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UNICE AUTUMN STATEMENT

ON THE ECONOMIC SITUATION IN EUROPE

I. ANALYSIS OF ECONOMIC SITUATION

- ***Pessimism in industrial opinion surveys is becoming widespread in Europe:*** the deterioration in indicators on confidence in the economic situation is spreading at European level. European business people are more pessimistic than in the summer and are reviewing their assessment of the economic situation downwards. This feeling has been exacerbated by the recent appreciation of European currencies against the dollar, or influenced by perceptions about a change of direction in economic policies which is less business-friendly.

- ***The international environment remains problematic:*** the Russian crisis has exacerbated a financial crisis started by events in Asia, and has prompted a sharp correction on western stockmarkets. The effects of a crisis emanating from emerging countries raises important questions and concerns for the world economy: how much will growth slow down in Europe and the United States next year? How will Japan find ways to pull itself out of a growing and general recession in the country when confidence indicators are at their lowest despite the announced rescue plan? How will Europe manage this crisis on the eve of the final stage of EMU? How can systems of information on banks and financial intermediaries be improved, notably in emerging countries?

  The present situation runs the risk of weakening companies and financial institutions. In addition, world trade is slowing, leading to lower exports from industrialised countries: the crisis in Asia has brought about a contraction in world trade, Asian countries' export revenues have fallen and, above all, their capacity to import has tumbled. This crisis is also fuelling more prudent behaviour by the various players, making credit more difficult to obtain and casting doubt over the prospects of an economic recovery next year.

  However, it is important not to overemphasise a negative scenario for the immediate future: signs of stabilisation are appearing in Asia, Brazil and China have maintained their exchange-rate objectives, domestic demand in Europe continues to be sustained, and the United States is benefiting from lower interest rates accompanied by stronger-than-forecast growth.

- ***European growth still in place but weakening:*** the impact of the crisis on European countries is calculated to be several tenths of a percentage point as compared with the region's original growth forecast for 1998. As the year comes to an end, some slowing can be perceived as compared with the first six months. In its autumn forecasts, the European Commission has also revised the European Union's growth forecast downwards to 2.9% in 1998 and 2.4% in 1999. Strong growth in domestic demand and the relative importance of intra-European trade therefore justify hope that GDP will continue to grow, although less robustly, despite the perceived risks around the world. In a less favourable context, the economic situation in Europe continues to be carried by good fundamentals.

  More specifically, however, European countries are not all in the same situation. Growth this year is expected to range from below 2% (Italy) to above 5% (Ireland and Finland).

- ***No risk of generalised inflation in Europe:*** continuing low commodity prices together with slower economic activity has reduced the risk of inflation taking off in Europe. Average European inflation is still below 2%. This absence of inflationary pressure makes the risk of monetary tightening by the new European Central Bank less likely. Combined with a "flight to quality", it has allowed government bonds in Europe to converge at very low long rates. The curve between short and long rates is likely to remain virtually horizontal while the period of market uncertainty persists.

- ***The Euro-11 zone appears to be have been spared monetary instability,*** a precursor for the feasibility of and confidence in the Euro. This situation is to be welcomed: practice shows that the prospect of EMU is a favourable element. Thus, the European countries in the Euro zone are already enjoying advantages in terms of the monetary stability brought about by economic and monetary union. By contrast, countries outside the future Euro zone have not benefited from the same market assessment.

- ***Relaxation of budgetary consolidation:*** it should be added here that, after two consecutive years of lower public deficits, the consolidation period slowed down in 1998. Moreover, according to Eurostat, the amount of compulsory levies in the European Union is the highest among developed countries (42.6% of GDP in 1997, unchanged on 1996), while it is even higher in the Euro zone (43.2% of GDP in 1997, up 0.4 point on 1996). This problem is serious: Europe has not increased its margins for manoeuvre with the recent improvement in the economic climate. It does not appear to be taking the measures needed to maintain growth and employment in a less healthy, more unstable and more competitive environment.

