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STUDY
GOING GLOBAL
THE WAY
FORWARD

Securing the EU's Export Competitiveness

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INTRODUCTION

Openness to the international economy is at the heart of Europe's prosperity. International trade accounts for 15% of EU GDP and Europe is the world's largest exporter. However this strong position should not lead us to complacency. If the EU does not continue to focus on excellence in its goods and services, other companies in other regions of the world will certainly overtake our leading position. What is more, international economic integration will only intensify in the coming decades as companies' production and service delivery models become ever more globally integrated. Europe's future growth depends on remaining fully engaged with the world economy.

The European Union's answer to this challenge has been in the form of the Lisbon Strategy, established in 2000, which aims to make the European Union the world's most competitive economic area in the world. This strategy explicitly included a dimension focusing on Europe's international performance and this was fleshed out with the launch of the Global Europe Strategy of 2006. Global Europe focuses on securing market access for EU goods and services through trade agreements, reinforced diplomacy and international regulatory cooperation. In addition it referred to an implicit element of Lisbon: that export competitiveness must also be taken into account in the EU's domestic policies.

This survey asks just how well these approaches are working for Europe. The principal measure used is Europe's share of world export markets. Exports play a vital role in the strength of the EU economy, contribute to growth and jobs and are a key indicator of the competitiveness of the overall business environments in the EU vis-à-vis other territories. The market share measure is the most appropriate to assess Europe's export competitiveness as it allows us to compare our position with those of major competitors such as the US, China, Japan and India and also tracks the fact that world trade is expanding at two to three times as fast as world GDP growth.

A preliminary look at the headline figures shows that Europe has held out much better against the rise of the emerging countries in world export markets than counterparts in the US and Japan. However, it is not fully immune from the trend, with its market share dropping from 20.8% to 19.5% between 1995 and 2005. Also, the EU trade deficit has increased continuously, reaching €185.7 billion in 2007 and reached €138.5 billion by July 2008 alone.

The objective of this study is not, however, to lament Europe's decline. In absolute terms, the EU's exports are increasing and constitute an ever greater contribution to growth and jobs. But Europe is not taking full advantage of the increase in world trade as much as it could and as much as some other countries. This study therefore seeks to assess why this is the case and put forward coherent policy recommendations to secure the EU's competitive position in global markets.

The study proceeds as follows:

- The second chapter reviews the developments of the EU's market share in global exports over the years 1995-2005. Conclusions are drawn about the EU's competitiveness vis-à-vis some other major exporters, notably the US, Russia and China. The study also examines the competitiveness of various EU sectors and compares the performance of several EU member states. Considerable performance variations can be identified among sectors as well as Member States.

- The third chapter identifies a number of factors affecting Europe's competitiveness. These factors can be subdivided into changes in the international economic environment, cost challenges and capacity constraints.
- The final chapter outlines policy recommendations for the EU and its Member States that flow from the challenges faced by European exporters. Action is needed both at home and abroad, at EU-level and at national level to create a more favourable economic environment. Among the most prominent recommendations at EU level are: implementation of the Lisbon Strategy, improvement of market access and a raising of awareness of international elements in domestic policy making. At national level, the study puts forward recommendations on, amongst other issues, productivity, entrepreneurship and research and development.

The European Union and its Member States have taken many positive steps since the launch of the Lisbon strategy. Global Europe has seen the EU move in a number of important areas on the international stage. More will be needed however to guarantee Europe's future place in the international economy but, guided by the right framework of policies, European competitiveness can be kept on track to deliver growth and jobs for future generations.

1. EUROPE'S EXPORT MARKET SHARE

1.1 Export Markets

Europe is the world's leading exporter but changes in the international economy and the European Union's domestic business environment are forcing companies and policy-makers to look closely at how this position is developing. The information in this chapter assesses the position of European Union exports on the world market as a whole and in major export markets such as the United States, China, Japan and Russia. It also looks at difference in performance across economic sectors and regions to give a snapshot of Europe's current performance and current trends.

Overall market share

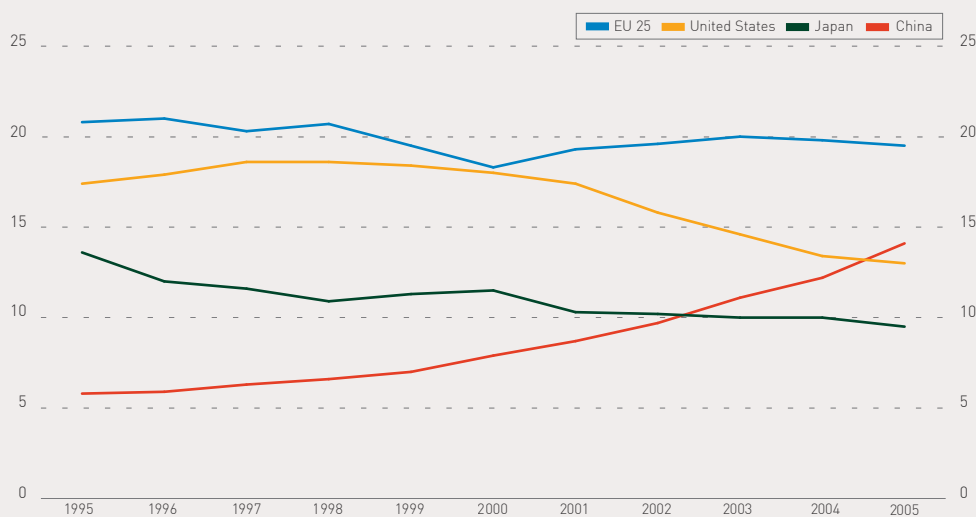
The rise of emerging countries, exemplified by China, in world trade has meant that Europe's traditional competitors Japan and the United States have seen their share in world trade substantially diminish during the period 1995-2005¹. The US proportion diminished from 17.4% to 13% and Japan's from 13.6% to 9.5%. China's proportion rose from 5.8% in 1995 to 14.1% in 2005.

The EU-25, on the other hand, came much closer to maintaining its share, an important achievement in light of these changes. Nonetheless, over the period a small but steady decline can be observed, from 20.8% in 1995 to 19.5% in 2005. Though there are some fluctuations within that period, after 1996 the EU only manages to achieve a market share of over 20% once in nine years. This shows that the EU is not fully immune from the trends that have affected the US and Japan.

Chart 1

World market share (% of total world exports by value)

Source: BACI Database, CEPII



EU share in US, Russia, China and Japan

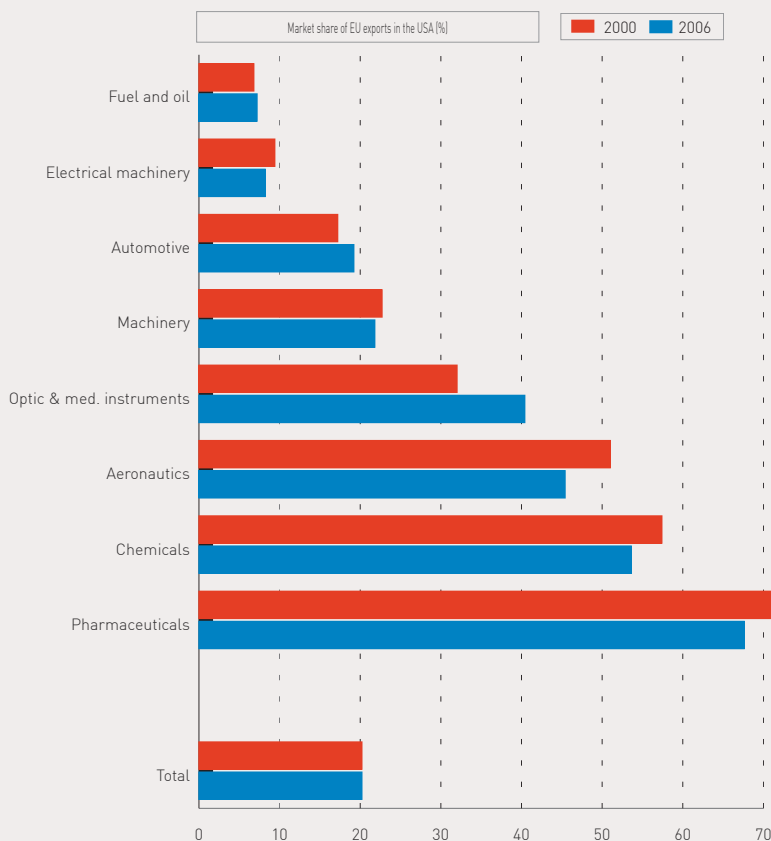
In 2006, 22.3% of European exports were destined for the **US**, making the US Europe's main export partner². Europe's performance in this market is therefore crucial for its competitiveness. Europe slightly increased its market share in the US between 1995 and 2005, up 1.5% to 20.8%. By contrast, Japan's share fell from by 8 percentage points to 10.1% in the same period.

If we review the development of Europe's market share in the US on a sectoral basis, here using US Commerce Department statistics for the period 2000-2006, some interesting facts are revealed. Europe is gaining market share in automotive, fuel and oil, and optic and medical instruments. However, its shares of pharmaceutical, chemical, aeronautic and electrical machinery imports are declining³.

Chart 2

Sectoral market share in the United States

Source: TradeStats Express (US Department of Commerce), BUSINESSEUROPE



While **Russia** accounts for an increasing percentage of EU exports (6.2% in 2006 up from 2.5% in 1999⁴) Europe's market share in Russia fell by over 9% between 1995 and 2005 though it remained at 54%.

The EU market share losses in **China** and **Japan** were similar and equally limited in terms of percentage points (respectively 1.8 and 2.0), but of course in the long run the impact is potentially more problematic for the EU in the rapidly expanding Chinese market. From 2003 (latest sector data available for the EU-25)

to 2006, Europe's market share in China declined in all major sectors: automobile (from 44% of market share to 41.8%), office and telecom equipment (from 5% to 4.3%), chemicals (from 12 to 11.8%) and electrical machinery (from 15.6% to 13.3%)⁵.

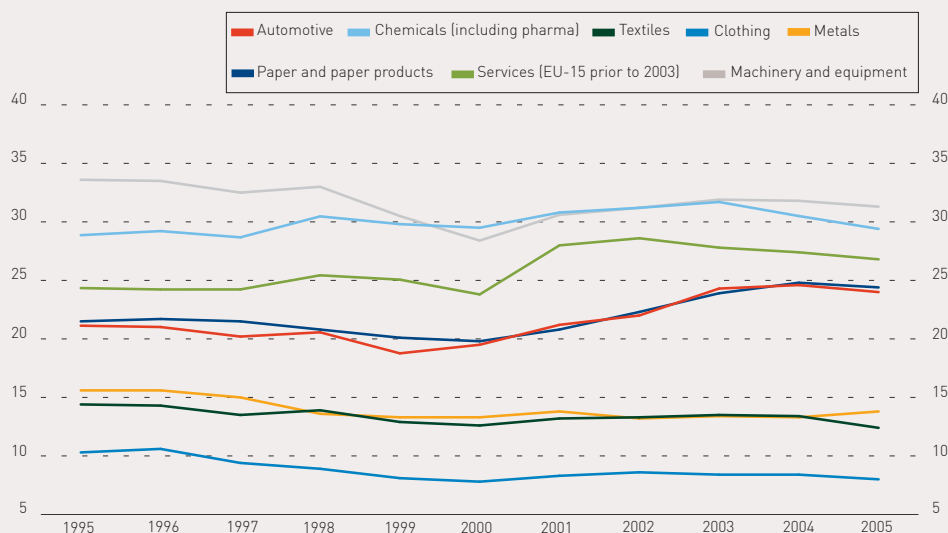
1.2 Divergent Sector Performances

A more nuanced picture of the EU's export position can be found by looking at the situation in different sectors. Services, chemicals, automotive and fuels and mining make up 46.2% of total EU exports. Comparing these European exports with their importance in world trade, services, chemicals and automotive clearly stand out as the main specialisations of EU exports, as services make up 18.4% of total world exports, chemicals 7.7% and automotive 6.2%⁶. Other major sectors include machinery, textiles, clothing, metals, and paper and pulp.

Chart 3

EU share of world exports by sector

Source: BACI Database, CEPII



The automotive sector

Over the period 1995 to 2005, **the EU's market share in the automotive sector rose** (from 21,14% to 22,6%), showing the industry's remarkable resistance to the rise of emerging countries. Extra-EU exports by value of EU automotive products almost doubled in the period. Nevertheless, more in-depth analysis reveals contrasts behind this overall performance. First, production has to a certain extent shifted from Western to Eastern Europe: the share of new EU members represented 13.5% of EU production in 2006, compared with 8% in 2002⁷. Second, German car producers, accounting for 40% of EU output but specialised in top of the range products, have performed much better than their other European competitors, particularly those in France⁸.

The machinery and electrical sector

The machinery and electrical industry is extremely diverse covering all of the mechanical engineering sectors as well as electrical and electronic equipment. These sectors play a major role in the European economy, both in their own right and through acting as enabling industries for other manufacturing and services sectors. Mechanical engineering is a key player in EU exports; with 41% of the world market, Europe is the world's largest producer and exporter of machinery. Worldwide electrical and electronic

production accounts for more than €1.5 trillion of production value and the EU is the second largest producer of electrical engineering products after China.

The machinery sector has performed relatively well in the face of increasing global competition, though some declines have occurred. The figure for share of world exports for machine equipment has decreased from 33.6% in 1995 to 30.1% in 2005. For the electrical equipment sector the figure has fallen from just over 20% to 17.5% since 1995. In electronics (office, accounting and computing equipment) the EU has largely held on to its share, falling just over 1%. This is particularly important given that China's share of high-tech exports (though this is broader than electronics) rose from 3% to 15% in the same period. Japanese and US exporters have borne the brunt of this increase.

