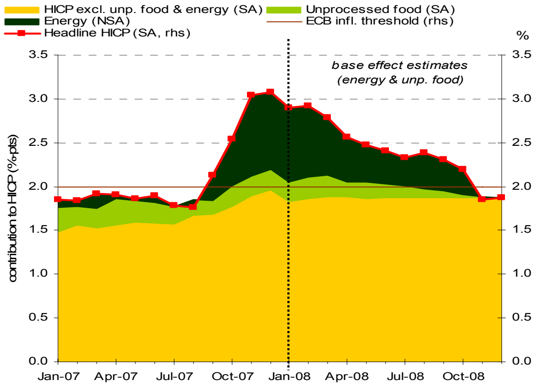
Source: BUSINESSEUROPE, Eurostat

Across Member States, the evolution of energy and unprocessed food sub-indices varies considerably. Particularities of national markets are an important reason for these divergences, such as the origin of energy and food price imports, the degree of liberalisation of energy, retail and wholesale markets. Indeed, comparing the variation of aggregated HICP indices suggests that markets that have been shielded from cross-border competition tend to witness the broadest divergence in inflation rates (figure 4). The more open and integrated non-energy industrial sector shows the lowest divergence of inflation rates across Member States, while the range of energy, food and services price inflation is much wider and differences are more persistent.

2. <u>An uncertain inflation outlook and rising inflation expectations</u>

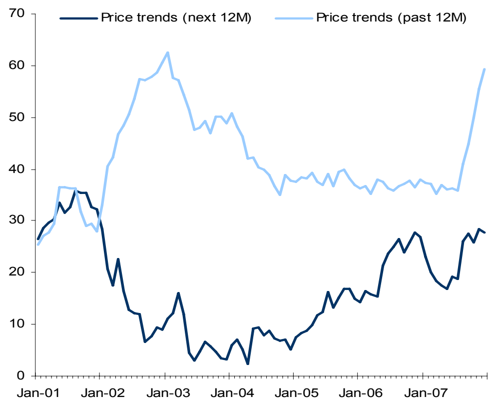
Based on the assumption that euro area price indices for energy and unprocessed food remain stable at December 2007 levels throughout 2008, base effects at play can be easily observed (figure 5). In fact, the inflation rate would fall back quickly from its peak throughout the first half of 2008. However, if core inflation remains stable at past levels, headline inflation would remain on average significantly above 2% in 2008. Departing from the underlying hypothesis of constant core inflation, outcomes could possibly exceed the mechanical projections presented in figure 5.

Figure 5: Inflation evolution into 2008



Source: BUSINESSEUROPE, ECB

Figure 6: Spiking inflation perceptions



Source: BUSINESSEUROPE, Commission Consumer Survey

At present, the risk of second round effects cannot be excluded.

First of all, the impact of energy and food price hikes tends to affect the price of other consumption items with variable lags (up to one and a half to two years).

Second, an increase in inflation expectations could boost the likelihood of second-round effects, notably through higher wage demands. In this regard, the significant rise in consumers' inflation perception towards the end of 2007, driven by higher prices in more commonly bought items such as milk, butter, bread and fuel, is worrisome (figure 6).

Although the impact on consumer expectations for the next twelve months is limited so far, the risk of significant pay rises to compensate for the perceived loss in purchasing power has increased in the context of a still robust labour market. Wage demands in the ongoing German public sector negotiations are worrying and risks could easily be exacerbated by wage indexation mechanisms in several euro area member states.

III. Lisbon cycle and adoption of the new Integrated Guidelines

Since the relaunch of the Lisbon Strategy in 2005, nine million jobs have been created, the unemployment rate has reached its lowest level since the early 1980s and the average education level of the workforce has also risen gradually.

Furthermore, the Lisbon Strategy itself is working better. Community policies have become more firmly anchored in the growth and jobs strategy and coordination instruments have clarified what is expected from Member States. We see the fact that Country-Specific Recommendations were agreed collectively in the Council last year as one very important step forward for the Lisbon strategy.

