NOTE

15 September 2008

BLEAKER PICTURE FOR THE EUROPEAN ECONOMY ï TIME FOR ACTION

NOTES FOR PRESS CONFERENCE, 16 SEPTEMBER 2008

Over recent months, the outlook for the world economy has deteriorated with a broad-based downturn in industrialised economies (*Figure 1*). The contraction in EU GDP in the second quarter of 2008 was exacerbated by an exceptional first quarter, boosted by mild weather conditions and other one-off factors. However, it clearly indicates a loss of growth momentum which will likely carry over in the third quarter of 2008 (*Figure 2*).

The upsurge in ***oil, food and other commodity*** *prices* since the start of the year can be singled out as the most important factor, triggering a cascade of fairly immediate negative repercussions for consumers (lower purchasing power and morale ï *Figure 3*) and for companies (rising costs and lower margins).

Less dramatic factors denting EU growth in the first half of the year included the ***euroôs strength*****,** putting euro-area exporters under pressure, and more ***stringent lending standards*** subsequent to the credit crisis.

Despite the challenging environment; we are confident that the current soft growth patch will remain a temporary phenomenon and that risks of a full-fledged recession in Europe are exaggerated. Four fundamental factors argue for the EUôs resilience:

1. ***Supportive labour market conditions***
   17 million jobs have been created in the EU since 2000 (*Figure 4*), the unemployment rate remains at its lowest level for more than two decades and European labour markets continue to prove their resilience in the present period.
2. ***sound corporate balance sheets***
   European companies have gone through a period of restructuring and strengthened their balance sheets. Corporate investment remains well oriented despite financial market turmoil and reduced profit margins.
3. ***Strong export penetration in the worldôs most dynamic markets***
   European companies ï in particular those specialising in investment goods ï enjoy strong demand for their products in particular in China, other dynamic Asian economies, Russia and oil-exporting countries (*Figure 5*).
4. ***No EU-wide housing market imbalances***
   Despite significant difficulties in some member states, the aggregate EU housing market does not risk a major correction as currently being witnessed in the US (*Figure 6*). European banks also prove less exposed to the current turmoil than their US counterparts, while households have robust balance sheets and high savings rates.

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While these factors should offer a reliable floor for GDP growth, the recent ***sharp drop in oil prices*** (-25% since early July ï *see Figure 7*) and a ***weakening euro*** (-10% vis-à-vis the US dollar since mid-July - *see Figure 8*) should give breathing space for the EU economy and help growth pick up again later this year.
Europe as a whole should thus be able to avert recession. The situation is more preoccupying in specific member states, though. **Spain, Ireland and the UK** which face substantial housing market corrections are particularly exposed. The negative impact of a lacklustre UK economy for the euro area is currently compounded by severe sterling weakness.

At the current juncture, BUSINESSEUROPE is convinced that first and foremost European institutions, national governments and social partners should send a strong signal of confidence in order to avoid sowing panic and fatalism among citizens.

But policy stakeholders must also agree rapidly on tangible and sustainable solutions that allow the European economy to emerge strengthened from currently turbulent waters. Targeted policy action should focus in particular on:

1. ***Setting the right policy mix to stimulate EU growth***
   - On the side of budget policies, governments which have developed sufficient budgetary margins should allow automatic stabilisers to work during the current soft growth patch (*see Figures 9*). But it must be crystal clear that the Stability and Growth pact should be fully respected in all European member states. Permitting deficits and public debt to spiral out of control will not provide a viable solution to present difficulties. A credible commitment to sustainable public finances is essential to spur confidence when the effect of demographic ageing starts to bite (*Figure 10*). In this sense we very much appreciate the message that came out of the informal ECOFIN Council on 12 and 13 September.

   - The business community supports the ECBôs current policy stance and the need to keep inflation expectations well anchored in present times. We remain confident that the ECB will do what is necessary to support the euro-area economy looking forward, and has in this regard plenty of ammunition with interest rates currently standing at 4.25% (compared with 2% in the US - *Figure 11)*. For the ECB to provide ongoing support to growth and job creation, it is essential that inflationary pressures are contained.

2. ***Reducing inflationary pressures and restoring citizensô purchasing power***
   - Credible signs that social partners are committed to keep wages in line with productivity and avoid them contributing to a wage-price spiral are essential.
   - Governments must take decisive action to improve the functioning of vital market segments. In particular, increased competition in the retail, energy and services sectors will bring about significant direct gains to consumersô purchasing power and will imply longer-lasting effects through higher productivity and employment levels. In this respect, European business welcomes ministersô agreement to commit to continued structural reforms and to improved competition.