The chemical sector

The chemical industry has also come close to maintaining its market share in world exports (down just 0.4% between 1995 and 2005). However against this picture, the strong performance of pharmaceuticals must be noted. Its global export share increased considerably – up 3.5% to 47.7% in the period. Given that pharmaceuticals made up 35% of chemical exports in 2005 this performance masks a less rosy outlook across other chemicals sub-sectors. In basic chemicals, for example, market share fell by over 5% to 23.5%. This would seem to reflect the rise of China and other South-East Asian countries in chemicals exports (from 10.6% of world exports in 2000 to 12.4% in 2006)⁹.

The paper and pulp sector

The share of the European pulp and paper sector increased by almost 3% between 1995 and 2005, thanks to sustained investments. However, a slowing of this growth is noticeable in 2004 and 2005. Apart from other factors such as cost questions discussed later in the study, it is notable that 50% of new global investment in the sector was destined for China¹⁰.

The metals sector

The metals sector, which is an important part of the supply chain of other major industries including automotive, machinery, construction, transport, packaging and consumer goods sectors, is not the largest element in EU merchandise exports, representing just 4.4% of the total in 2006. Nonetheless, the EU's share world of exports of metals is significant and it is of concern that EU market share has declined from 15.6% to in 1995 to just over 12.9 in 2005.

This decline is also noticeable in Europe's share of global production of metals which has greatly diminished over the two last decades. In aluminium, it went from 21% in 1982 to 9% in 2005 and from 25% to 16% in steel¹¹.

The textile and clothing industry

Europe's world market shares in textiles and clothing have shown some stability in light of the huge changes in the global pattern of production for the industry but nonetheless have registered some declines. In the period 1995-2005 textiles' share fell 2.7% to 11% and clothing's by the same amount to hold a 7.6% share in 2005. Though European exports have increased in both sectors, world trade increased by over 50% since 2002 and Europe has not been able to win its share of these new markets. Nevertheless, Europe remains the second largest exporter of textiles and clothing in the world with €34 billion worth of exports¹².

The services sector

The EU market share in services (extra-EU 25 exports) stood at 26.8% in 2005. This represents an increase since 1995 (2.5%) and is still far above Europe's nearest competitor the United States (at 19%)¹³. Services market share statistics for EU-15 are only available prior to 2003. As in other sectors, the rise of China should be noted, its position moving from a 4.1% to 4.7% market share from 2004 to 2006. Again, this rise seems to affect Japan and the US slightly more than the EU but overall is less impressive than in manufacturing sectors¹⁴.

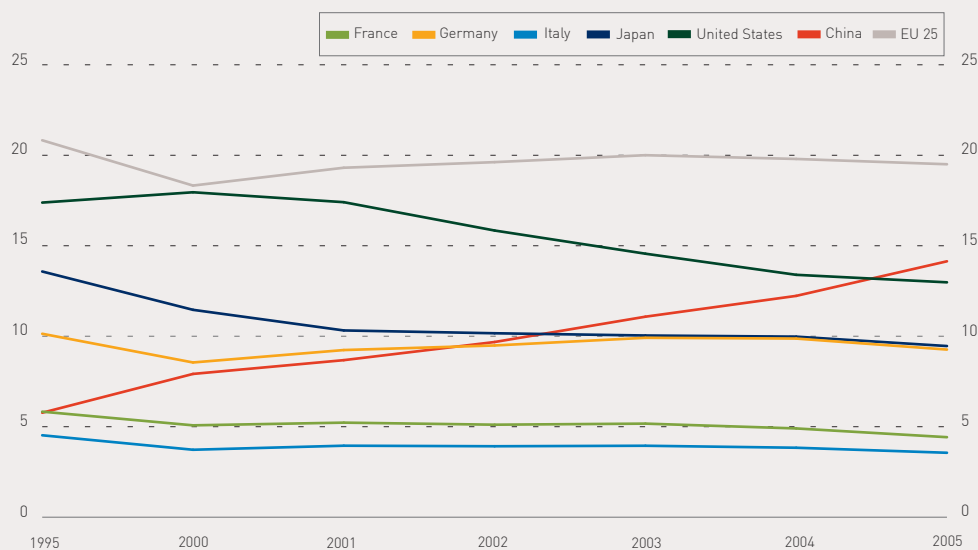
1.3 Divergent Country Performances

The state of EU export competitiveness varies considerably across its Member States, with the position of countries such as France and Italy in marked contrast to those of Germany and Slovakia. These four countries have been chosen as examples of the differing position of different EU Member States. Two examples show countries facing greater challenges and two show countries that are having greater success in export markets.

Chart 4

World market share Member States (% of total world exports by values)

Source: WTO/BACI Database, CEPII



Italy and France

France's export competitiveness has declined since 2000 and is continuing to lose ground. Whereas France's world market share (in value) was 5.8% in 1995, it was only 4.4% in 2005. Italy's share of world markets has also declined, from 4.5% in 1995 to 3.5% in 2005¹⁵.

Although it is predictable that France or Italy could lose market share as emerging Asian countries such as China are catching up, both countries are also losing market share within the euro zone. From 2000 to 2006, France's market share in the euro zone lost more than a tenth while Italy's decreased by more than a third. This indicates that France and Italy are also losing ground compared with their European neighbours¹⁶.

Germany

Germany has maintained its world market share at roughly 10% over the past ten years, demonstrating its ability to compete effectively in spite of the rise of China and other Asian nations in world trade. It has also regained market share lost in the early 1990s following its reunification¹⁷. It is interesting to note that Germany's 160 billion euro trade surplus in 2006 consists of €101 billion with the EU 27 (up 54 billion compared with 2000)¹⁸ and 56 billion with the rest of the world (up 43 billion compared with 2000). In other words, although most of Germany's trade surplus comes from trading

with other EU members, a proportionally greater share of the improvement in its trade balance comes from extra-EU countries. Therefore, its extra-EU competitiveness has significantly improved and is greatly contributing to EU competitiveness in general.

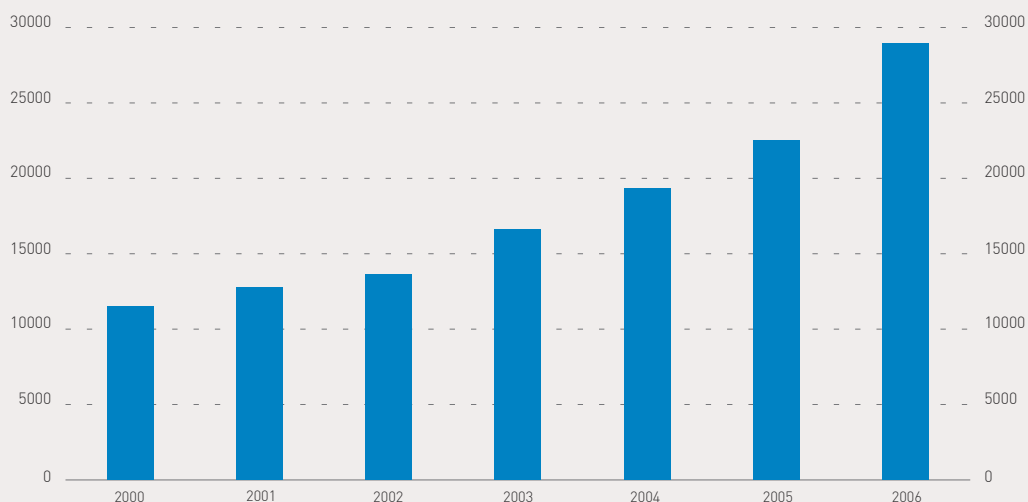
Slovakia

Though Slovakia is not a country with major extra EU-exports it is an interesting example as due to high levels of investment from EU-15 Member States, notably Germany, it is benefitting from their success on global markets. In the early 1990's, Slovakia's economy was considered by many to be ill-prepared for the transition to a market economy and for competition with the outside world, as it inherited energy-intensive and non-competitive industries from the communist period. Yet, today, it is the best performer in EU-12, with GDP growth exceeding 8% in the past three years. This success story is based in large part on a successful integration in world and in particular in European trade specialisation. Slovak exports to the EU-27 have risen on average by more than 20% per year since 2002, with an impressive 29% rise in 2006. Exports have almost tripled since 2000 while world trade rose by 30% (see chart below). As it is often the case in "small" countries, external trade makes up a dominant share of the economy. In Slovakia's case, exports represented 75.2% of GDP in 2007, a share which has continuously grown over the years. Most of Slovakia's exports are to other EU members¹⁹. However, its share of extra-EU trade has increased from 0.14% to 0.16% from 1995-2005²⁰.

Chart 5

Slovak exports to the EU 27, in value (million euros)

Source: Eurostat



1.4 Investment

It should be noted that a conscious choice has been made to focus this study on exports from the EU given their importance to the EU economy and their importance as a measure of the competitiveness of the overall business environment within Europe against other territories. Nonetheless, exports alone do not fully reflect the activities of European companies. EU firms are major investors in other markets around the world including in emerging countries such as China and Russia as well as developed countries, particularly in the United States. Turnover of these foreign subsidiaries is highly important, often larger than exports alone. Companies have been able to enjoy the benefits of

international division of labour and exploit the competitive advantage of emerging markets in mass production for global markets. This specialisation; diversification of production processes and outsourcing of inputs; knowledge and expertise has been a driving force for productivity and competitiveness. It has strengthened companies' profits and balance sheets and, at the same time, their overall competitiveness in the global market. These business activities also strengthen the competitiveness and wealth of Europe and underline the importance of transparent, predictable and non-discriminatory business environment in third countries.

Furthermore, Europe has emerged as a principal recipient of foreign direct investment (FDI) since 1990 and is the world's most dynamic region for FDI. Its inward FDI stock as a percentage of GDP has soared from 10.8% in 1990 to 38% in 2006. EU Member States have benefited enormously from FDI inflows: between 1997 and 2006 Belgium received €890 billion in FDI, the UK €600 billion, France €360 billion and Germany €355 billion²¹. Europe's economic vitality is tied therefore not only to its ability to export, but also to its ability to attract investment. An increasing amount of production located in the EU will be destined, however, for global markets in future so again the importance of export competitiveness is crucial.

1.5 Conclusion

The export performance of the European Union is far from being disastrous. Though we are not fully immune from the trend, there is a relative stability of our overall market share in comparison to those of the US and Japan. However, this fact obscures the real problems faced in certain Member States – such as France and Italy – and in certain sectors – such as metals, electronics and textiles. The excellent performance of German exports masks weaknesses elsewhere and the success of other Member States – such as Slovakia – is to a large extent a part of German advances. All of this underlines this survey's contention that the EU as a whole cannot afford to be complacent about its position on international export markets. The next chapter will assess the factors affecting this in more detail.

2. FACTORS AFFECTING EUROPE'S EXPORT COMPETITIVENESS

The results of the first chapter beg the question: What explains the challenges Europe is facing in terms of the competitiveness of its products on world markets? The varied picture that emerges across sectors, Member States and in different international markets may help to explain the factors at work. This will provide the foundation for policy recommendations to address problems and enhance success.

2.1 International Economic Environment

One thing is clear from our analysis of the EU's position. The international economic environment, through both old and new challenges, is having an impact on Europe's exporting capabilities.

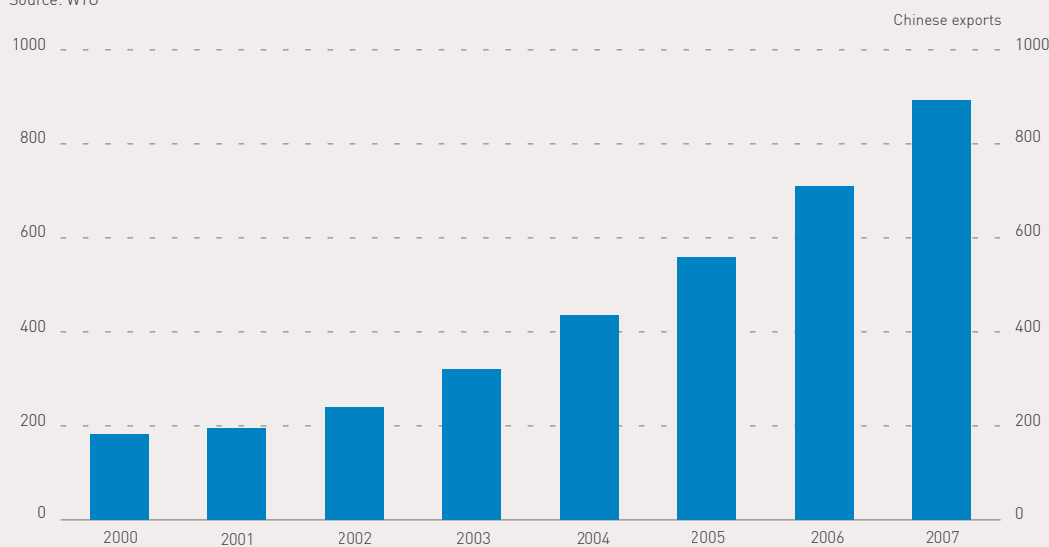
The rise of China and other emerging economies

The near-exponential growth of emerging country exports, the vast majority from China, clearly stands out as the principal feature of today's international trade landscape and the major factor in reductions of European export market share. After the European Union, China is now the world's second exporter. In 2007, its exports amounted to €907 billion and it registered a trade surplus of €195 billion²². Every three and a half years, China doubles its exports. As a result, from 2000 to 2006, China's share in total world exports more than doubled, from 5.2 to 11.1%.

