BUSINESSEUROPE

20th Macro-economic Dialogue at Technical level

20 January 2009

I. The economic situation

The series of recent data and in particular the Commission's interim forecasts confirm the depth of the crisis.

- The Commission forecasts for 2009 a contraction of real GDP by 1.8% in the EU27 and by 1.9% in the euro area.
- In December, EU27 business confidence has hit the lowest level since 1985.
- Industrial production is contracting at the fastest pace since early 1993, with a year on year decline of 7.7% registered in November 2008 (industrial production excl. construction and energy).
- Unemployment in Europe is rising at the fastest pace since 1993. Following a fall in the number of unemployed by 300.000, the current Commission forecasts suggest an increase in the number of unemployed close to 4 million in 2009.
- After a EU27 job creation of 4 million in 2007 and 2 million in 2008, close to 3.5 million jobs will be lost in 2009 according to the latest Commission forecasts.

The current state of economic paralysis and the negative economic spiral is a direct consequence of the financial turmoil and reflects in particular a dramatic shortage of financing and heightened risk averseness. All traditional channels of corporate financing are currently being affected:

- The ECB Bank Lending Survey confirms a rapid tightening of credit standards. At present, large corporations seem to be slightly more affected than SMEs or households.
- The persistent stress on financial markets and the risk averseness of investors makes raising financing on bond- or stock markets almost impossible. Spreads of BBB company debt above government bonds remain extremely high. Bond issues with BBB ratings and 5 to 7 years maturity currently need to offer a yield of around 8%. Stock market capitalisation has almost halved since August 2007, losing close to 5,000bn euro.

The considerable drop in oil prices over the last six months means that inflation in the euro area will continue its downward trend from the latest estimate of 1.6% in December 2008 to close to zero by mid year. While this will provide significant support to purchasing power and will reduce companies' costs, there is non-negligible risk that a sharp recession will transform this temporary drop in inflation into more persistent deflationary pressures. The Commission forecasts average euro area headline inflation not to exceed 1.0% this year.

- Outright deflation would have dramatic negative repercussions by heightening debt related difficulties, be it for governments, companies' or households.

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- However, in the longer term, macroeconomic stimulus measures will need to be unwound in a timely manner to avoid rapidly rising inflation pressures once the recovery takes hold.

II. Appropriate policy responses

Important initiatives have already been taken by governments and central banks to address the more immediate concerns:

- Interest rates set by central banks have been slashed to very low levels, and liquidity interventions broadened considerably. BUSINESSEUROPE welcomed the ECB's decision to cut interest rates further to 2%. Against the recent series of very weak economic data and with further evidence of falling inflation, it is important that the ECB maintains its pragmatic and pro-active attitude and will provide further monetary stimulus to the economy if deemed necessary.
- Bank rescue plans in the euro area were accorded for a total amount of almost 2000bn EUR, of which 1700bn in guarantees and 300bn in capital injections. In the EU as a whole, rescue plans amount to more than 2500bn Euros, of which 370bn in capital injections.
- European heads of states agreed on an EU recovery plan amounting to 200bn euro at their December Summit, made of 170bn in national measures and 30bn from EU financial resources.

But challenges remain immense, and despite common intentions, European member states still fail to show a strong commitment to coordination. BUSINESSEUROPE therefore advocates action along the following lines:

a) Reduce level of financial stress

Member states:

- The scope and size of bank rescue plans has been impressive, but their effectiveness varies. The recapitalisation process remains incomplete and interbank guarantees are fragmented and insufficient to restore confidence in the banking sector. A significantly higher degree of coordination among member states is of the essence.
- Te business community also strongly encourages public guarantees and risk sharing facilities to support lending to companies, keeping in mind the need to maintain a level playing field on the internal market

ECB

- While the ECB will need to continue to cut interest rates, and should also broaden its actions to ensure an effective transmission to financing conditions for companies and households. The ECB could take a more prominent role in restoring interbank lending by becoming a "clearing house" for the interbank market. Businesses appreciate that ECB vice-president Papademos recently communicated that such option was "potentially applicable"
- BUSINESSEUROPE is also reflecting at present on the suitability of more radical measures if normal conditions to finance economic activity cannot be

restored rapidly, e.g. the direct purchase of long term government bonds, commercial paper and other corporate instruments by the ECB and other European central banks. Such increased demand for bonds – in particular for the segment up to 5 years – would help to bring down yields and thus ease companies financing costs significantly.
- In this respect companies are wondering in how far the ECB might be disposed to adopt such a form of quantitative easing and what technical arguments might inhibit it.