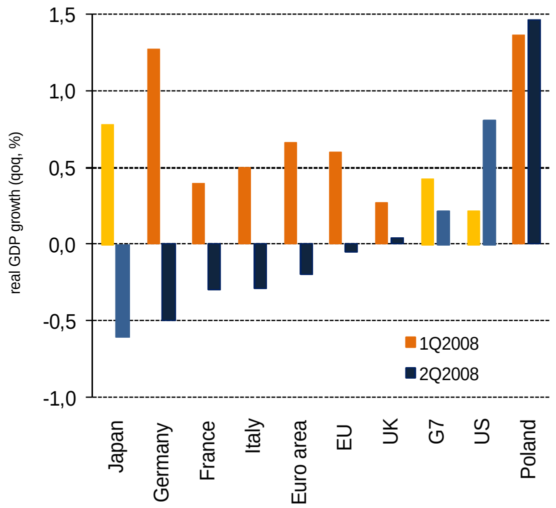
- Regarding energy markets, electricity prices are already significantly higher in Europe compared with global competitors. To avoid amplifying the drift, we need urgently to complete the single energy market and ensure that the EU’s energy and climate change targets are implemented with great care (*Figure 12*).

3. *Resilience to financial market turmoil and SMEs access to finance*

- Turmoil on financial markets has moved into a new phase and uncertainty has increased substantially. Nevertheless, officials have stressed that, at present, Europe has been spared a breakdown of major financial institutions (except for UK’s Northern Rock and Germany’s IKB) as its banking sector seems less at risk from the credit market turmoil.
  However, recent developments underline that markets remain extremely fragile. BUSINESSEUROPE therefore appreciates the ECB’s determination to ensure the smooth functioning of financial markets. At the same time, while being aware of moral hazard problems, we urge policy-makers to stand ready to intervene decisively in the event of a systemic crisis.

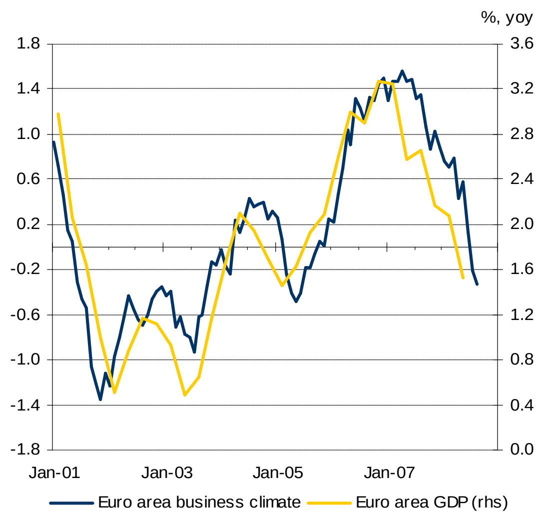
- SMEs face disproportionate consequences when bank lending standards tighten. The EU’s overall resilience to the present turmoil critically hinge on its capacity to maintain and facilitate SME’s access to finance. We are therefore pleased that the ECOFIN Council has made a decisive contribution to improving SME financing conditions by agreeing on EIB loan guarantees. Generally speaking, much more should be done to help the development of SMEs in Europe, and we have in this regard high expectations for implementation of the recently unveiled European Small Business Act.

Table 1: Broad-based downturn in industrialised economies - with USA holding up better than expected