Chart 6

Growth of Chinese merchandise exports (bn €)

Source: WTO



Its specialisations include textiles, steel (for which it is the largest exporter but which only represent a minor part of its exports) and electronics and electrical equipment (China is also the largest exporter of ICT products). Textiles, electronic goods and electrical equipment make up 40% of its export surplus. China is also affecting the international trading system by being the world's third largest importer of raw materials²³. Other emerging economies, such as India and the ASEAN countries are enjoying high export growth, if at slightly less intense levels.

China has become the “factory of the world” and Europe is not unaffected by this phenomenon. The US and Japan have been much more affected by the rise of China, but Europe's slight but noticeable market share loss in world exports (see Chapter one) can be attributed to a certain extent to the rise of China in world trade.

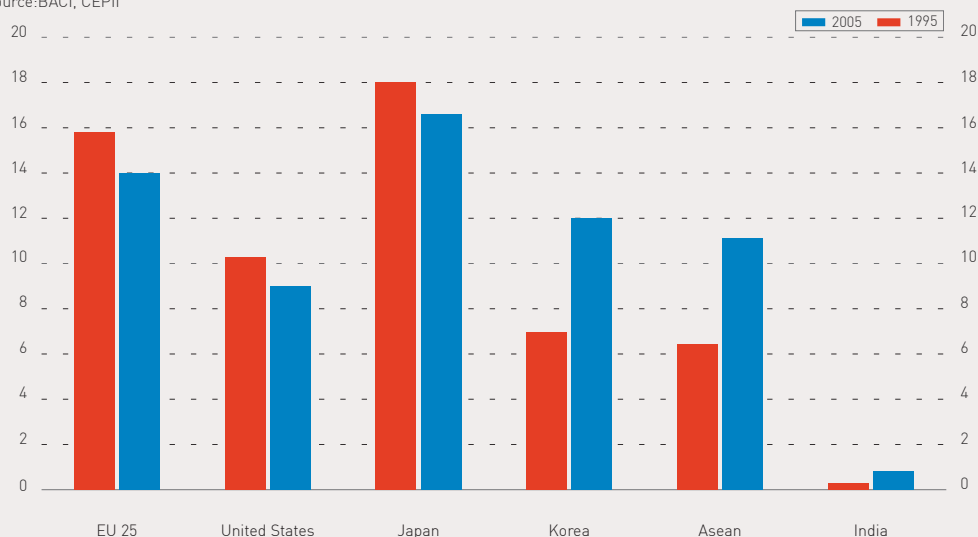
This is being felt in the key EU export market of Russia as noted in Chapter one. In Russia exports from China and other Asian nations are having a particular impact in markets for machinery and vehicles, two of Europe's strongholds.

Even within China, Europe's relative decline seems to be related to the rise of other Asian countries. As the graph below shows, both Korea and the ASEAN countries have increased their market share in Chinese imports by roughly 5% between 1995 and 2005. These countries are tending to replace the EU, Japan and the United States as suppliers of China's processing trade. They export components to China in growing proportions.

Chart 7

Evolution of export market shares in merchandise to China (%)

Source: BACI, CEPII



On a sectoral level the changing environment is also clearly observable, particularly in metals, where production of steel in China has increased by more than 20% a year and this country has moved in only three years from a status of net importer to the world's biggest steel exporter²⁴. In electronics, we have seen that European companies are rapidly increasing their sales, but not as fast as world demand. On the contrary, China's exports in office and telecom equipment rose by 37% a year on average from 2000 to 2006. China is now the dominant exporter in telecom equipment, with 22.7% of world exports²⁵.

It is important to stress, however, that European companies also benefit from the rise of China in world trade. First, it is remarkable that between 38% and 55% of Chinese exports are actually made by foreign-owned companies. In some sectors (assembly and transformation of semi-finished products), this proportion rises to 80%²⁶. As many of these companies are European companies, a significant proportion of Chinese exports are actually exports made by European firms or joint-ventures. Second, European exports to China are increasing on average by 20% a year, a highly significant development even if it is not sufficient to maintain EU market share²⁷. In addition to supplying China's domestic market, these imports are used in Chinese factories for the export market. European carmakers, for example, have invested in China and are now exporting parts from Europe in order to supply Chinese car factories²⁸.

What are the future prospects for China's position on world markets? The country's current success is due to efficient public infrastructure, tax incentives for investment, a 1.3 billion consumer market and technology transfers from joint-venture investors as well as direct state intervention in the form of measures such as low cost financing. However, it is the combination of these factors with China's cost advantage from its large and inexpensive labour force that has been at the core of the country's success.

An April 2008 study by the consultancy Booz Allen Hamilton²⁹ has shown that China is becoming a less attractive destination for investors wishing to create an export base. The rising price of raw materials and a tendency of the economy to overheat have led to an inflation rate of 8.7% in February 2008. Salaries are also on the rise as qualified labour demand strongly exceeds available supply – though this is less the case inland. Furthermore, Chinese authorities have also taken measures to rein in the overheating of the economy and to promote “harmonious development”. Legislation on overtime has been tightened and fiscal advantages for foreign investors have been made less attractive. The relative appreciation of the Yuan compared with the dollar has also impacted China’s cost competitiveness. As a result, the study shows that companies that invest in China solely to export abroad tend to be less profitable than those that invest in China to sell on the domestic market, which could reduce China’s export potential in the future.

However, China’s exports are becoming increasingly sophisticated. Chinese authorities have invested in the education system and the proportion of university graduates in China is growing. This, as well as technology transfers from joint-ventures, has led to an increase in range and in technology of the content of exports of Chinese goods. In 2007, 43% (compared with 29% in 2000) of exports were made up of electrical and mechanical goods. Although China is the largest exporter of clothing and textiles, they now only represent 15% of its exports (5% for textiles and 10% for clothing)³⁰.

This trend should not be exaggerated as some high tech exports are only assembled in China, with R&D and design remaining abroad – this so-called processing trade is a highly important explanatory factor for the rise in value added terms of China’s exports³¹. Nonetheless, it must be expected that competition from China will be a continuing and increasing factor for EU exports across the board.

Market Access Barriers

The second major factor determining Europe’s export competitiveness lies in legal obstacles - whether tariff or non-tariff barriers (NTBs) - to market entry in its current and future trading partners. Even though average tariffs may have been reduced in key markets, for many of Europe’s important export sectors tariff peaks and specific NTBs exclude European exports from competing on a level playing field. An internal survey among member federations of BUSINESSEUROPE has indicated that countries and regions where significant market access barriers exist are: **Russia, the US, India, China, Japan and Brazil**. Other important regions with barriers to trade are the Association of South East Asian Nations (ASEAN) and South Korea. Below are some illustrative examples of the problems companies face.

In **Russia**, European companies are facing several obstacles to market entry. In quite a few products, tariff peaks exist, such as in aluminium foil (20%); motor vehicles and parts (27%); footwear (33%); paper (20%) and leather products (38%). Moreover, there are several categories of fish, sugar, alcohol, clothing and footwear with tariff lines above 100 %. In addition, European companies are faced with significant non tariff barriers, such as export taxes and dual pricing. These barriers result in the provision of natural resources at cheaper prices internally than for export, causing severe market distortions that represent an important threat to European industry³².

In the **US**, European companies are also faced with barriers to market entry. Tariff barriers, although not commonly highlighted, do exist. Around 5% of all US tariff lines exceeded 15% in 2007, such as a 25% tariff rate for transport equipment. Furthermore, even for the vast majority of products that have low rates, the enormous volumes of transatlantic trade mean that tariffs represent a substantial tax on trade. There are also numerous NTBs in the form of, for example, US legislation requiring scanning of 100% of all containers entering its ports, which will, if it enters into force, create serious logistical and cost barriers to market entry. European companies also face considerable barriers when it comes to services. For professional services, the US employs several state-level exceptions, particularly in the

field of financial, legal and accounting, auditing and bookkeeping services.

In **India**, European companies are faced with high tariffs. Numerous peak tariffs exist, such as a maximum applied tariff of 100% for chemicals and transport equipment. For example, on light intensifier tubes, the customs duties in India reach 41%, against 2.7% in the European Union. In addition, India maintains double-digit additional duties on imports, meaning that even when the basic import duty is low the net rate of taxation on imports is a double-digit rate. In India's highly competitive service economy important barriers also face European companies, such as the limitation of foreign participation in the capital of local insurance companies at 26% and restrictions on branching in the banking sector. Moreover, India upholds the obligation to create a joint venture with an Indian company for any local establishment.

In **China**, European companies face varied barriers to market entry. Problems for European industry can be identified for example in the automotive sector. China keeps both high tariff (47%) and non-tariff barriers to enter this market. In addition, European companies have reported discrimination in favour of local producers and ineffective enforcement of their intellectual property rights. NTBs exist for example in the agro-food sector where EU exports of one product can only take place after a protocol is concluded between the Member State wishing to export and China. These protocols take years to negotiate, require the provision of burdensome information, and are very expensive for the operators who have to pay for inspection visits. Furthermore, barriers to market entry exists in the services sectors. In telecommunications, China has capped foreign equity at 50% for value added services, and 49% for basic services.

In **Japan** the principal problems affecting European companies are non-tariff and regulatory barriers. For example, Japan is a signatory of the WTO General Procurement Agreement (GPA). However, the Japanese legal framework for procurement is characterized by a complex system of diverse statutes and regulations. The difficulties created by different tendering rules at central and local levels are aggravated by the fact that not all prefectures are subject to the WTO GPA rules. Further complications are poor dissemination of procurement information and the absence of a single point of access. In the pharmaceutical sector, including medicinal products and vaccines, Good Clinical Practice (GCP) rules remain different from global standards, which make clinical trials more expensive in Japan and participation by multinational companies difficult and costly. If anything, the situation for medical devices, diagnostics and veterinary medicine is more severe.

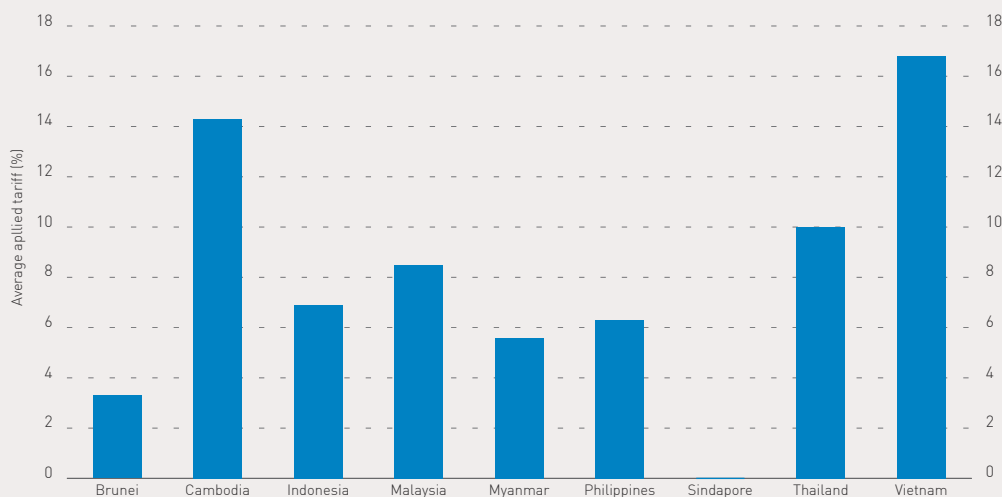
For **Brazil**, average bound tariffs are very high at 29.6%, in comparison to only 4% for the EU. Brazil maintains tariff peaks under for example chemicals (18%), pulp and paper (16%) and transport equipment (35%). Neither has Brazil committed to fully opening its services markets, particularly in telecommunications, banking and insurance. Several barriers exist, such as Presidential discretion on granting of licenses. On NTBs, European companies face a variety of customs-related NTBs. Brazil's Secretariat of Foreign Trade (SECEX) implemented a computerized trade documentation system (SISCOMEX) in early 1997 to handle important licensing. All importers must register with SECEX to access SISCOMEX. Registration requirements are onerous and include a minimum capital requirement.

In the **ASEAN** region European companies face high tariff barriers. The market share of European exporters is only 10.4% just over half of its world average. As the graph below shows, tariff levels differ between ASEAN countries but are significant in all countries except Singapore and perhaps Brunei and can be considered to be part of the reason for European companies' limited market penetration.

Chart 8

Asean tariff profiles

Source: WTO trade profiles 2006 (all data 2005 figures except Cambodia 2003)



In **South Korea**, Europe's market share is now 13%, which is also low compared to its world average. European companies are faced with numerous tariff and NTBs in the Korean market, such as a 50% tariff rate for chemicals. In total 2.5% of domestic tariff lines have rates over 38.4%. Non-tariff barriers are a particular problem for EU automotive exports. Korean standards and certification represent a significant market access barrier to the Korean sector, as the Korean Government does not recognise the international UNECE standards. In services, Korea utilizes a 49% cap on foreign ownership in the telecom sector and has quite a few restrictions in energy, shipping and banking.

From this brief survey it is clear that for important export markets, high barriers to trade exist. These barriers, such as peak tariffs, NTBs and restrictions on investment, can severely limit the EU's export potential in key sectors. European industry has thus much to gain from the opening of these markets through multilateral or bilateral trade agreements.

Sharing the burden of exchange rate volatility

In the medium term, the persistence of important macroeconomic imbalances – a huge current account deficit in the US and massive surpluses especially in Asia – is a risk to international economic stability. Stimulating US savings or an appreciation of Asian currencies leading to more equilibrated current accounts would be important steps into the right direction. Currently, the persistence of inflexible exchange rates in particular in emerging Asia with close pegs to the US dollar prevents the necessary balancing. In addition, they impose a disproportionately large burden on the euro as the common currency is one of the few variables of adjustment.

