BUSINESSEUROPE

Economic Outlook
June 2010

GO FOR GROWTH
AN AGENDA FOR THE EU IN 2010-2014

RECOVERY CONSOLIDATING DESPITE UNCERTAINTY

- BUSINESSEUROPE predicts real GDP growth in the EU to reach 1.1% this year and 1.6% in 2011.
- The European economy has continued to show signs of recovery during the first half of 2010, supported in particular by a revival in global trade and industrial activity.
- The ripple effect of the sovereign debt crisis is an important source of uncertainty at present, but is not expected to derail the recovery in our baseline scenario.
- Exports are a key support factor in the upturn, growing by more than 5% this year and next. A weakening euro is providing additional support for European exports, but this is counterbalanced by a loss of confidence and higher risk premia.
- Unemployment in the EU as a whole is expected to stabilise just below 10% in coming months, and job creation to resume in the later part of 2011.
- Conditions are not yet in place for a revival in business investment, although a return to moderate growth is expected next year. Access to finance and low capacity utilisation are the main restraints at present, with 82% and 74% of respondents mentioning them as negative factors affecting investment decisions.
- Countries that have accumulated severe imbalances in the past will continue to suffer longer-lasting consequences of the crisis this year and next.
- Compared with other parts of the world, rigidities in both labour and product markets and greater obstacles to entrepreneurship and market innovation will weigh on the strength of the upturn in Europe.

POLICY CONSIDERATIONS

- Companies identify the situation of public finances as a major concern, with 92% of respondents mentioning it as a major downside risk to growth.
- The massive stabilisation programme agreed for the euro area in early May is welcome but is only buying time to address structural challenges and governance failures.
- Smart consolidation will have to combine both exit strategies to cap public indebtedness with entry strategies to support growth and job creation.
- Euro-area governance will have to be significantly reinforced in the future, tightening surveillance and enforcement mechanisms, including through a system of gradual penalties.
- The European business community commends the role of central banks in this crisis, and in particular that of the ECB. Its independence is an essential pillar of the institutional framework of the European Monetary Union.

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Table 1: BUSINESSEUROPE forecasts

Main variables	EU27		Euro area	
	2010	2011	2010	2011
Real GDP (annual % growth)	1.1	1.6	1.0	1.3
Inflation (%)	1.6	1.6	1.3	1.4
Unemployment (%)	9.8	9.9	10.4	10.6
Employment (%)	-1.0	-0.1	-1.2	-0.3
Net government lending (% of GDP)	-7.1	-5.9	-6.4	-5.4
Gross public debt (% of GDP)	79.1	82.0	84.0	86.7

GDP components	EU27		Euro area	
	2010	2011	2010	2011
Private consumption (%)	0,4	1,1	0,4	0,7
Public consumption (%)	0,7	0,2	0,7	0,5
Private non-residential investment (%)	-1,6	2,6	-0,5	1,8
Private residential investment	-3,4	1,8	-5,2	0,7
Public investment	1,6	-0,8	0,8	2,0
Gross fixed Capital formation	-2,2	1,5	-3,0	1,1
Exports (%)	5,6	5,4	5,6	5,1
Imports (%)	3,9	4,3	3,3	3,8

Source: BUSINESSEUROPE Economic Outlook, June 2010

Table 2: Forecast largest EU Member States

	Real GDP Growth (% change)		Unemployment (%)		Private non-res. investment (% change)		Exports (% change)		Government Position (as % of GDP)	
	2010	2011	2010	2011	2010	2011	2010	2011	2010	2011
Germany	1.8	1.4	7.6	7.8	0.4	0.7	8.0	6.3	-4.9	-4.2
United Kingdom	1.0	2.5	8.5	8.3	2.4	4.6	4.7	6.2	-12.1	-9.8
France	1.7	1.4	9.9	10.0	-3.5	1.7	4.5	5.0	-7.8	-6.9
Italy *(c)*	*(c)*	*(c)*	*(c)*	*(c)*	*(c)*	*(c)*	*(c)*	*(c)*	*(c)*	*(c)*
Spain	-0.8	0.3	19.4	19.8	-16.0	-6.7	4.5	6.4	-10.7	-9.4
Netherlands	1.5	2.0	6.5	6.5	-7.0	5.3	8.3	5.3	-6.3	-4.9
Poland	3.2	3.8	8.6	8.0	4.0	6.0	8.0	10.0	-6.6	-6.0
Belgium (*)	1.2	1.4	9.0	9.0(*)	-1.9	2.1(*)	3.0	4.3(*)	-5.4	-5.0(*)
Sweden	3.1	2.7	9.2	8.6	-3.2	6.1	11.0	5.0	-2.1	-1.0
Austria	1.5	1.7	5.3	5.5	1.0	3.0	5.7	5.4	-4.5	-4.0

(*) Data for Belgium in 2011 refer to the European Commission 2010 Spring Forecast, except for Real GDP growth
(c) Data for Italy is confidential
Source: BUSINESSEUROPE Economic Outlook, June 2010; European Commission 2010 Spring Forecast