EU institutions
- Finally, EU policy makers must bear in mind the situation of new member states which are severely affected by the crisis but have limited financial resources to rescue their economies. The EU must stand ready to help them financially and make sure that more mature economies are mindful of the effects of their rescue measures and guarantees for new member states.

b) Implement recovery plans
- According to BUSINESSEUROPE's calculations, national recovery plans in the EU for 2009 amount to 140 bn euro or 1.1% of GDP, compared with 170bn has committed by Heads of states at the December European Council.
- It is strongly appreciated that after some hesitation also Germany has signalled its intention to implement a more substantial national rescue package. For the credibility and impact of the EU's recovery plan it was absolutely critical that Germany committed to more ambitious actions.

Member states and EU institutions
- It is also important that governments, as Germany just did with its plan to prohibit deficits in excess of 0.5% of GDP in "normal times", take measures showing their commitment to restore sound budgetary positions after the peak of the turmoil has passed.
- This is a condition for the effectiveness of the recovery measures. Otherwise, concerns about rising public debt will dominate, which will crowd out the effect on consumption and business investment (i.e. higher long term interest rates, expectations of higher taxes in the future). Indeed, sovereign bond spreads have widened across the euro area over recent weeks and the rating of Italian, Greece and Spanish debt has already been downgraded. This emphasises that markets start to question the solvability of governments.
- In this respect, the Commission will have to
  - adopt a suitable strategy as regards the application of the Stability and Growth Pact. A new discussion on its usefulness and demands for reforms are definitely not welcome.
  - make concrete suggestions – in the context of annual stability and convergence reports – how member states should return to balanced budgets in the medium term. In this respect, raising taxes would definitely send the wrong message.
  - start reflections about appropriate replies for the – until now – hypothetical case of a euro area member state default.

- At EU wide level, businesses regret that some member states appear reluctant to agree on the use of 5bn euro of unspent CAP funds for investments in broad-band internet infrastructure and energy interconnections. While the commission should provide sufficient details about the nature of the investment projects, we consider that these are in principle "smart" infrastructure projects that should receive the backing of member states.

c) Speed up reforms

- The current situation must serve as a catalyst for structural reforms, in particular to increase the long term sustainability of public finances, boost skills and innovation.
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- Social security reforms, such as the extension of retirement age, should be considered as a necessary complement to the short term fiscal stimulus measures.
- Improving skills by investing in education and training is also vital. Flexicurity principles also need to be implemented urgently in order to avoid lasting negative repercussions of the crisis on employment.
- Of course, this does not mean the flexibility to merely lay off workers, but rather think about more flexibility in the system. Three aspects come to mind:

    - <u>Allow for more flexibility in working time</u>. This can take various forms, but two examples might offer interesting lines of thought

      Netherlands: As part of the national recovery plan, a fund has been created in order to pay for redundant employees' training and schooling programmes

      Austria: Social partners discuss the creation of "negative time accounts" – analogous to the existing time accounts on which employees credit their extra hours. The idea is that employees will be able to work less in periods of slow growth – i.e. accumulate negative hours – and equilibrate their accounts with extra hours once economic activity accelerates. If sufficiently funded and with the help of government guarantees, such a system could avoid layoffs.

    - <u>Reduce non-wage labour costs</u>
      In order to improve companies' incentives to hire workers once the crisis has abated, it is important to reduce non-wage costs. Several recovery packages (e.g. Germany) already include specific measures to reduce social security contributions.

    - <u>Focus on training</u>
      The next economic upswing will only be sustainable if companies can rely on a sufficiently qualified work force. Therefore it is crucial that

companies and governments invest in people and use periods of lower activity for training of their workforces.

- These measures also need to be placed in a bigger context. The economic recovery is unthinkable without further product market reforms or stimulating SMEs and entrepreneurship across Europe. Putting substance to the “Think Small First Principle” is therefore crucial. 2008 has been the year of adopting the Small Business Act, 2009 must be the year of implementation.

d) Resist all forms of protectionism

- As protectionist measures are increasingly adopted around the world, BUSINESSEUROPE will press for a comprehensive EU strategy to contain, and if possible reverse, protectionism. At the EU level, BUSINESSEUROPE will encourage the Commission to intervene bilaterally with trade partners whenever they introduce a protectionist measure.

- At the bilateral level, BUSINESSEUROPE will press for the rapid conclusion of ambitious trade agreements under negotiation and for the resumption of the Transatlantic Economic Council to prevent regulatory divergence with the US. At the multilateral level, in addition to pressing for the resumption of Doha negotiations, BUSINESSEUROPE will explore the possibilities for a WTO Standstill Agreement which would require members to refrain from introducing new protectionist measures until the Doha Round is concluded. BUSINESSEUROPE will also examine possibilities for early harvest agreements along sectoral lines to demonstrate that trade liberalisation is possible and beneficial.