In this respect, the undervaluation of the Chinese Yuan is a striking example. On the one hand it creates an artificial comparative advantage for Chinese exports especially in Europe as the Chinese Yuan benefits from the US dollar's weakness vis-à-vis the euro, on the other it prevents European competitors from entering the Chinese market.

At present, the pressure on the euro is alleviated by concerns regarding the outlook for the economy. In the absence of effective international agreements on exchange rate regimes, the upward pressure on the euro could resume.

The sharp and rapid appreciation of the euro in 2007 affected countries and sectors to various extents. Wage moderation and productivity gains have provided countries like Germany or Austria with better competitive positions as compared to France or Italy³³.

Chart 9

Evolution of nominal effective exchange rates

Source: Bank for International Settlements

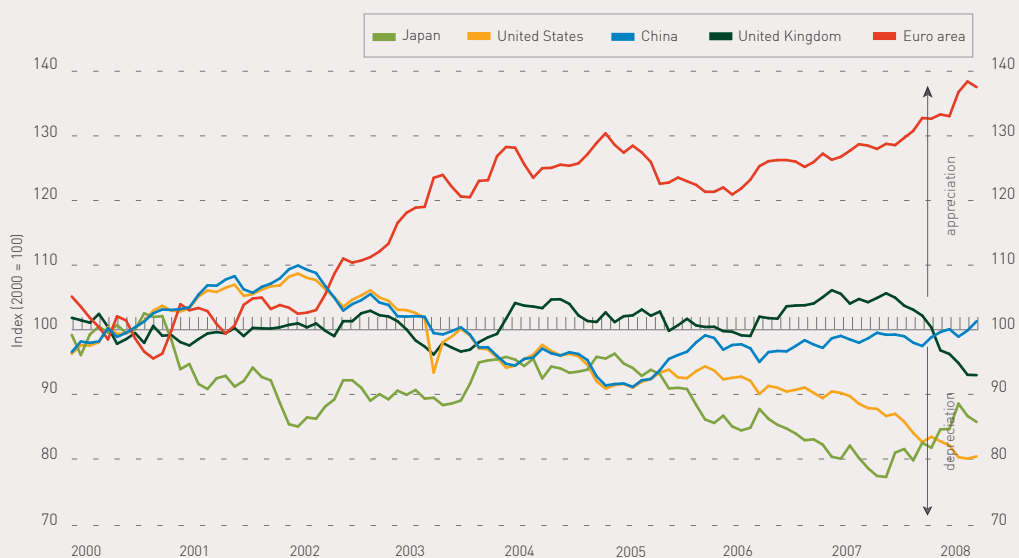
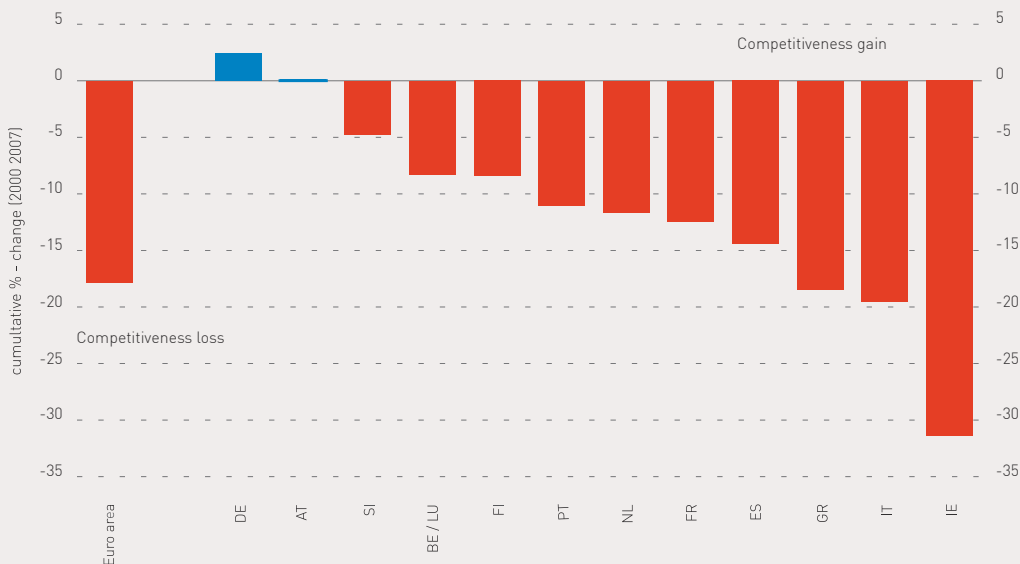


Chart 10

Competitive position of European countries (REER)

Source: Eurostat

Note: Competitiveness gain/loss based on evolution of UCL-based real effective exchange rate



Furthermore, the impact of the euro appreciation on countries' export performance also can depend on their specialisation regarding products and markets. For example, if the euro appreciates by 10%, French exporters cut their prices in euros by more than 3% on average and German exporters by just 1.5% on average. As a result, French exporters are likely to compress their margins to maintain their export market shares, whereas German exporters pass on exchange-rate fluctuations in their export prices much more directly, which enables them to uphold their margins. German exporters are able to do this because their products, such as machinery or luxury cars, are more oriented towards top of the range or specialised products designed to suit precisely their customers' needs. However, French, British, and to a lesser extent Spanish and Italian products are more medium or low-range oriented and more sensitive to exchange rate variations³⁴.

The rise of the euro also affected the export performance of Europe's economic sectors, however in a disparate manner. Sectors that produce relatively standardised products (textile, metals) in a very competitive environment, where price is sometimes more a differentiation factor than quality, have been hit especially hard. But even rather more competitive sectors such as automotive, machinery or food products are sensitive to exchange rate variations. In this respect, cutting margins only offers limited answers to an increasingly challenging exchange rate environment.

Although the rise of the euro represented an important challenge for European companies, positive effects of a strong currency which attenuate the overall impact to some extent also need to be stressed.

- Only 31% of total EU exports are destined to countries outside the EU. Intra-European trade thus offers an important protection for European exporters³⁵.

- The euro appreciation has tamed the impact of high commodity prices and is helping to contain inflationary pressures. For example, oil prices increased by 75% between the second quarter of 2007 and the same period in 2008 but only by 50% in euro terms³⁶.
- Prices European companies need to pay for parts in the supply chain located outside the euro zone have fallen in relative terms.
- The growing role of the euro as a reserve currency and in international financial markets increases the capital pool available for European companies.

Chart 11

Extra-EU exports by destination

Source: Eurostat (COMEXT)

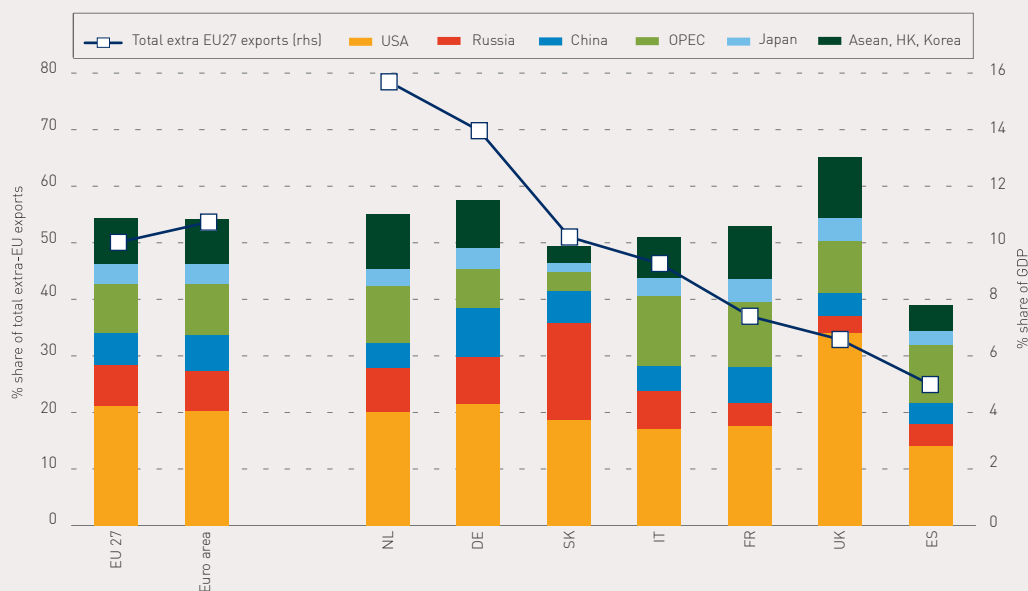
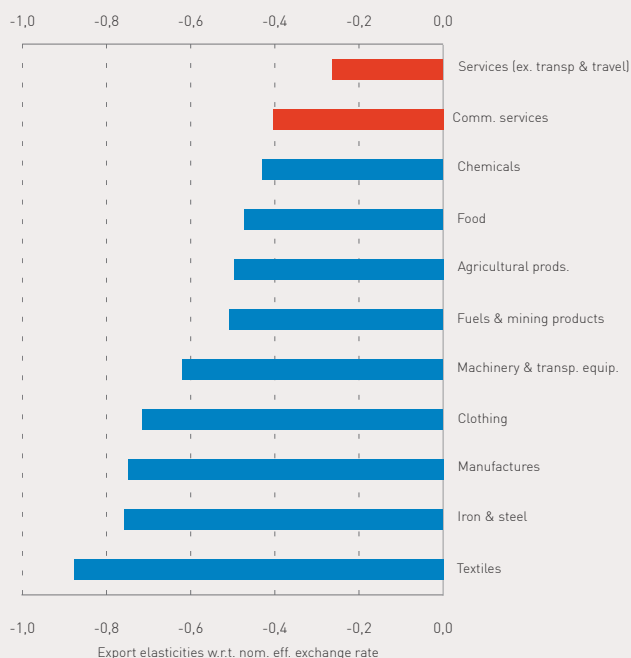


Chart 12

Sector exposure

Source: WTO, BUSINESSEUROPE



2.2 The Cost Challenge

Raw Materials

Security of supply of raw materials is an essential precondition for the competitiveness of the EU economy and for EU exports in particular. However, European companies face considerable problems concerning raw materials which have to be imported from abroad as well as those which are in principle available in Europe.

In recent years pressures on international raw materials markets have increased drastically. Demand for commodities has soared in fast-growing emerging economies, and in particular in China (see Chart 14). The strong growth in demand led to an unprecedented pressure on the global raw material markets, which has been reflected in sharp upward price movements since 2002. These price increases on the international raw material markets have led to large increases of production costs for European companies. For instance, from 2002 to 2005, the cost of raw materials in steel manufacture more than doubled. Since 2002, the cost of freight has even tripled³⁷.

Chart 13
Operating cost in steel by component (in US \$ per tonne)

Source: Steelconsult

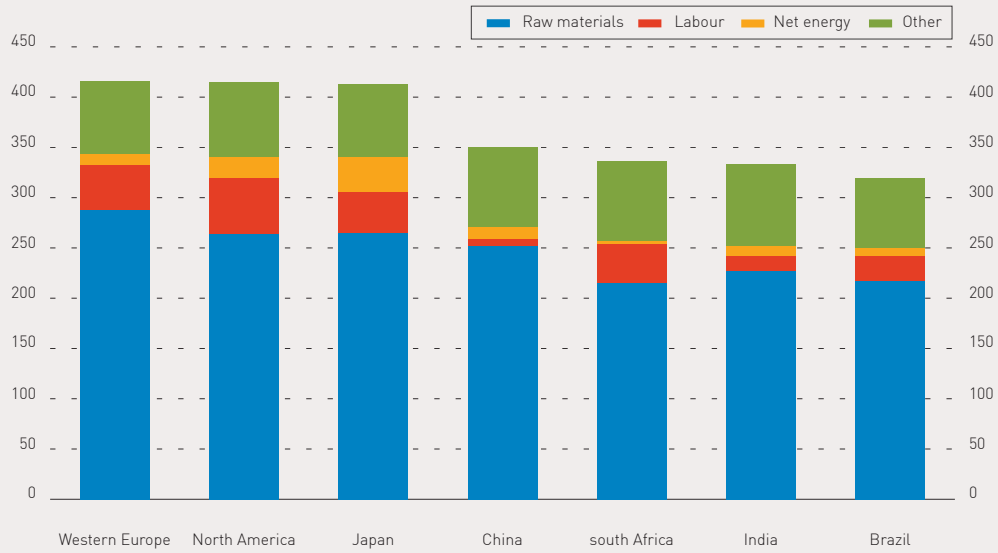
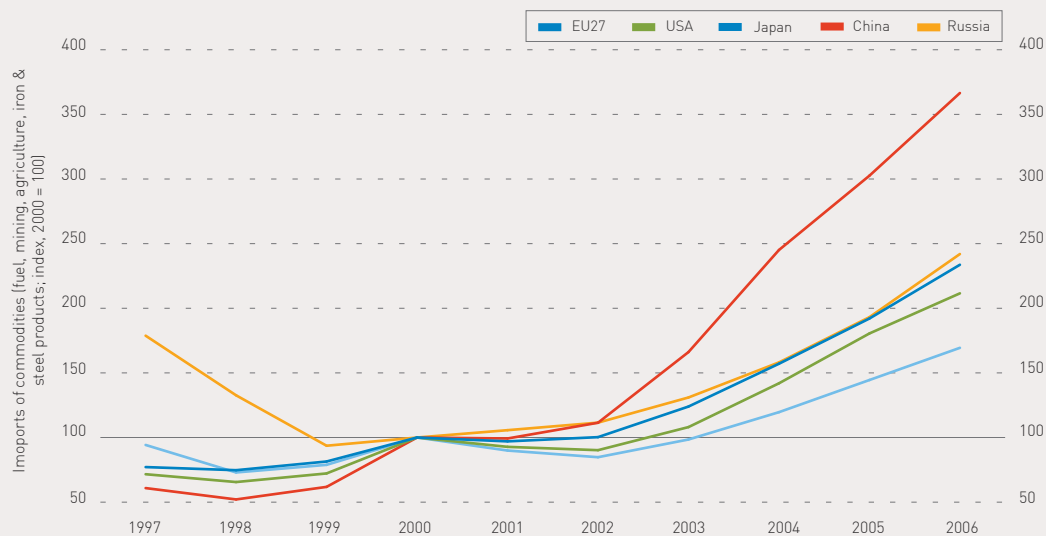


Chart 14
Skyrocketing commodities demand in emerging economies

Source: WTO, BUSINESSEUROPE



However, prices have not only increased due to market factors: An increasing number of countries restrict the export of raw materials by means of export taxes or other measures, operate dual pricing schemes on the export of their natural resources or subsidize the import or local purchase of raw materials.