ECONOMIC SITUATION

1.1. The recovery is still consolidating despite growing uncertainty

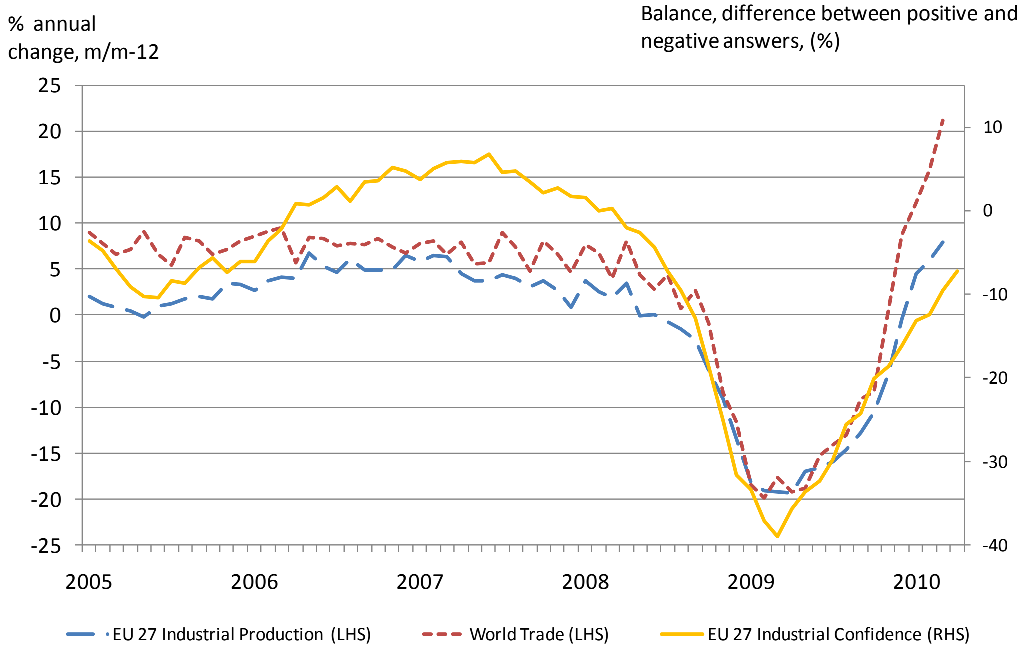
We forecast real GDP growth in 2010 to reach 1.1% for the EU and 1.0% for the euro area. This represents a slight downward revision from our February forecasts, mainly stemming from a weaker outlook for investment.

However, real GDP growth in 2011 is expected to strengthen somewhat to 1.6% for the EU, and 1.3% for the euro area, as an export-led recovery percolates through the domestic economy.

At the end of the first quarter, industrial production in the EU 27 was already up 8% compared with its level a year earlier. This significant upturn was mainly driven by a resurgence in global trade, which expanded over the same period by 21%, its fastest annual growth rate on record. However, industrial production level in Europe is still 13% below its peak of early 2008.

In this context, confidence in industry has gained significant momentum, although increasing less than the recent trend in industrial production would suggest. This highlights caution on side of companies as an exceptional degree of uncertainty still characterises the current environment (Figure 1).

Figure 1: The recovery is led by exports and industrial activity



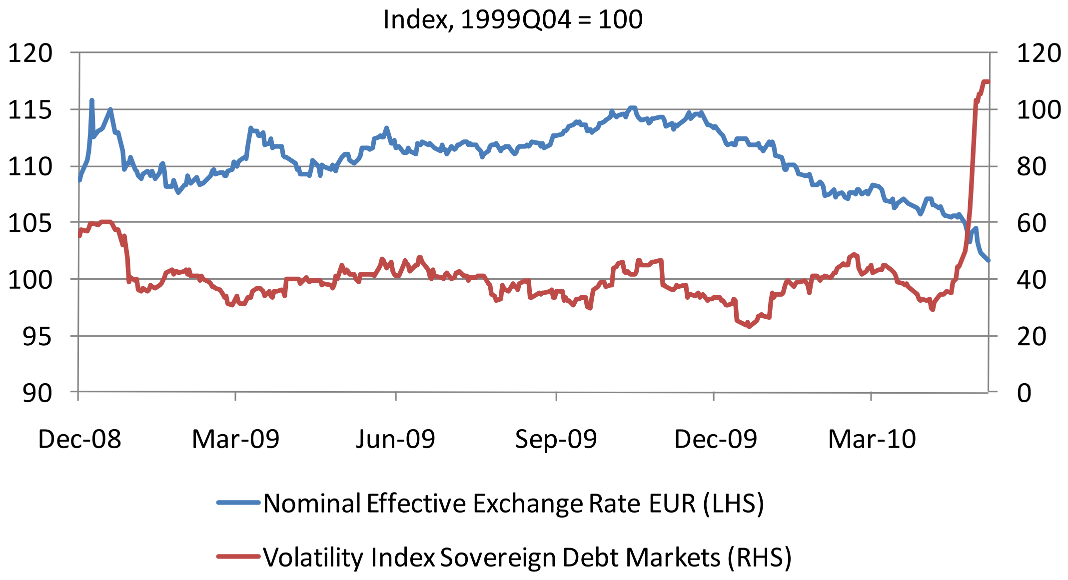
Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

This uncertainty has been recently accentuated by renewed instability in financial markets linked to growing concerns about fiscal sustainability in a number of European countries. This uncertainty is undermining confidence in the European economy.