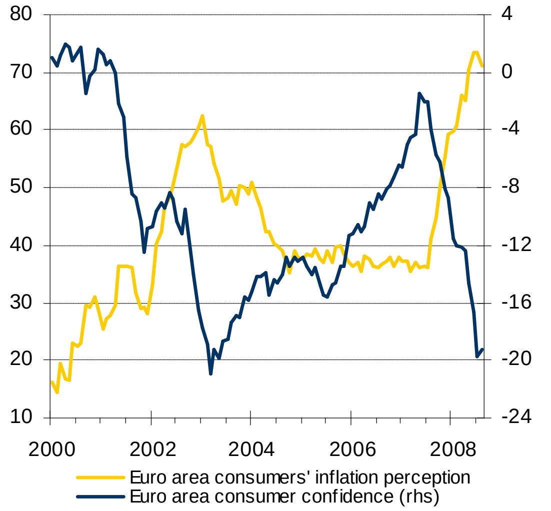
Source: OECD

Figure 2: Confidence indicators suggest a modest growth momentum for 3Q2008



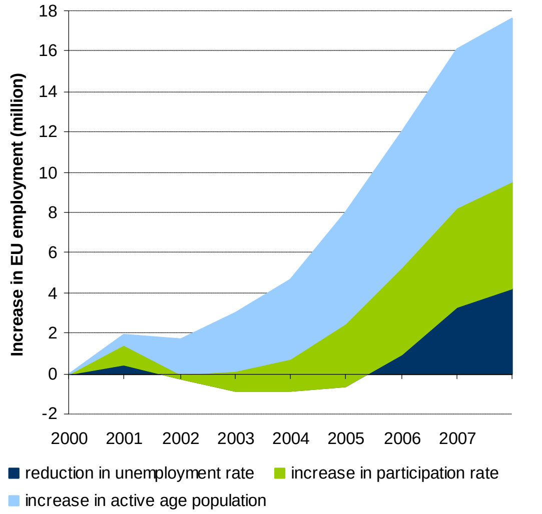
Source: Eurostat, European Commission

Figure 3: Record inflation perceptions have dented consumer confidence



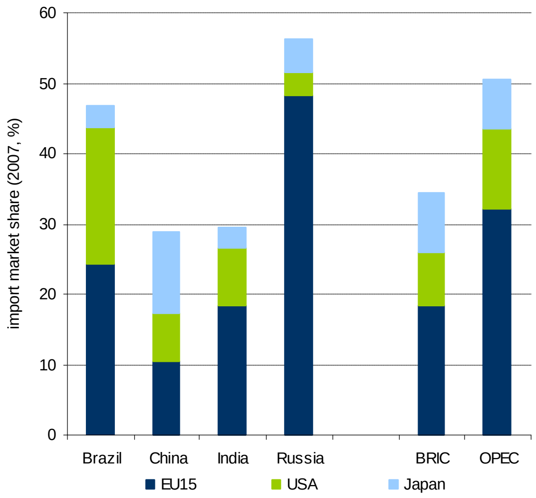
Source: BUSINESSEUROPE, European Commission

Figure 4: 17 million new jobs since 2000 have helped to increase economic resilience



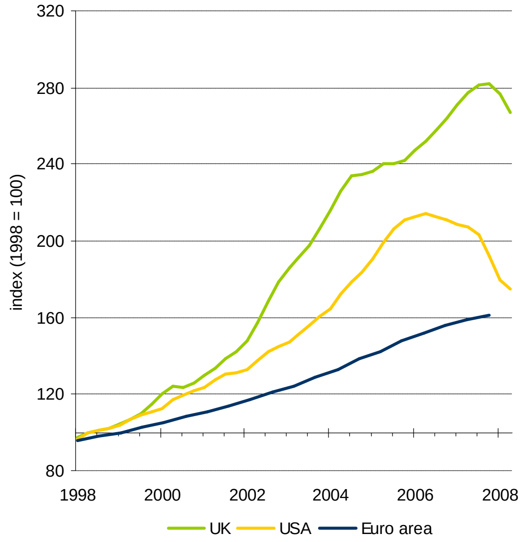
Source: BUSINESSEUROPE, Eurostat

Figure 5: European exporters enjoy a strong position in dynamic regions with strong GDP growth



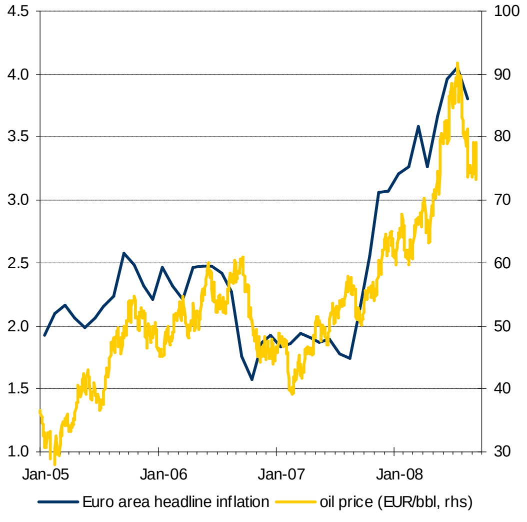
Source: BUSINESSEUROPE, IMF, OECD, WTO

Figure 6: On average, the euro-area housing market is not facing the correction of severe imbalances



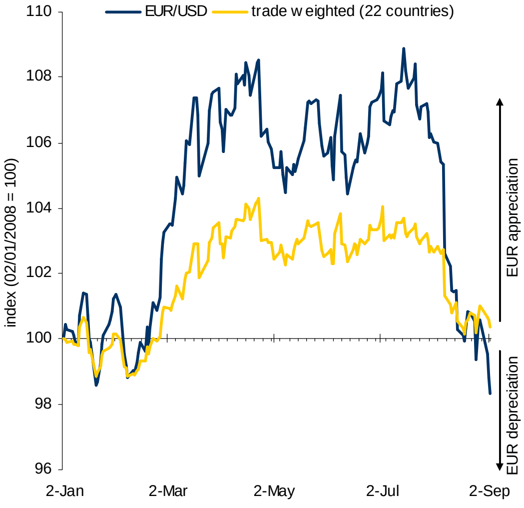
Source: ECB, Nationwide, S&P Case-Shiller

Figure 7: A significant fall in energy prices will bring relief on the inflation front