The WTO estimates that up to a third of its members impose export taxes³⁸. As an example, Russia applies export taxes of up to 50% on materials like copper and aluminium scrap and a specific duty of up to €15 per cubic metre on wood (likely to be raised to €50 in 2009). The case of China is of particular concern. Over recent years China has progressively introduced export measures (tariffs, quotas, taxes and/or license systems) for a wide variety of raw materials, including fluorspar, yellow phosphorus, magnesia and iron ore, but also for high tech metals such as rare earths, antimony, tungsten, indium and molybdenum³⁹. The chemicals sector is negatively affected by dual pricing schemes for feedstock in Russia and the Middle East. While the price in Europe is over US\$9 per million BTU (fourth quarter 2007), dual pricing means that this key input costs less than US\$2 per million BTU in Russia⁴⁰. Trade distorting practices not only contribute to price increases but also cause de facto shortages on the international raw materials markets.

With regard to some raw materials, especially construction minerals, the EU is still self-sufficient. However, the land area available for extraction in the EU is constantly decreasing due to other land uses, such as urban development and nature conservation. Further constraints relate to the complex and time-consuming administrative procedures in connection with exploration.

Beside primary raw materials, the EU is increasingly relying on secondary raw materials. The use of recycled scrap has increased significantly in recent decades and represents today between 40 and 60% of EU metal production⁴¹. However, within the past 8 years, EU imports of non-ferrous and precious metal scrap have dropped by nearly 40% whereas its exports have increased by more than 125%, resulting in scarcities and price rises on the EU scrap market⁴².

In addition to these problems there are a number of risks which could endanger supply with raw materials in the future. Some countries outside the EU try to systematically secure their supply of raw materials by building up relationships with raw materials producing countries. As a consequence there is the risk that raw material flows from an increasing number of raw materials producing countries do not reach the international raw material markets but go directly to certain raw materials consuming countries.

In addition, renewable energy policies are having an impact on prices for agriculturally produced raw materials, which are crucial within the food sector but also beyond it in industrial production in various sectors. EU trade restrictions on renewable raw materials such as bioethanol or native starch do not help.

Finally, an increasing number of mergers of extractive companies have led to a higher concentration of raw materials production. In certain sectors, a relatively small number of companies operating worldwide account for a large share of the production and international supply of essential raw materials. In such highly concentrated market structures, the principle of effective competition is of paramount importance to ensure effective functioning of the market.

Obstacles in the internal market

The relevance of the EU internal market to extra-EU trade is perhaps not clear at first glance. However, the single market plays a key role - the first step to international expansion for many small and medium sized companies (SMEs) is into another European Union member state. Once this has been achieved, the company has a larger base from which to branch out further into more distant regions. In effect, a well functioning single market means European companies have unencumbered access to the much larger home market than they would in their own country taken alone, providing them with the opportunities for economies of scale that constitute a major competitive advantage as they face the world. Furthermore the dynamic effects of the internal market should not be underestimated. Its competitive pressures have helped to ensure European companies' competitiveness on the global stage.

There have been many milestones in the development of the internal market since the principles of the free movement of goods, people, services and capital were first established in the Treaty of Rome in 1957. These include among others the creation of a Customs Union in 1968, the establishment of the mutual recognition principle by the European Court of Justice, technical harmonisation of many goods, and more recently, the Services Directive.

However, the many regulatory and administrative obstacles that continue to exist within the European market make it still difficult for European companies to reap the benefits of a 495 million-consumer home market.

A few examples:

- 1 With regard to the free movement of goods, businesses continue to run into national barriers both in the areas subject to harmonised EU legislation (e.g. through incorrect or slow implementation of EU rules) and in areas that are not subject to common EU legislation (as a result of the principle of mutual recognition not being respected)⁴³. Companies wishing to avoid these barriers either have to use the services of the EU's SOLVIT or to challenge regulations imposed by Member States before national or European courts. Such action can be lengthy and costly.
- 2 Much of European economic growth is driven by the service sector. However, many legislative and administrative barriers are hampering the proper functioning of a true single market. The Services Directive is an important step to realise the untapped potential of the service sector both domestically and internationally. Member States bear the responsibility to make this happen by ensuring a correct and timely transposition.
- 3 Competitive government procurement is an important incentive for more efficient production and lower government expenditures. Therefore, discrimination against European companies in bidding for government projects both within the EU and outside should be eliminated.
- 4 The absence of a European Private Company Statute is an obstacle to the improvement of European competitiveness. Differences between national legislations governing private companies in Member States lead to additional and disproportional administrative and financial costs, by requiring access to information and legal counselling and reducing the appeal of cross-border activities. This is especially true for SMEs wishing to operate beyond the home country.
- 5 Due to insufficient harmonisation of indirect tax systems, companies face long delays and administrative obstacles for the refund of VAT costs incurred in a Member State where they are not registered. Some individual sectors, such as automotive, are burdened by particularly divergent tax systems which function as obstacles to free movement.
- 6 The absence of a common approach to corporate taxation also constitutes an obstacle to a well functioning internal market. There are currently 27 different systems in Europe for calculating a company's taxable earnings. As a result, companies frequently face double taxation related to conflicting tax claims and the lack of cross-border loss consolidation, as well as high compliance costs due to several sets of rules.
- 7 Planned Trans-European infrastructure networks remain unfinished. This applies to roads, rail, energy and pipeline networks. For instance, the lack of a seamless cross-border pipeline network for several chemical products means that logistics costs are 13% higher in Europe than in the US. With regard to the Trans-European Transport Network (TEN-T), there are still huge financing needs and a higher commitment from both the EU and the national level is crucial. The Commission estimates that completion of the TEN-T will cost some 900 billion EUR by 2020, of which almost 500 billion still remains to be invested.

In addition to transport infrastructure, the lack of harmonisation of EU rules relating to transport inhibits the functioning of the single market. For instance the weight and dimension limits for trucks are not harmonised across the EU.

8 The integration of the Internal Market for electronic communications is still incomplete. Reforms are needed to encourage investment in efficient European network industries and the deployment of new ICT infrastructures. Liberalised network industries—and particularly electronic communication services, which support productivity and innovation in other sectors - are vital for the global competitiveness of European companies.

Labour costs

Labour cost developments have a direct influence on a country's competitiveness and export performance. Countries that have been able to contain wage pressures effectively also fare better as regards their export performance. Indeed, comparing Germany's, Italy's or France's evolution of unit labour costs on the one hand and their export performance on the other clearly underlines the importance of responsible wage policies in line with productivity improvements in order to maintain a comparative advantage⁴⁴.

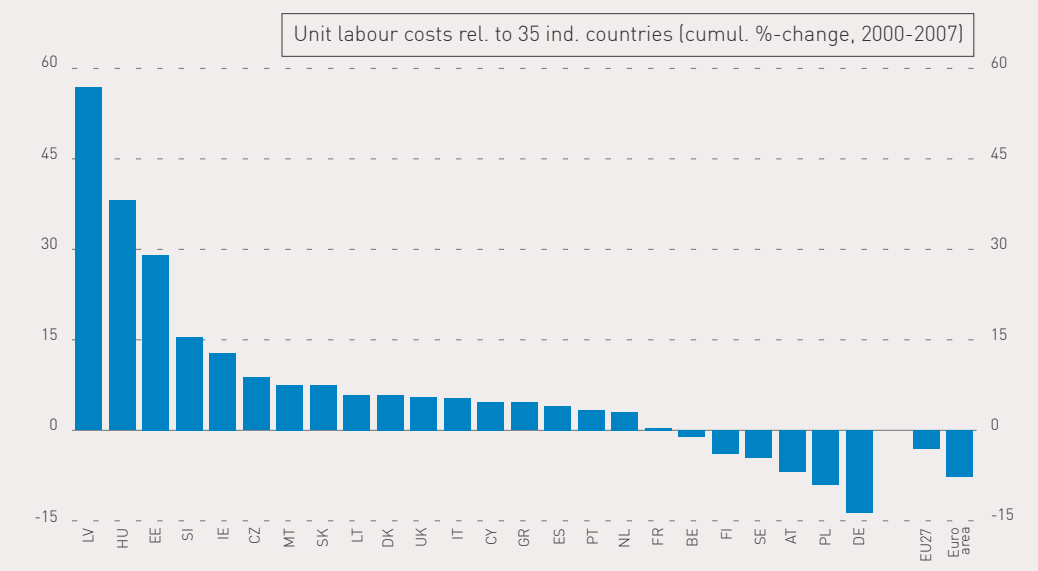
Central European member states have seen the fastest increase in unit labour costs since 2000. Rapid growth due to the catching-up process, foreign investment and outward migration of qualified workers in particular have caused severe wage pressures. In Slovakia, the increase in wages has been rather benign relative to EU-10 counterparts which helps to explain the countries sustained buoyant growth rates and its positive export performance.

For the EU as a whole, wage developments have not infringed its competitive position. However, it needs to be borne in mind that the substantial reduction in unit labour costs especially in Germany contributes a large share to the positive aggregate evolution. The general picture across Europe remains very heterogeneous.

Chart 15

Evolution of unit labour costs

Source: Commission AMECO database



The regulatory costs: Energy and climate change package

EU regulators are increasingly tightening EU health, safety and environmental standards relative to regulators in most other parts of the world. In recent years the EU has adopted the REACH regulation, giving Europe the most stringent chemicals legislation in the world. Its policy towards genetically modified organisms imposes costs of up to €10-20 per ton on the agricultural raw materials⁴⁵. Under its current work the EU is looking at an energy and climate change package that will substantially increase prices for European industry and will have a negative effect on its global competitiveness. We will look at this latter package as useful case study.

On **energy**, the 2007 Spring European Council set a target of 20% of renewable energy and a reduction of 20% of greenhouse gases by 2020⁴⁶. These objectives will substantially increase electricity supply costs for companies, since renewable energy is much more expensive than coal or nuclear energy. Several studies have tried to estimate the impact of the renewable energy target on electricity prices. A March 2008 study⁴⁷ conducted by Pöyry, one of Europe's leading energy consultancies, concluded that, even in the least-cost scenario, the total lifetime cost of meeting the 20% renewable target would be €259 billion⁴⁸. The annual cost of meeting the target in 2020 was estimated to be €18.8 billion for the whole economy. It is important to note that these figures represent the costs in case of the implementation of a renewable-energy production trading system. If such a scheme were not implemented, the price of electricity is set to rise even further. This is due to the insufficient domestic potential of countries such as Belgium, the Netherlands, Malta and Cyprus, which are unable to meet their national targets with "low-cost" renewable energy. In a scenario where a permit and trading scheme would not be available, Pöyry estimates the cost of achieving the 20% target at €25.6 billion a year, and at €351.7 billion for the total lifetime cost. Consuming 41.6% of all electricity (see Chart 16), industry is the biggest customer of energy suppliers and will therefore take on a substantial part of this burden⁴⁹.