As a consequence, volatility and risk premia on capital markets have increased, and the euro has experienced a sudden depreciation (Figure 2).

Although a weaker euro may result in increased export performance, our assessment is that the negative effects arising from financial instability and exchange rate volatility more than offset the potential gains.

Figure 2: Nominal effective exchange rate of the euro and volatility on sovereign debt markets



Source: BUSINESSEUROPE (June Economic Outlook), Eurostat, Markit

Bold actions were decided by European and international institutions in early May to address risks of a sovereign debt crisis in the euro area running out of control. This has demonstrated solidarity with most affected countries and a strong commitment to the euro.

But it has not yet restored confidence and has only bought some time to undertake significant reforms in order to effectively and credibly restore fiscal sustainability without hampering the recovery.

Our policy recommendations in this area are detailed in the second part of the report.

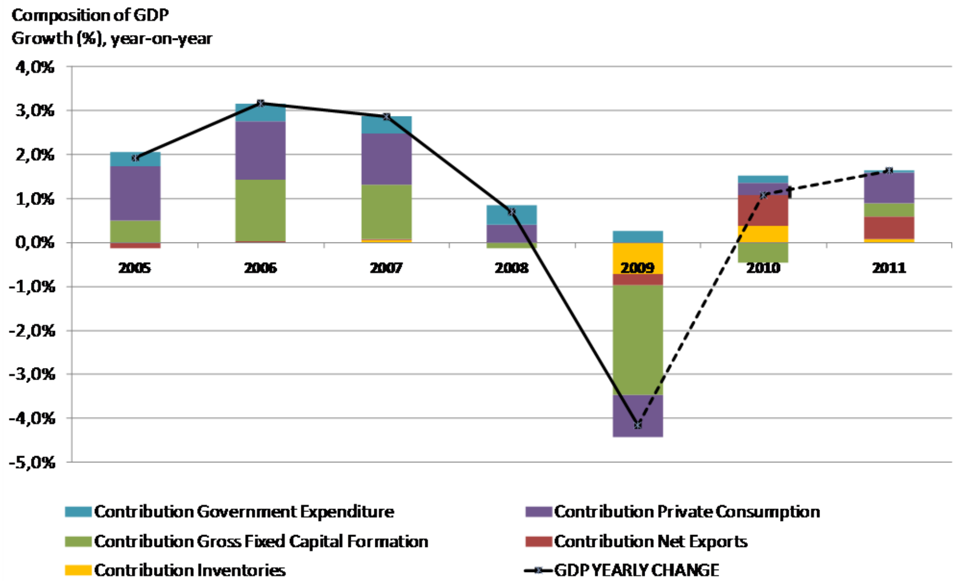
1.2. Exports as the main driver in this recovery

At present, exports are the main contributing factor supporting growth on our continent. This reflects to a large part the revival of global trade, following its collapse in 2009. Exports are expected to grow by more than 5% in 2010 and 2011, supported by a continued upswing in global demand and the additional, but transitory, impetus from a weakening euro.

Overall, BUSINESSEUROPE expects net exports to contribute by 0.7% to real GDP growth in 2010 and 0.4% in 2011 (Figure 3). However, exports have a greater impact on economic activity that these figures suggest. They stimulate intermediate consumption and activity in highly productive, competitive and capital-intensive sectors, and have large spillover effects on the entire supply chains. This is supporting higher income and job creation throughout the economy, and helps strengthen domestic activity.

Global competiveness will be an essential pillar of a successful growth strategy for Europe and a necessary condition for a return to sustainable job creation and sound public finances.

Figure 3: Composition of GDP growth



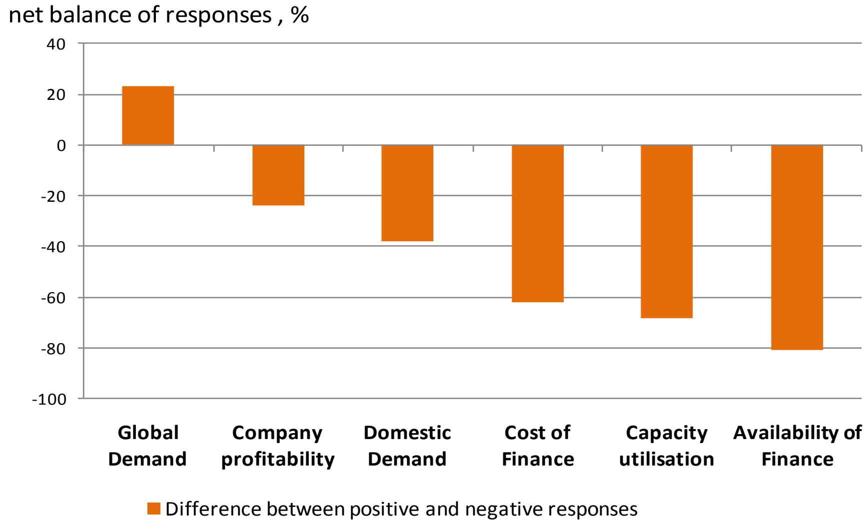
Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

1.3. Investments continue to be a drag on growth

Access and cost of finance continue to severely affect investment decisions by companies. Respondents from BUSINESSEUROPE members representing more than 80% of EU's business activity identify these two factors as being a major drag on capital spending at present (Figure 4).