But progress remains uneven across countries and policy areas. BUSINESSEUROPE's Reform Barometer published in December has assessed most recent efforts in the 27 Member States, to note that robust growth last year has not been used to accelerate reforms in most EU countries. Worse, in some countries the risk of reform slowdown or dilution of past reform efforts is evident, which is particularly worrying considering the immense domestic and global challenges that Europe is facing.

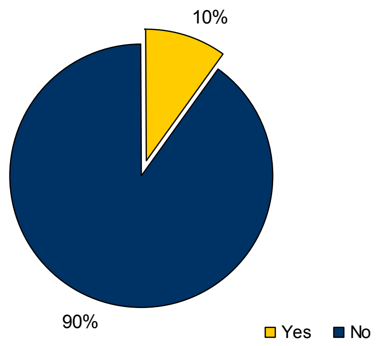
Figure 7: Assessment of national reform progress

	2007 annual GDP growth: below EU average	close to EU average	above EU average
reform progress above EU average	France Denmark Hungary	Malta Netherlands Sweden Austria	Ireland Cyprus Slovenia Luxembourg Greece Latvia
reform progress close to EU average	Portugal	United Kingdom Belgium	Finland Lithuania Czech Republic Poland Norway
reform progress below EU average	Italy	Germany	Spain Bulgaria Estonia Slovakia

Source: BUSINESSEUROPE Autumn 2007 Reform Barometer

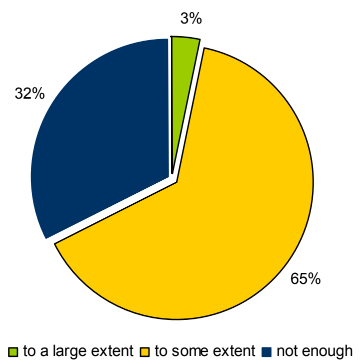
According to BUSINESSEUROPE's assessment, the most urgent reforms to address these challenges have been identified in the past Lisbon Coordination Cycle (figure 8). Indeed, business federations in 20 out of 27 EU countries consider that the Country-Specific Recommendations (CSR) issued by the Council last spring covered the key reform priorities for their countries, and that they require only minor adjustments for 2008. However, implementation of recommendations has been poor and frustration within the business community is substantial. Business federations in only three European countries consider that implementation of CSRs was satisfactory in 2007, the rest only refer to patchy or disappointing progress (figure 9).

Figure 8: Is an update of country-specific recommendations necessary in 2008?



Source: BUSINESSEUROPE Autumn 2007 Reform Barometer

Figure 9: Have country-specific recommendations been implemented in 2007?



Source: BUSINESSEUROPE Autumn 2007 Reform Barometer

Against this background, BUSINESSEUROPE recommends the following decisions to make the Lisbon strategy more effective over the period 2008 to 2010 is:

8. Reconfirm existing Country-Specific Recommendations, adjust the at the margins when priorities are changing
9. Ask Member States for clear targets and time schedules in their implementation reports
10. Help raise the profile of the Lisbon Strategy in European capitals, for instance by involving national parliaments and social partners more and at an earlier stage.
11. Link the use of EU cohesion funds with National Reform Programmes
12. Improve evaluation criteria, encourage peer pressure and avoid complacency, especially towards larger EU Member States
13. Reinforce the role of the eurogroup in the Lisbon governance for euro-area countries

Regarding the Integrated Guidelines, the risk of driving the political debate at the Spring 2008 Council away from concrete decisions in the areas mentioned above outweighs the benefit of a revision by far.

Hence, during the next three years, it seems crucial to reinforce what has already worked in the past and focus on concrete deliverables. The most effective way to do achieve this at the national level is to keep Member States focussed on stable CSR and take measures to ensure ownership and timely delivery.