Chart 16

Sectoral electricity consumption (EU 27, 2004)

Source: Eurostat, JRC Survey, PÖYRY

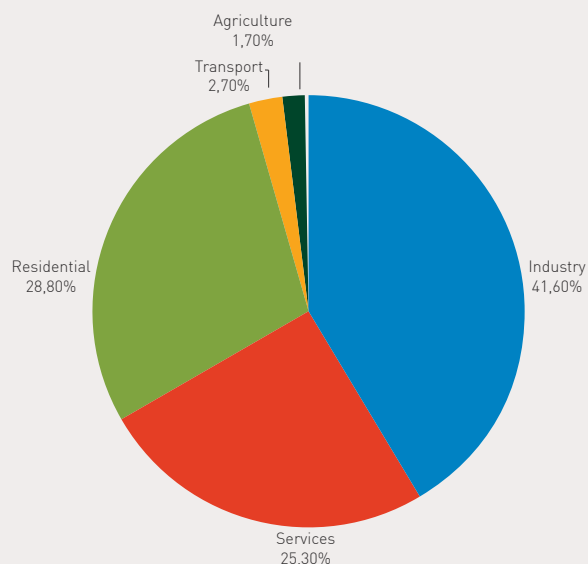
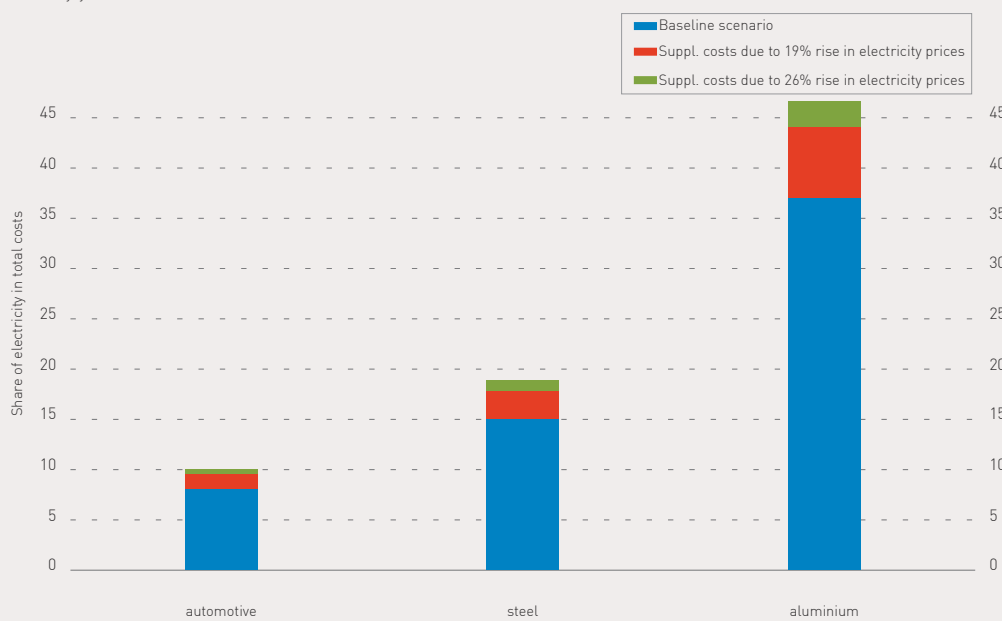


Chart 17

Cost increase as a result of the energy and climate change package

Source: Pöyry



In the situation where the percentage of electricity consumed by European industry remains constant, industry should, based on these figures, have to pay approximately between €107.7 and €146.3 billion over the whole period and between €7.8 and €10.6 billion a year, depending on the implementation of a permit and trading system on renewable energy production.

The rise in the average cost of electricity prices (which the European Commission has estimated at between 19 and 26%⁵⁰ - see Chart 2) particularly impacts industries for which electricity costs represent an important expenditure, such as the automotive, steel and pulp and paper sectors, where electricity costs represent between 8 to 15% of total costs. That share is even higher in the aluminium (37%) sector and for the production of certain chemicals such as chlorine (40%)⁵¹. European companies which are not in direct competition with extra-European companies have of course the possibility of raising their prices, making consumers pay for the rise of energy costs. However, the above-mentioned industries are in direct competition with companies from the rest of the world, which prevents them from raising their prices. Therefore, the 20% renewable energy objective poses a direct threat to the competitiveness of these European companies. Industries for which electricity represents a major production cost might consider relocation of production to areas where such constraints do not exist. This is particularly true as these industries are also affected by the Emissions Trading Scheme (see below).

Attention should also be paid to the aspect of competition for raw material use. Promotion of renewable energy sources may create market distortions and result in changes in the availability or price of raw materials used for example by the pulp and paper, chemicals and food industries. For instance, the chemicals industry and other sectors use cultivated raw materials from agricultural and forestry products such as meat, plants and timber and their derivatives such as fats and oils, cellulose, starch, sugar and fibres in their production. Any instrument that uses state intervention to divert at least some of the cultivated raw materials into other uses will have the consequence that they will only be available for industrial production in insufficient quantities and at higher prices. Pure combustion removes valuable raw materials from a production chain which could have been used as material in manufacturing

industry with much higher added value. A recent study⁵², also by Pöyry, found that the value added of using raw materials for the pulp and paper industry is four times higher than in the bioenergy sector. Substitutes would primarily involve greater use of fossil raw materials, which would be inconsistent with the ecological approach of the entire initiative.

The second of the proposed climate policy is the **Emissions Trading Scheme (ETS)**. The ETS represents a real challenge for the competitiveness of EU industry. Introduced in 2005, it allows companies to buy and sell CO₂ emission permits. It involves the 10,700 biggest industrial emitters in Europe. In the current scheme, allowances are allocated freely to companies. Companies must pay only if they wish to emit more CO₂ than they have been allocated, in which case they buy allowances from another company on the CO₂ market. This system gives an incentive to companies to develop and implement new technologies that emit less CO₂ in order to reach the EU's emissions reduction targets of 20% by 2020. The investment that companies will make to achieve this will alone be highly significant. However, this will also put a limit on potential growth of energy-intensive production.

The next period of the ETS, due to start in 2013, represents an even bigger challenge for the competitiveness of EU industries. In the system proposed by the Commission, emission permits would no longer be distributed for free according to production but would have to be bought through an auctioning system. According to the Commission's own estimate, the price of a tonne of carbon should be €20-€60, while the total amount of CO₂ allowances auctioned would be 2 billion tonnes in 2013. These allowances would progressively diminish to reach 1.7 billion tonnes in 2020⁵³. Based on these assumptions, European industry could then have to pay up to as much as €90 billion a year by 2020, merely to maintain its basic economic activities.

Although the Commission has proposed a phasing-in system, the costs associated with purchasing permits would obviously greatly impact the ability of European companies to compete with third-country companies, especially if the latter have no obligations regarding their carbon emissions. The ETS has a particularly harmful effect because Europe is specialised in relatively medium to high carbon intensive products. Therefore, Europe is more sensitive to a permit and trading carbon scheme (see Box 1). The cost of permits are however also self-defeating, as extra costs imposed by emissions trading will reduce and in some cases eliminate the pool of funds available to invest in emissions reducing technologies.

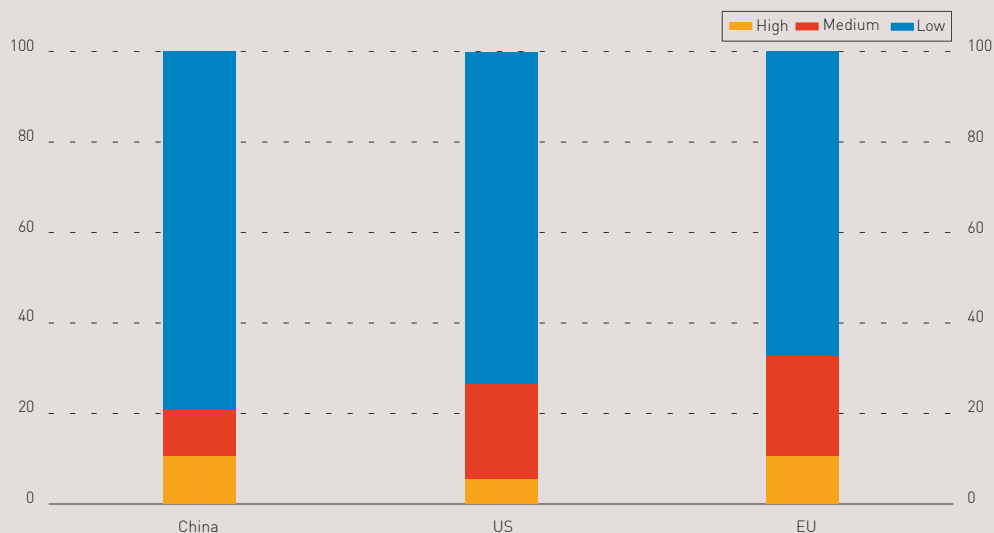
To **conclude**, if not pursued correctly, the energy and climate change package could represent a serious threat to the competitiveness of European industry, in particular for energy-intensive industries, which risk being strongly impacted both by the rise in electricity prices and by the obligation to buy CO₂ permits. In addition to the economic and social costs occasioned, the likely result of relocation of industries outside the EU would defeat its climate change objectives as no reduction to emissions takes place where there is carbon leakage.

Box 1

Carbon intensity of European exports

Source: Bruegel

Note: Carbon intensity: the EU's export mix contains a higher percentage of high carbon-intensity goods than the export mixes of China or the United States



A study by the think tank Bruegel⁵⁴ shows that contrary to common belief, Europe specialises in relatively medium to high carbon intensive products, compared with its main competitors. European exports comprise mainly chemicals, pharmacy, automotive and machine-tools, as well as metals (medium to highly carbon-intensive products). This carbon intensity has even increased in the past years as certain labour-intensive sectors such as textiles have seen their market share greatly diminish, due to competition from third countries such as China.

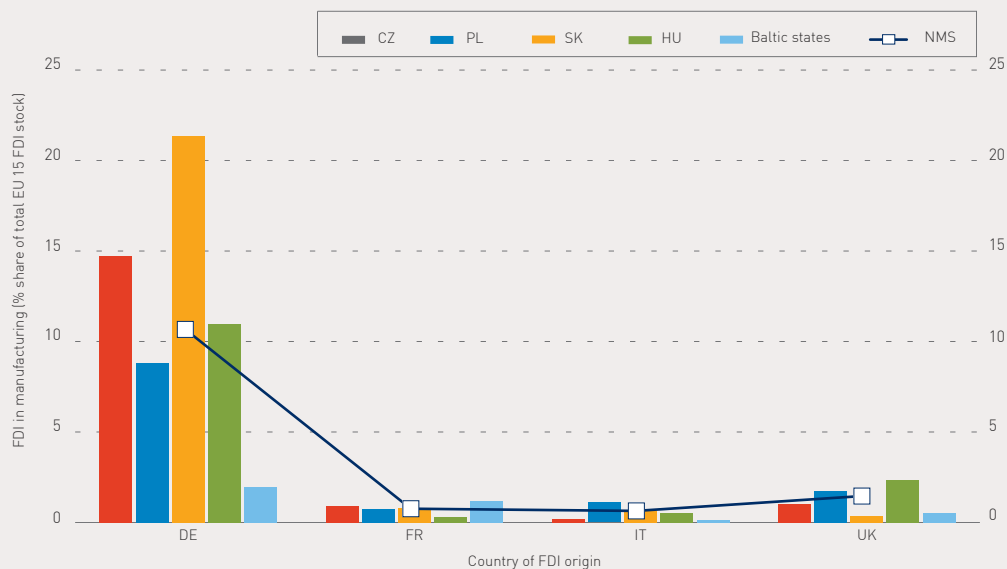
In this context, European exports are actually the most sensitive to a permit and trading carbon scheme. Even if a global agreement is reached the EU's main competitors would be less hurt by a legally binding emission trading scheme, considering their respective competitive advantage.

Enlargement: a positive story

As mentioned earlier, European producers have also invested in low cost producing areas as export bases, in particular in the new EU Member States, which has increased their cost-competitiveness. Germany has also greatly benefited from lower labour costs and economic growth in Central and Eastern Europe. Many German companies have invested in Central Europe where a large share of their supply chain is now located. As an important part of German products is then produced in low-cost countries, this reduces the final price of German products and gives them a competitive advantage. Another factor is that Slovakia is directly benefiting from the dynamism of German exports. As mentioned earlier, many German industrial firms have outsourced part of their supply chain to Eastern Europe, and to Slovakia in particular. Germany is today by far Slovakia's largest customer, making up 28% of its exports (in 2006)⁵⁵. Slovakia's export success story is therefore based on attracting foreign investments to build an export platform to the rest of Europe and to the world. It is a very different export model from Western Europe as Slovakia ranks fairly low in innovation comparisons (23rd in Europe according to the European Commission⁵⁶). Its export model is nonetheless very successful.

Chart 18
Foreign direct investments in new Member States

Source: Eurostat, BUSINESSEUROPE



2.3 Capacity constraints

A third response to the trends outlined in Chapter 2 is to see limitations in Europe's capacity to respond to the growth of world demand. In this light, even when Europe's exports are highly competitive on a cost basis companies are unable to fully respond to that stimulus due to capacity constraints.

Labour flexibility

Several problems within European labour markets amplify the pressure on Europe's export competitiveness and put at risk its ability to keep up with growing world trade. Productivity gains alone are not sufficient to offset this negative situation.