A weakened banking sector and renewed instability in capital markets are playing a negative role in this regard.

Figure 4: Factors affecting investment decisions

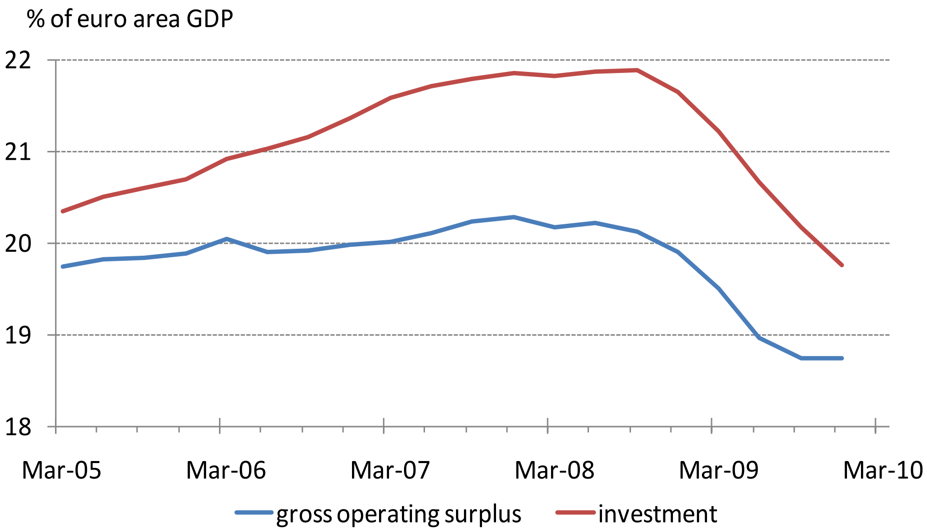


Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

A low level of capacity utilisation and the ongoing de-leveraging of corporate balance-sheets are also contributing to delayed investment decisions.

Corporate profitability has stabilised recently, but is still significantly below pre-crisis levels, and continues to exert a negative effect on investment decisions (Figure 5).

Figure 5: Evolution of profitability and investment levels

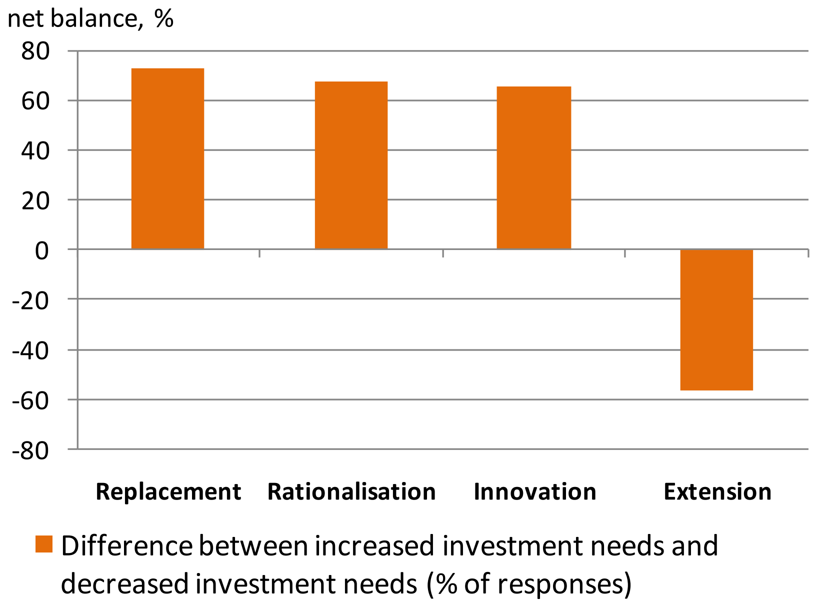


Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

Rigidities in both labour and product markets, and greater obstacles to entrepreneurship are factors that could particularly hamper the prospect of a dynamic supply-side recovery in Europe.

Against this background, investment needs are focused currently around replacement and rationalisation of capital stock, rather than extension (Figure 6). On the positive side, innovation remains a key priority among companies' investment plans.

Figure 6: Most important investment needs



Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

1.4. Labour markets are stabilising

Unemployment stabilised in March 2010 at 9.6% for the EU, and 10% for the euro area, whereas our unemployment forecasts for 2010 as a whole have been revised downwards to 9.8% the EU27 and to 10.4% for the euro area, compared with our February assessment. In 2011, conditions are expected to be broadly unchanged and unemployment to remain stable on average in the EU.