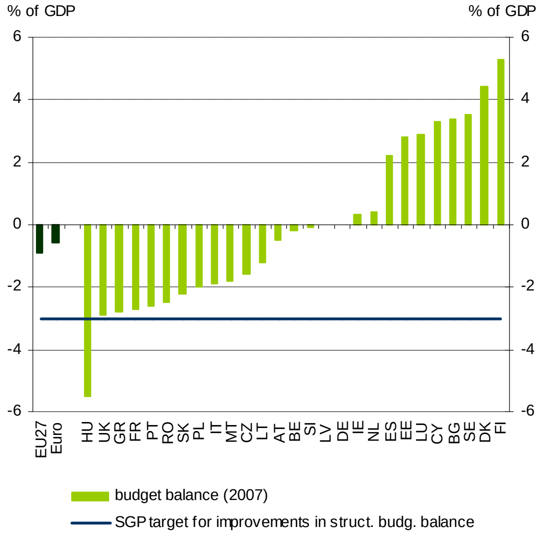
Source: Eurostat, www.handelsblatt.com

Figure 8: Foreign exchange markets have witnessed a sizeable turnaround in recent weeks



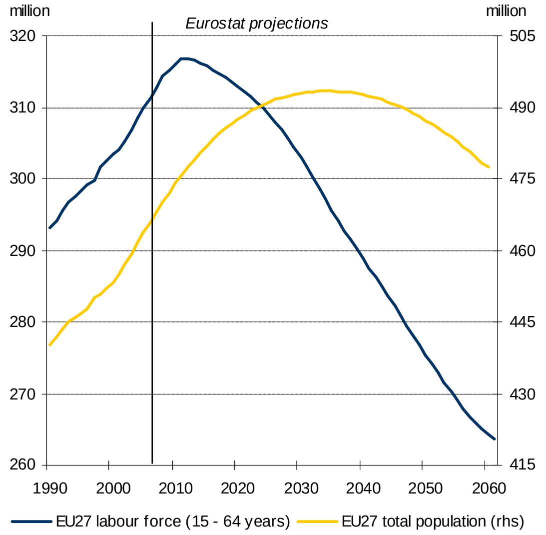
Source: ECB

Figure 9: Improvements in member statesô public finances have been disparate, limiting the scope for Europe-wide fiscal support packages



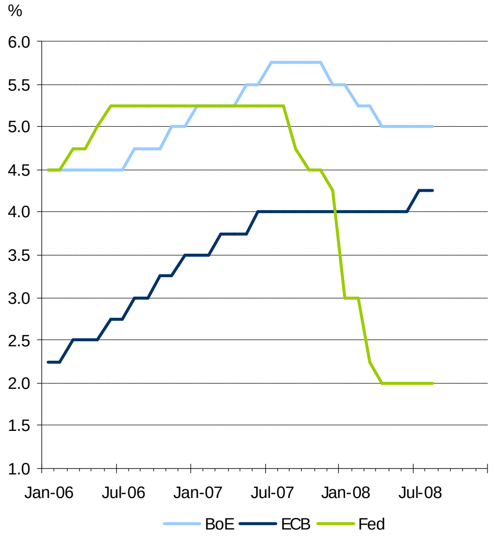
Source: AMECO Database

Figure 10: Dramatic demographic changes will challenge the sustainability of public finances



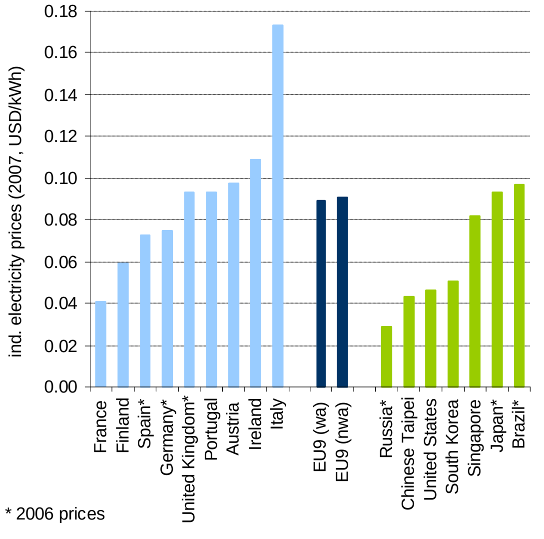
Population projections based on convergence scenario incl. migration
Source: Eurostat EUROPOP 2008

Figure 11: European central banks have ample ammunition to stimulate the economy once inflation rates have subsided and expectations remain well anchored



Source: Bank of England, ECB, Federal Reserve

Figure 12: Electricity prices in Europe already at a disadvantage



Source: BUSINESSEUROPE, Federal Energy Information Agency ï US Department of Energy