Chart 19

Employment rates and Lisbon targets

Source: Eurostat

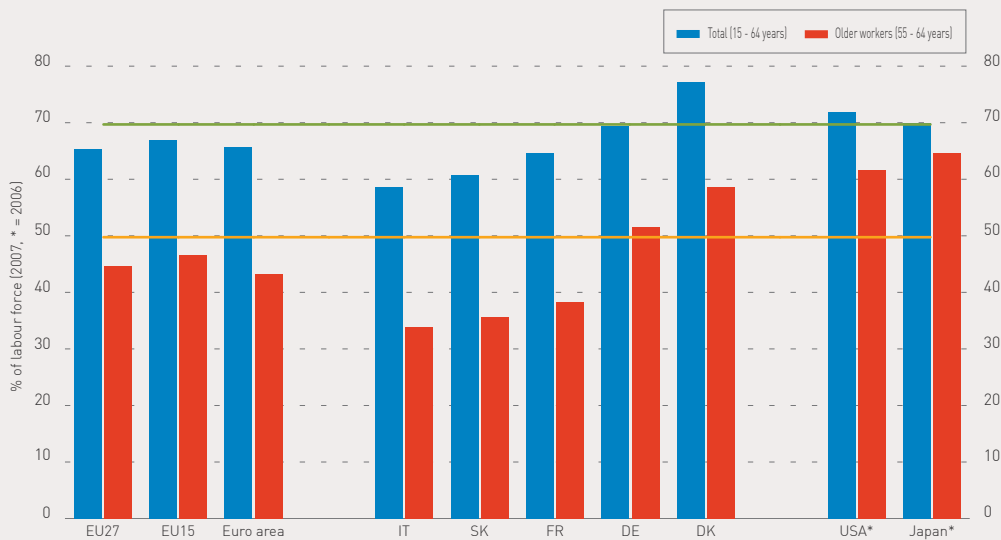
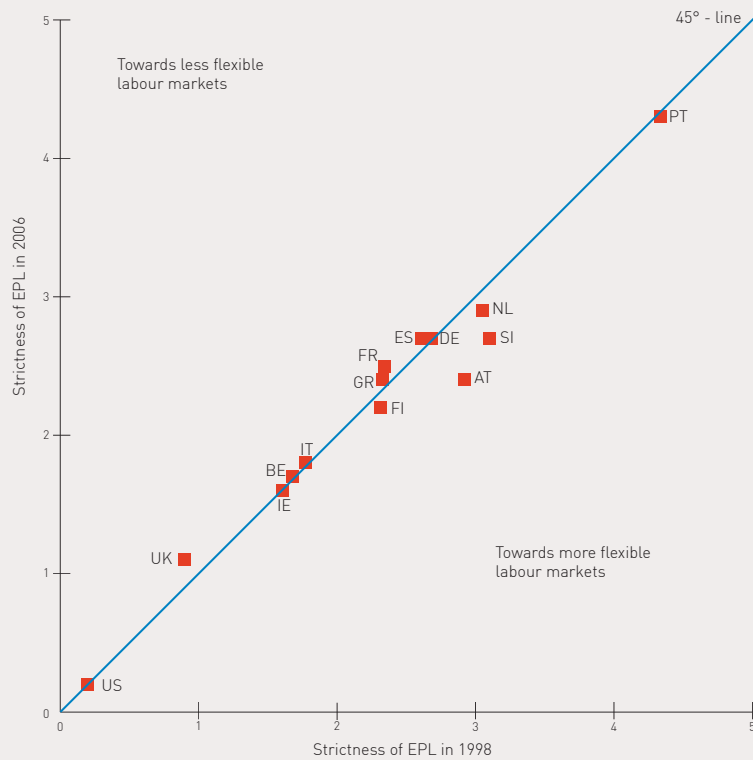


Chart 20

Labour markets remain restrictive in Europe

Source: OECD, European Commission



- For a majority of Member States, low employment rates prevent Europe from responding to the rise in world demand⁵⁷. The existence of early retirement schemes and unemployment rates that are still structurally high add to the problem.
- The average number of hours worked per year per worker is 1,600 in Europe: lower than in Japan (1,760) or the US (1,800)⁵⁸.
- Labour market laws remain too restrictive despite significant improvements in recent years. They hamper inter-sector labour movements and companies' faculty to match their labour force in accordance with specific needs. Furthermore, wage negotiations at national level instead of company or sector level infringe companies' room to manoeuvre⁵⁹.

Innovation

European Union companies' capacity to compete can also be hampered by problems in deploying innovative technologies and business models throughout their operations. There is a strong link between innovation and export competitiveness. Chapter 1 has highlighted the differences in export performance between Germany, France and Italy and notable differences in innovation levels exist between them. Germany is highly specialised in top of the range products (48.9% of its exports in 2003), while France (42.4%) and Italy (38.3%) lag further behind⁶⁰.

Several general economic studies⁶¹ confirm this specific data, showing that innovative firms and firms where R&D spending is higher than average export more, for three reasons: First, innovative firms tend to perform better and grow faster and are therefore more capable of dedicating resources to exports. Second, innovative products benefit from a competitive advantage based on quality – by definition an innovative product is in some way superior. Third, a firm's presence in international markets can stimulate innovation further by allowing it to access foreign technologies and through exposing it to different market needs as well as to increased pressure from competition. Innovation is thus a strong driver of export competitiveness.

It is unfortunate, therefore, that the European Union is facing difficulties with regard to innovation. One measure of innovation levels is the number of patents registered. By this measure, the EU is in fact far less well placed than its major traditional trading partners. In 2007, the EU registered 53 patents per million inhabitants, compared with 173 for the United States and 211 for Japan. Translated into the percentage of total patents registered, the EU captures 15.6% of world patents, compared with 17.6% for Japan and 34.7% for the US. The rise of emerging countries in patent applications (in particular China) is also remarkable, although their overall applications are still relatively small in absolute figures⁶².

Chart 21

R & D spending

Source: Eurostat, WIPO

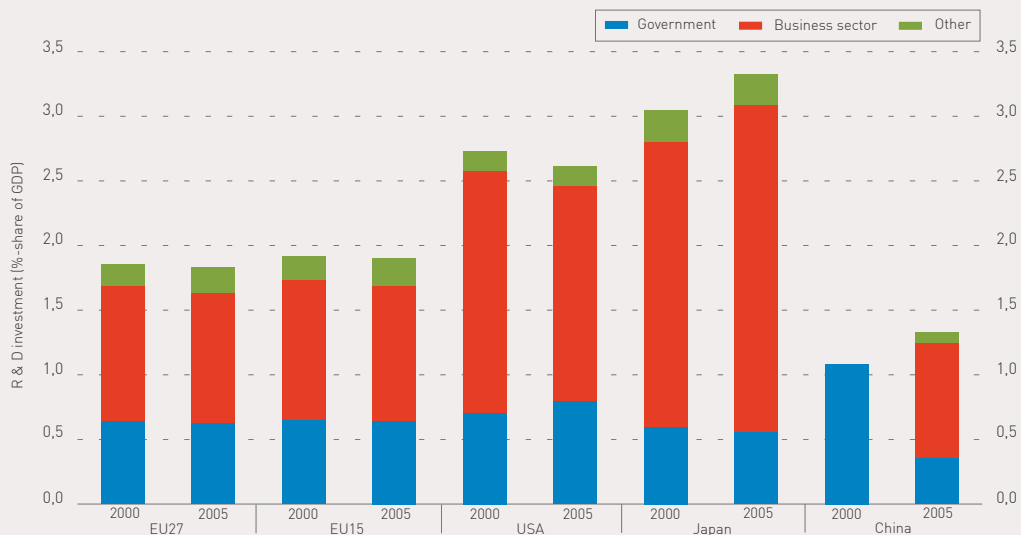
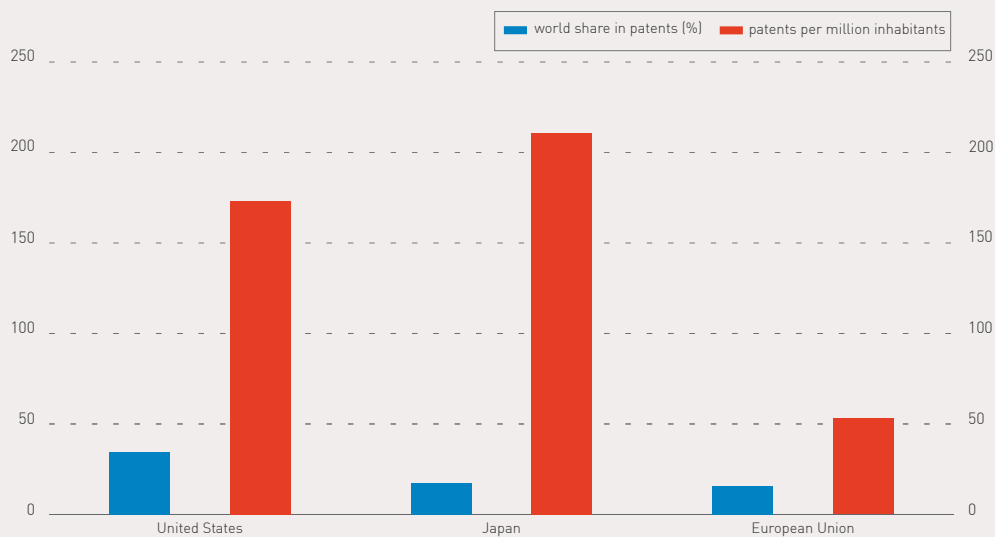


Chart 22

Patents registered

Source:



Although there is a wide range of factors determining innovation, three factors are considered in this chapter: research and development (R&D) spending; the patent system; and education policy.

Europe is faced with an immense challenge as **investment in R&D** remains insufficient relative to its competitors. Although the European Council in 2002 set out objectives to raise overall R&D investment to 3% of GDP by 2010, actual R&D spending has progressively diminished (1.84% of GDP in 2005, compared with 1.88% in 2001). In addition, large differences in R&D spending persist among the Member States: from 2% - 4% in Austria, Denmark, Finland and Germany to as little as 1.1% in Italy in 2005. This decrease in spending on R&D is all the more worrying as global competition gets stronger. The R&D intensity (R&D expenditure as % of GDP) of Europe's major traditional competitors is greater than its own: e.g. the United States (2.6%) and Japan (3.2%) in the same year⁶³. Newcomers, such as China or South Korea, are rapidly catching up with through technology transfer and investment in R&D and are progressively increasing the range and the technology level of their production.

The lack of a more efficient **patent system** has a negative impact on Europe's innovation capacity. First, the cost of innovation is greater in Europe compared with its main competitors due to translation costs for each patent, but also due to administrative and legal recognition costs. Second, the London agreement, which reduces costs for patenting, has yet to be adopted by several European states. Third, the absence of a common patent litigation system creates a source of legal uncertainty for companies. Fourth, there has been no progress on a Community Patent that fully meets users' needs in terms of costs, quality and legal certainty.

On **education**, an insufficient investment in higher education is leading to poor results in research and innovation. Investment in higher education represents around 1% of GDP for the EU-25. However, private finance in higher education is only 0.2% of GDP in Europe, compared to 1.8% in the US and 2.3% in South Korea. The OECD average is 0.9%, and even spending in EU countries with the greatest private involvement is far below the OECD average⁶⁴. Other reasons for limited funding of EU education is the lacking tradition of raising money from alumni and the limited tuition fees charged by EU universities.

As a result of these limited investments, EU universities are lagging behind in global rankings. In a 2008 ranking by Shanghai Jiao Tong University, the top-50 included only 9 universities from the European Union, compared to 39 from the United States. Europe is also faced with the problem of brain drain. Today, there are about 400,000 Europeans with scientific and technical education living in America. Nearly 10% of the 1.5 million people with a PhD in the US are EU students who moved across the Atlantic⁶⁵.

3. RECOMMENDATIONS

Europe's engagement with the outside world has long been founded on trade. The European Union itself is, in its most basic sense, a trading bloc. If today's policy makers wish to plot a course for the Union's future growth and prosperity, trade must play a major role. In Chapter two, we saw how a variety of factors were affecting the EU's ability to compete on world export markets, to do with the international environment, costs challenges and capacity constraints. In this Chapter, we make series of policy recommendations to address those challenges in order to allow the EU to compete effectively. The recommendations flow from the challenges faced by companies but are organized according to the appropriate level of decision making rather than by subject. They concern the EU's efforts in the international arena and in its domestic policy making. They also highlight the crucial role that Member States must play.

These recommendations should form the core of a new focused external dimension of a post-2010 Lisbon Strategy. The EU-level recommendations should be fed into the planning mechanisms of the Commission, Council and Parliament. Member States should have new planks of their National Reform Programmes listing actions to be taken to support external competitiveness.

3.1 EU recommendations

3.1.1 External Action

The changing international environment represents a serious challenge for European export competitiveness (rise of emerging economies, market access barriers and the burden of the falling dollar) but some of the challenges to costs (particularly on energy and climate) must also be addressed by external action.

Continue to implement the Global Europe strategy

BUSINESSEUROPE's core recommendation for external action must be to continue to implement the European Union's Global Europe strategy. Above all, Global Europe means keeping export competitiveness of European companies at the heart of EU's external action. The following actions must be taken to put that commitment into practice:

- 1 *Deliver new market access through existing trade negotiations.* Business strongly supports the conclusion of ambitious negotiations guaranteeing real market access in the Doha Round and in bilateral and regional free trade agreements. Chapter two of this survey pointed to the significant hurdles placed in the paths of European companies wishing to gain access to major emerging markets. The Doha Round should be a decisive step forward to address these barriers. If successful, the EU's negotiations with Korea, India and ASEAN, launched under Global Europe, will also take significant steps to make EU companies more competitive in these markets. Finally, the EU must conclude the longstanding free trade agreement negotiations with the Mercosur countries and the Gulf Cooperation Council on ambitious terms.
- 2 *Deepen the refocused Market Access Strategy.* The relaunched strategy seeks to deliver greater market access outside of trade negotiations by better coordinating Europe's formidable economic diplomacy resources at Commission, Member State and company level. It has begun to deliver its first results, in Brazil, Argentina and Kazakhstan for example, but must be strengthened through greater involvement of business, enhanced information sharing, and more engagement by Member State embassies in third countries.
- 3 *Continue to step up the EU's action towards China.* As we have seen, Europe is benefiting from China's growth through rising exports, but not as it could if more open market conditions prevailed there. The Commission has made progress since its October 2006 communication on China but more needs to be done.
 - Consider WTO dispute settlement action to enforce China's commitments to its trading partners. This is particularly important in the areas of intellectual property and restrictive trade measures where the present situation is far from satisfactory. It could also be considered in relation to tackling the use of prohibited export subsidies and the issue of non-provision of import certificates by local authorities.
 - Ensure that China grants real new market access in the WTO Doha Round commitments within a reasonable implementation period. China should also honour its commitment to open negotiations in 2008 on accession to the Government Procurement Agreement.
 - Develop a coordinated approach to technology transfer. Europe needs to be more aware of the medium term consequences of the large scale technology transfer through forced joint ventures and other mechanisms applying when EU companies invest in third countries. The EU should undertake an awareness raising campaign with companies.