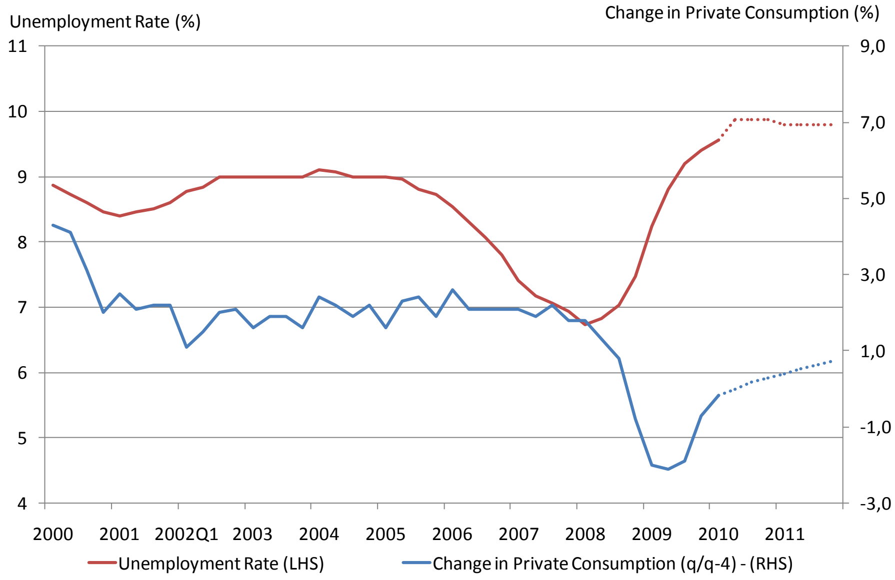
Labour market resilience in some countries has been better than previously projected, and temporary short-time working schemes have managed to contain the increase in unemployment.

This partly explains the fact that private consumption, which is largely influenced by employment trends through both income and confidence channels, has adjusted less rapidly and severely in the crisis than other demand factors.

However, persistent labour market rigidities could play a significant role in dampening the pace of the recovery, preventing a faster return to growth and job creation in the face of major structural changes.

Adopting labour market reforms along EU "flexicurity" principles seems all the more urgent to encourage the necessary adaptability and to support companies hiring decisions. This will also contribute to strengthening consumer demand through rising income and lower precautionary savings.

Figure 7: Unemployment and private consumption tightly connected



Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

Beyond these broad trends and considerations lie significant divergences in labour market developments at the national level, with some countries such as Spain, Ireland, the Baltic States, and Slovakia, having unemployment rates above 14% in 2010.

Using the results from our Spring 2010 Reform Barometer[1] - Figure 8-, it can be seen that those countries that had sound economic foundations before the crisis - **Category I** countries- have better medium-term prospects for employment, growth and public finances in this recovery. On the contrary, those countries that had accumulated important imbalances before the crisis - **Category II** countries- are suffering more dire consequences today in terms of foregone growth and job creation, as well as rising public debt.

These results highlight the evident need to undertake massive reform efforts to correct the current fiscal and external imbalances in certain countries, but also the urgency to reform everywhere to maintain the overall growth momentum of the European economy while lagging countries undertake the necessary adjustments.

[1] The European Reform Barometer, Spring 2010, BUSINESSEUROPE.

Figure 8: Pre-crisis v. post-crisis macroeconomic performance

Overall Assessment of economic performance based on Spring 2010 Reform Barometer	Current Account position, 2008 (% of GDP)(*)	Average GDP growth 2009-11 (*)	Increase in Unemployment Rate (2007-2009)(*)	Change in Government Debt 2008-2011 (% of GDP)(*)
Category I: countries with results above average	4,18	-0,29	-0,23	13,68
Category II: countries with results below average	-5,63	-0,92	3,69	26,19

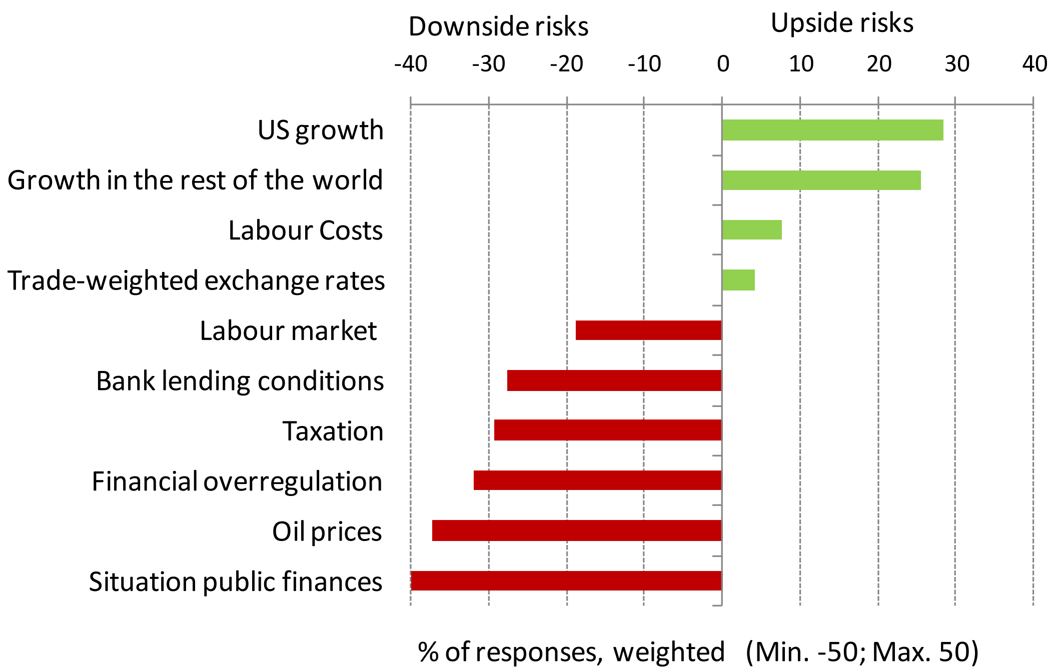
Category I includes: Austria, Cyprus, Czech Republic, Denmark, Fnland, Germany, Luxembourg, Netherlands, Poland, Sweden
Category II includes: Belgium, Estonia, Greece, Italy, Lithuania, Malta, Portugal, Spain, United Kingdom
(*) Weighed by GDP

Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

1.5. Downside risks dominate the outlook

Despite the general improvement in economic activity, substantial downside risks remain. In order of importance these are (1) the state of public finances, (2) oil and other commodity prices, (3) risk of financial over-regulation, (4) taxation, and (5) bank lending conditions.

Figure 9: Risks to economic activity



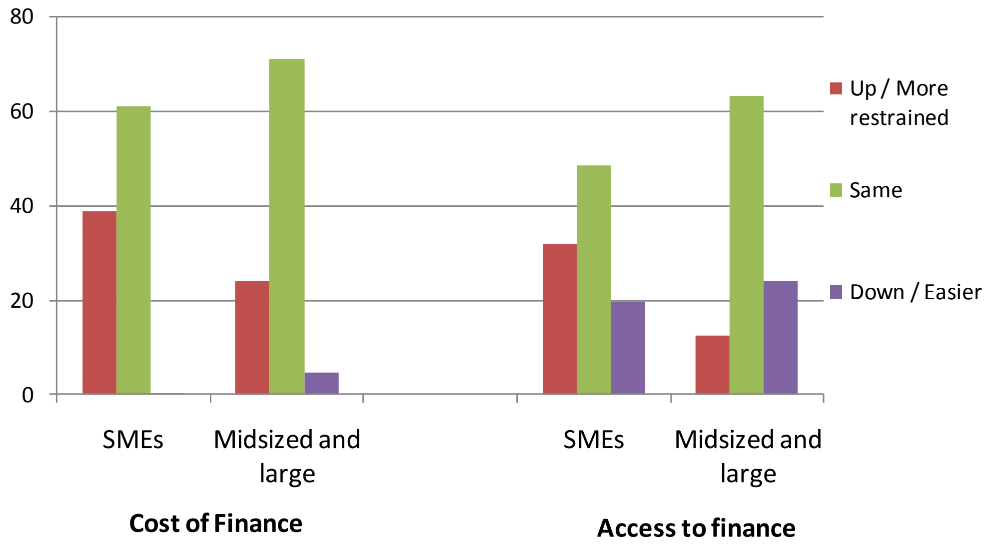
Source: BUSINESSEUROPE (June Economic Outlook)

On the positive side, growth in the US and elsewhere in the world, provide with an upside risk to our forecasts, and could further reinforce an export-led upturn in Europe.

Many of the downside risks mentioned above affect companies' access to finance in one way or another. In particular, the situation of public finances is crowding out private investment by reducing the availability and raising the cost of capital; by inducing higher risk premia on capital markets; and by raising expectations of higher taxes in the future.

Financial overregulation is also a major risk. Higher capital requirements, beyond a certain level of stability, could potentially damage companies' finances and have negative effects on the broader economy. Impact assessments should consider complex interactions between various regulatory initiatives, which may have non-additive effects, and should therefore be assessed in a comprehensive approach.

Figure 10: Cost and access to finance over the next 6 months



Source: BUSINESSEUROPE (June Economic Outlook)

In the area of taxation, companies fear that a tax-driven budgetary consolidation would undermine EU's capacity for growth and job creation without supporting fiscal sustainability in the long term.

Instead, businesses advocate in this area growth enhancing-tax reform, which would help broaden the tax base and attract rather than deter investment in Europe.

POLICY CONSIDERATIONS

To guarantee a sustained recovery, far-reaching measures will have to be taken to restore trust in the sustainability of public finances and to foster the necessary reforms of markets and institutions to support growth and job creation in the years ahead.

2.1. Sustainability of public finances

The collective challenge of putting public finances on a sustainable course is daunting. It can be illustrated by three figures.