- 4 *Reinforce action on regulatory barriers to trade.* As global tariff barriers are reduced, non-tariff measures become all the more important in creating prohibitive market entry costs for companies. The EU should continue to tackle non-tariff barriers through trade negotiations: The maximum must be achieved through the Doha Round but FTA negotiations are also important vehicles to tackle regulatory barriers. The Transatlantic Economic Council (TEC) is a promising instrument for dealing with this issues and its work should be further intensified in the coming years. BUSINESSEUROPE strongly values this approach and urges an extension of the model to other major partners such as Japan, through the creation of an EU-Japan Economic Partnership Council.
- 5 *Continue to fight distortions of trade and competition with regard to raw materials.* The promise of the Ukraine to lower its export duties subsequent to its WTO accession and to completely abolish them under a bilateral trade agreement with the EU is a notable success of the EU's policy in this field. The EU should continue its efforts:
- Aim at the removal of trade barriers and competition-distorting measures which affect access to raw materials in particular;
 - Work towards achieving a ban on export restrictions and improved regulations against subsidies at WTO level;
 - Initiate action at the WTO level against countries whose infringements of their WTO commitments affect fair access to raw materials;
 - Integrate specific provisions on raw materials into its Generalised System of Preferences (GSP). Countries which impose or maintain export restrictions or other trade distorting practices on raw materials or other trade distorting practices should be excluded from GSP benefits until their withdrawals;
 - Liberalise the EU trade regime with respect to certain agricultural products which are used as industrial inputs by a range of European manufacturers (e.g. bioethanol).

BUSINESSEUROPE recommends:

- Maintain the competitiveness focus in international trade policy: Continue Global Europe;
- Achieve real new market access for European companies through current multilateral and bilateral trade negotiations;
- Enhance the EU's Market Access Strategy, particularly through company and Member State involvement;
- Take a robust stance towards China on IPR, public procurement, market access barriers, subsidies and export restrictions;
- Continue to fight distortions of trade and competition with regard to raw materials;
- Enhance our regulatory cooperation efforts with the United States and other major partners through use of instruments such as TEC.

Build on Global Europe

In a number of areas the EU can move beyond its current approach:

- 1 *Take a closer look at FTAs with developed country partners.* Despite the relative importance of regulatory barriers with major partners such as the US consideration should also be given to addressing the tariff issues which can only be dealt within an FTA.

A free trade agreement might help to secure the EU's position within the market of its largest trading partner – the United States. The US absorbs 23.3% of European exports and the EU accounts for 17% of US exports. Europe also enjoys a comfortable trade surplus with the US (€90 billion in 2006). The tariffs between the two areas are relatively low, but there remain some tariff peaks and the volume of trade makes even the low tariffs significant. Furthermore, the

EU's position in the US is under pressure from emerging economies, and there is a risk of rising protectionism as the American trade deficit widens. A similar approach should be considered for countries such as Canada, with whom the EU has a trade surplus of €7 billion.

- 2 *The EU should modify the Trade Barriers Regulation (TBR) to encourage a more robust approach to WTO Dispute Resolution.* The great benefit of the multilateral trading system is that it provides a system of rules to govern international commerce. Where our trading partners do not respect these rules, the European Union should not shy away in using the enforcement mechanisms of the WTO. However, the EU has rarely made full use of this process. One way to improve the situation could be to make changes to the Trade Barriers Regulation (TBR) that would create a stronger obligation on the European Commission to launch action through the WTO if unfair trading practices are established. Such an approach would also increase uptake of the TBR mechanism.
- 3 *Promote a more equal burden sharing in light of exchange rate volatility.* BUSINESSEUROPE has no intention of blaming economic weakness in certain Member States on a strong euro. Yet, as we have seen in Chapter two there are anxieties in several key industrial sectors. The appropriate response from a European perspective will involve action at Member State level (see below) but also at EU level. In particular the EU must better coordinate positions among Member States and ensure a strong role of the Eurogroup president at the international level, in full respect of the Treaty provisions and of the ECB's independence. It must also engage in sincere dialogue with global partners – emerging economies in particular – in order to work towards higher exchange rate flexibility. Indeed, emerging economies with high growth rates, soaring inflation and realistic risks of overheating need to understand that flexible exchange rate regimes are in their best domestic interest and essential to guarantee global economic stability and sustainable growth rates.
- 4 *Develop a coherent strategy on raw materials.* EU business needs undistorted, non-discriminatory and stable access to raw materials. The EU should build an effective and comprehensive EU raw materials policy which takes into account the broad range of raw materials used by industrial sectors, i.e. metals, agriculture products, forestry products as well as secondary raw materials. The strategy should include trade policy, external relations, development cooperation, environment, health and safety, competition as well as research and innovation policies. The integrated approach should take greater account of the requirement of access to location-bound raw materials within the framework of environmental legislation; act internationally as outlined above; improve the framework conditions for the use of secondary raw materials by ensuring harmonized and sound implementation of the Waste Shipment Regulation across Member States as well as ensuring effective control on shipments in order to combat illegal exports.

BUSINESSEUROPE recommends:

- Consider closely new trade negotiations to secure market access in OECD countries.
- Modify the Trade Barriers Regulation to allow for more WTO cases to level the playing field.
- Take action to ensure better burden sharing on the falling dollar with emerging economies.
- Develop a coherent strategy on raw materials including all relevant fields of policy.

Ensure fair sharing of burdens in international climate negotiations

Climate change is a global challenge that requires a global solution. The potential cost impacts of the climate change initiatives adopted by the European Union will have a dramatic effect on European competitiveness on export markets should the EU move forward alone. Business is part of the solution to climate change; it can make the investments necessary to help provide technologies, products and services to meet society's needs. To continue EU development in a sustainable manner it is vital that EU business remains viable and competitive in line with the goal of the Lisbon strategy.

BUSINESSEUROPE recommends:

1. Negotiate a comprehensive, global, transparent, stable, regulatory framework for the post-2012 regime in the context of the UN Framework Convention on Climate Change.

3.2.2 Internal Action

The core conclusion of this survey is the fact that Europe's competitiveness on world export markets is intimately linked to Europe's domestic policy environment. The EU will only adapt to the changing international environment with support at home. While the Global Europe Strategy does make reference to this fact, BUSINESSEUROPE believes that the post-2010 framework for the Lisbon objectives should make this fact considerably more explicit. The export dimension must be borne in mind so that EU policymakers take action in a number of areas:

Complete the internal market

Completing the integration of EU's internal market would represent a huge boost to the relative competitiveness of European companies on international markets. BUSINESSEUROPE recommends the following steps, which would bring the EU much closer to a real single market:

- 1 *Implement correctly both the Services Directive of 2006 and the New Internal Market Package for Goods, launched by the Commission in February 2007.* The latter contains a series of essential measures on market surveillance, mutual recognition and accreditation.
- 2 *Abolish discrimination in public procurement markets.*
- 3 *Put in place a European Private Company Statute to facilitate cross-border expansion.*
- 4 *Remove double taxation and facilitate tax compliance across the EU.* This should be done through greater harmonisation of indirect tax systems, a common approach to corporate taxation and adoption of proposals to remove tax based obstacles to free movement.
- 5 *Create real European infrastructure networks.* More investment is needed to complete Trans-European Networks and other infrastructure projects. The EU must also complete the liberalization of electricity and gas networks.
- 6 *Create a genuine internal market for electronic communications.*

BUSINESSEUROPE recommends:

- Implement the Services Directive and the new Internal Market goods package.
- Ensure equal treatment for all on public procurement markets.
- Establish European Private Company Statute.
- Remove double taxation and facilitate trans-EU tax compliance.
- Develop real European infrastructure networks through the Trans-European Networks programme and liberalisation of energy provision.
- Create a genuine internal market for electronic communications.

Bring greater competitiveness focus to EU policies such as climate change

It is vital that European policies keep competitiveness at their core and not let it be outweighed by social or environmental arguments in the policy making process:

- 1 *Enhance the EU's impact assessment procedures.* The development of the Better Regulation Agenda and the impact assessment procedure under the current Commission has made considerable strides towards ensuring that competitiveness on both the domestic EU market and internationally is taken fully into account. However, in many new policy proposals it is clear that more weight needs to be given to competitiveness aspects.

- 2 *Europe's energy and climate change policy is a specific example of this trend and must be adapted to be compatible with securing the future of European industry.* The current proposals are set to raise energy prices and put levies on carbon emitting industries, without securing commitments for similar action from our major rivals in international markets. This policy threatens the competitiveness of many sectors, in particular steel, aluminium and chemicals and automobiles to a lesser extent. There is a real risk that an energy and climate change policy which does not take fully into account the competitiveness issue may severely harm Europe's industries and jobs by seriously undermining competitiveness of vital economic sectors.

BUSINESSEUROPE recommends:

- Enhance the weight given to competitiveness effects in impact assessments on future EU policies.
- Resolve the challenges to companies posed by current energy and climate proposals, without creating unnecessary and detrimental trade restrictions.

Invest in innovation

The European Union can take three important steps to improve its innovative capacity:

- 1 *Refocus the EU budget towards innovation.* The deficit in research and development funding will not be made up from the EU budget but the budget should be more focused on these questions. Whereas the rapid hike in agricultural prices and the cost of food is a concern for citizens in Europe and around the world, it is time to engage in a thorough reform of the Common Agricultural Policy. Modernisation of the Common Agricultural Policy should in future also make it possible for the European budget to be a more effective instrument in a strategy for growth and innovation.
- 2 *Create a unified and comprehensive European patent system.* Reforms to the patent system in Europe remain to be implemented. The London agreement, which reduces costs for patenting should be adopted by more European states. The absence of a common patent litigation system for Europe is a source of legal uncertainty for companies. Substantive progress on a Community Patent, fully meeting users' needs in terms of costs, quality and legal certainty is needed.
- 3 *Create the framework for Member State reform for an innovation-friendly education system.* The roadmap suggested in the Commission communication⁶⁶ on innovation rightly emphasizes the need to improve the education system to encourage innovation. EU action is necessary in the areas of lifelong learning, exchange of best practices for university reform, student and academic mobility, and its own funding through the European Social Fund.

BUSINESSEUROPE recommends:

- Refocus the EU budget towards innovation.
- Create a unified and comprehensive European patent system.
- Create the framework for Member State reform for an innovation-friendly education system.

3.2 Member State recommendations

The analysis in Chapter two makes it clear that the challenges for European export competitiveness cannot be addressed at EU-level alone. Member States have an important role to play. BUSINESSEUROPE believes that Member States National Reform Programmes under the renewed Lisbon Strategy need a greater focus on export competitiveness. This means that consideration of exports is given in Member States own regulatory measures and in their efforts to manage wage costs, increase employment rates and productivity, and invest in research, development and education.

Place competitiveness at the heart of Member State regulatory policy making

While a significant proportion of the regulatory measures that affect companies are produced at European level, Member States are also responsible for certain areas. These issues have an impact on European companies' competitiveness and thus the export dimension needs to be better taken into account at national level. BUSINESSEUROPE urges Member States to give competitiveness an appropriate weight in their decision making, in particular through the development of better regulation programmes and for impact assessment and simplification.

BUSINESSEUROPE Recommends:

- Develop meaningful Member State Better Regulation programmes that take export competitiveness fully into account.

Manage labour costs, increase employment rates and productivity

The impact of the falling dollar, the cost challenge generally for EU companies and the capacity limitations imposed on Europe by low employment rates mean that labour market action at Member State level will be crucial to guaranteeing Europe's export market share.

BUSINESSEUROPE recommends:

- Use wage moderation and encourage/boost productivity growth.
- Create more flexible labour markets based on the flexicurity model.
- Promote employability of citizens through education and training.

Invest in innovation

Member States have a crucial role to play in developing Europe's innovation capacity. A series of measures will be needed – greater public investment in R&D, measures to facilitate private R&D and comprehensive action on education.

BUSINESSEUROPE recommends:

- Increase Member States public spending on R&D to meet their Lisbon targets.
- Create tax incentives to encourage private R&D investment and encourage company participation in publicly funded research.
- Take comprehensive action on education for innovation:
 - Reform education systems to provide young people with the knowledge, skills, values and attitudes necessary to be innovative and entrepreneurial throughout their working lives.
 - Modernise universities to ensure better supply of relevant skills in the labour market and ensure provision of vocational training.
 - Step up efforts to increase take up of scientific and technical studies by young women and young men.

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ENDNOTES

- ¹ Except where otherwise indicated, the data on overall and sectoral market share is sourced from the BACI database, compiled by the Centre d'Études Prospectives et d'Informations Internationales (CEPII) from the UN COMTRADE database. CEPII processes the raw trade data to reconcile differences between countries' reporting methods. These figures exclude statistics on fuel exports to take account for the fact that, due to the dramatic rise in the oil price fuel has moved from accounting for 10% of the value world exports in 2003 to 15% in 2006. The latest data available is for 2005. Where other sources are used and more recent data is available, those statistics are used.
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BUSINESSEUROPE

MEMBERS ARE 40 LEADING NATIONAL BUSINESS FEDERATIONS IN 34 EUROPEAN COUNTRIES

 Austria	 Belgium	 Bulgaria	 Croatia	 Cyprus	 Czech Republic
 Denmark	 Denmark	 Estonia	 Finland	 France	 Germany
 Germany	 Greece	 Hungary	 Iceland	 Iceland	 Ireland
 Italy	 Latvia	 Lithuania	 Luxembourg	 Malta	 Montenegro
 Norway	 Poland	 Portugal	 Portugal	 Rep. of San Marino	 Romania
 Slovak Republic	 Slovenia	 Spain	 Sweden	 Switzerland	 Switzerland
 The Netherlands	 Turkey	 Turkey	 United Kingdom		