In order to bring public debt in the EU back to the limit of 60% of GDP by 2025, we calculate that European governments will have to sustain from 2015 onwards average primary surpluses (budget balance excluding interest payment) of close to 3% of GDP (from -3.5% currently) and undertake major reforms to raise EU's growth potential back to 2% at least.

Current instability is the result of years of indulgence and poor governance, long before the financial crisis broke-up. As a consequence, several EU countries have to put in place drastic austerity measures to restore confidence in their long-term future, including wage cuts and a reduction in social benefits.

We recognise the magnitude of the sacrifices these measures imply for workers, pensioners, and citizens. However, they are the only way to overcome this crisis and ensure the continuity of our social systems in those countries.

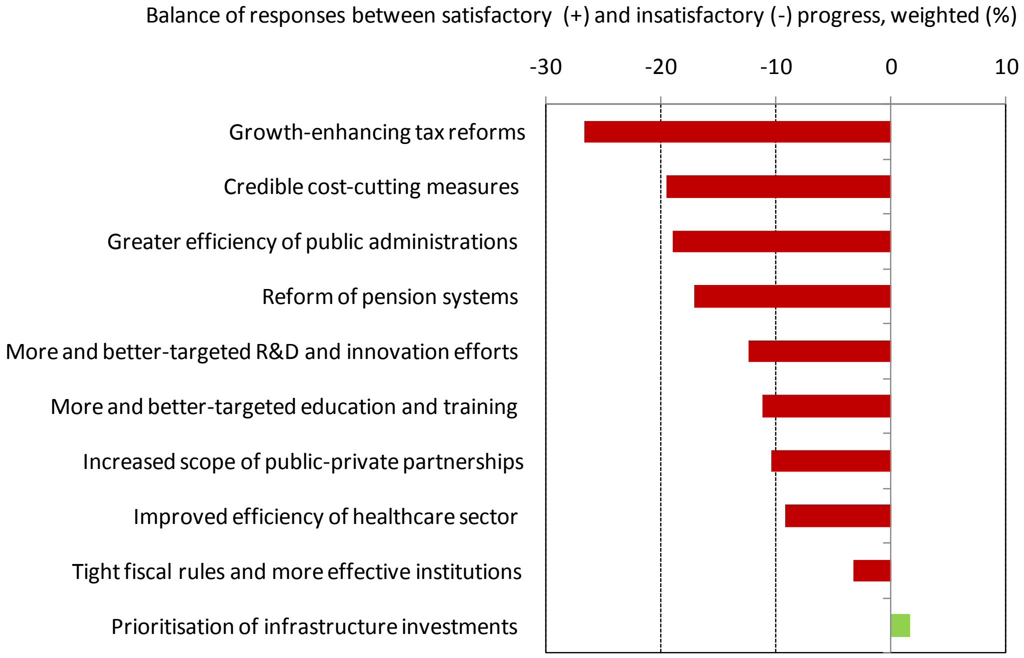
This needs to give way to a more positive reform agenda to tackle the issues at hand.

In our March report "Combining Fiscal Sustainability and Growth: a European Action Plan" we have recommended a comprehensive agenda combining an exit strategy to cap public indebtedness with an entry strategy to support investment in future growth areas. This agenda is organised around the following broad orientations:

- Tighter fiscal rules and better budget processes and institutions
- Greater efficiency of public administrations and credible cost-cutting measures
- Increased scope for public-private partnership
- Reform of pension and healthcare systems
- Higher return on education and training
- More and better targeted efforts in R&D and innovation
- Greater prioritisation of infrastructure investments
- Growth-enhancing tax reforms

Among these priorities, BUSINESSEUROPE members identify the following key areas where governments are showing insufficient commitments– Figure 11. Concerns are particularly important as regards taxation, cost cutting and efficiency measures in the public sector and pension reforms.

Figure 11: Assessment of budgetary consolidation efforts by BUSINESSEUROPE Members



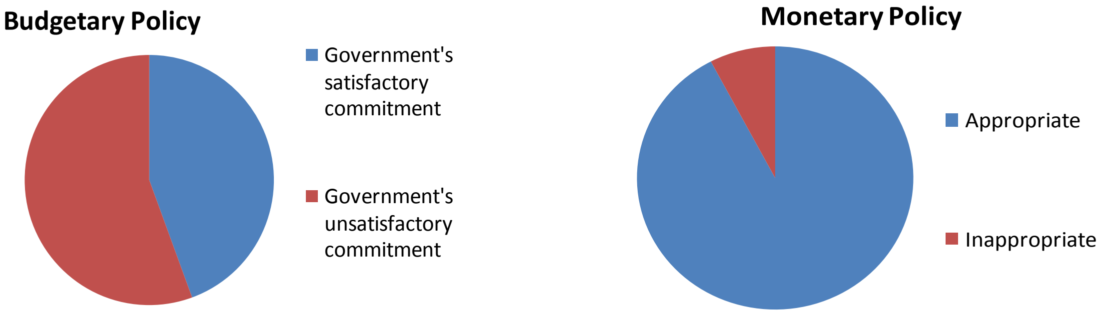
Source: BUSINESSEUROPE (June Economic Outlook)

Overall, more than half of respondents in BUSINESSEUROPE survey perceive that commitment towards greater fiscal sustainability is not sufficient – Figure 12 below.

This contrasts with more than 90% considering that monetary policy in this period of time is appropriate – Figure 13.

In this regard, the role of the ECB during the current crisis has been outstanding, as it has acted firmly to safeguard stability. Its strong independence is a fundamental element of its success and should be preserved and strongly guaranteed.

Figures 12 and 13: Assessment of budgetary and monetary policy



Source: BUSINESSEUROPE (June Economic Outlook)

2.2. Governance of the euro area

BUSINESSEUROPE supports the decisive actions taken by the European Council, the Commission, and the ECB and the launch of the European Stabilisation Mechanism to avoid contagion of the Greek sovereign debt crisis. We also praise the additional austerity measures put in place by several Member States during the last weeks.

However, the recent developments have stressed the need to reinforce coordination instruments at euro-area level in order to prevent such dramatic failure in the future and to preserve the achievements of greater economic and financial integration that came with the introduction of the euro.

A reinforced governance structure should mean in particular greater national commitments towards fiscal sustainability and competitiveness, better enforcement mechanisms at euro-area level and a stable system to address sovereign debt crisis in last resort situations.

The need to broaden surveillance of national policies and take a more forward long perspective on fiscal sustainability is highlighted in Figure 14 below. It demonstrates that those countries with large current account deficits before the crisis are also those having suffered the greatest deterioration in their public finances during the crisis.

Figure 14: Current Account Position v. Increase in Government Debt

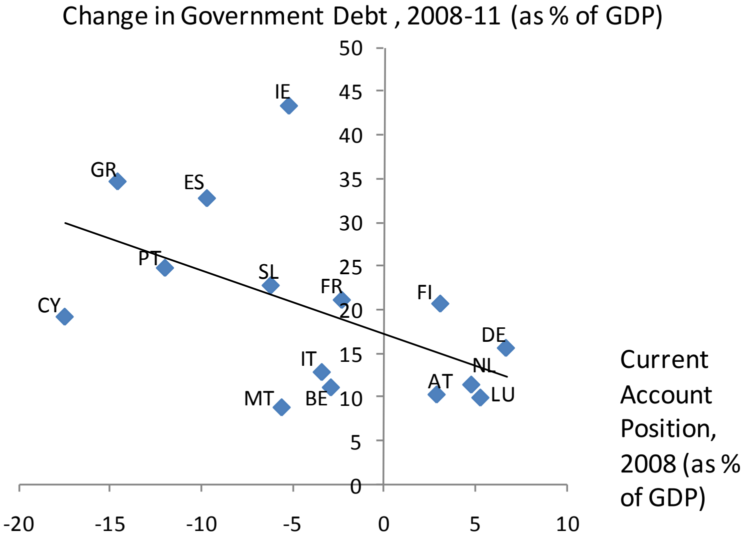


Figure 14 shows that there is an inverse or negative relationship between current account position in the pre-crisis period (horizontal axis), and the increase in government debt since its outbreak (vertical axis). The black line is the estimation of this relationship. Countries with better external positions before the crisis are experiencing smaller increases in public debt.

Source: BUSINESSEUROPE (June Economic Outlook), Eurostat

In its June 2010 paper “Improving euro-area governance, securing the long-term success of the euro”, BUSINESSEUROPE issued a number of recommendations, summarised below:

1. Transposing the Stability and Growth Pact rules in national law and reforming national, regional and local fiscal institutions
2. Granting new auditing powers to Eurostat for assessing the quality and reliability of national statistics in greater details
3. Broadening the concept of fiscal sustainability and stress testing public finances to assess their resilience
4. Reinforcing the surveillance of national economic policies and triggering earlier discussions in the Eurogroup in order to better contribute to the national policy debate
5. Ensuring that early warnings from the European Systemic Risk Board on excessive credit expansion lead to remedial actions
6. Protecting the European Central Bank's independence and its overarching mandate to deliver price stability for the euro area as whole.
7. Imposing obligatory non-interest-bearing deposits for Member States failing in good times to progress towards agreed medium-term budgetary objectives
8. Speeding-up Excessive Deficit Procedures (EDP) and making full use of the instruments available in the Treaty of Lisbon
9. Transferring pre-emptive deposits made in good times into a crisis resolution fund and considering the suspension of EU budget funds in case of persistent breach of EDP requirements
10. Working on a more permanent crisis management system, including emergency loans with strict conditionality and a resolution scheme to allow for debt restructuring or orderly default in last-resort situations

These recommendations address both preventive and corrective aspects, and foresee a gradual tightening of enforcement mechanisms through penalties and sanctions. BUSINESEUROPE recommendations are presented in greater details in the report.

BUSINESSEUROPE

GO FOR GROWTH
AN AGENDA FOR THE EU IN 2010-2014

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		

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