II. ECONOMIC POLICY RECOMMENDATIONS

- **Europe's commitment to the Euro must be given concrete expression by a policy of reducing public deficits in the medium term**. Given that most Member States have increased overall taxation in order to reduce public deficits to the 3% defined by Maastricht, the priority in the next few years must clearly be to reduce taxes, all the more because serious international imponderables make it difficult to predicate budgetary and social objectives on tax revenues which are uncertain at the very least.

- **Better labour market adjustment mechanisms**, with the ultimate goal of a marked drop in European unemployment, are even more necessary in a period of economic slowdown.

- **The market economy model and efforts to meet the convergence criteria must not be relaxed because of a slowdown in the economy**. It is also important to pursue the financial and banking reforms necessary for the smooth functioning of the international financial system.

- **The international dimension of the Euro requires and opens the way for better political and institutional cooperation** at both global level (G7, IMF) and European level (Ecofin Council, Central Bank).

A fragile shield

The stability of currencies in the Euro-11 zone, which some have described as a shield, should not cause people to forget that the confidence currently inspired by the European project has been built on several years of economic convergence and macro-economic rigour. Relaxing efforts and seeking to stimulate demand through more expansive budget policies on the pretext of a deflationary threat would be the surest way to place EMU in jeopardy and to accentuate inflationary pressure in the medium term. Member States have this year enjoyed economic growth but some of them have probably not used this upturn sufficiently to reduce their deficits. This reduces their margin for budgetary manoeuvre in the event of a major shock, and complicates implementation of a monetary policy more attuned to economic growth and competitiveness.

In addition, the fact that the problems of emerging countries are having asymmetric effects (e.g. effect of Russia on Germany or Latin America on Spain) must lead to questions being asked about the level of budgetary cooperation within the Ecofin Council, and about the practices to be adopted in the area of policy-mix between budgetary and monetary authorities. Unfortunately, at this stage of the cycle, if a slowdown is confirmed next year, it appears that efforts at budgetary vigilance will already be insufficient.

Need to maintain the competitiveness of companies in Europe

The co-existence of two broad groups of Member States whose economies are growing at different speeds, and thus face the prospect of a common monetary policy which could be too loose for some or too tight for others, is facilitated at the present time by the effects of the world economic slowdown, the difficulties of emerging countries and lower import prices. Convergence of interest rates less than two months ahead of currency union is therefore imminent.

This convergence will be all the easier to achieve if budgetary policy is conducted within the present confines of the Stability Pact. It should also facilitate a better balance between the objectives of internal and external stability of the currency thus preserving European competitiveness. It is a fact that several elements, notably the current account surplus and future portfolio diversification into the Euro, could combine to make the Euro a potentially strong currency.

Employment: moves towards flexibility still too timid

In terms of employment, European growth has brought down unemployment to around 10% in EUR15 as compared with 10.7% in 1997. This average fall should not hide the fact that unemployment in some countries such as Germany and Italy has remained stagnant or has only marginally come down, while other countries such as Ireland, Finland, the Netherlands and Denmark continue to benefit from an increase in the level of employment with unemployment rates falling on average by five points over five years. These countries all have measures specific to their national constraints, combined with moderate wage policies, labour market deregulation and/or attractive incentives for investment or business creation. Improved employment in Europe depends above all on a more efficient labour market and an environment which encourages a spirit of enterprise.

The temptation to return to a more managed economy is dangerous

Support for the process of opening the world economy and for development of trade is necessary, since some countries are much tempted by a return to a more managed economy where capital movements are controlled. The development and prosperity of the economy require better allocation of capital resources and goods based on economic considerations and not on protectionism. The present crisis has shown that Europe is benefiting from a positive reality which must be further given concrete form and strengthened.

The new international dimension of the euro requires better political and institutional cooperation

Stronger European cooperation must also bear fruit in relations between the ECB and the Ecofin Council, with mutual respect for their prerogatives. This institutional realisation must allow a balance to be found, notably between the objectives of the internal and external stability of the currency. Clearly, this balance must be guided by the bilateral Euro/dollar relationship, but also by relations between the Euro and non-Euro European currencies.

The new external dimension of the Euro will also have to encourage participating states to coordinate their actions in international fora to protect themselves better against future financial crises. If the International Monetary Fund failed to react in time to the Russian and Asian crises, it is also true that European responsibility was also involved in this failure. An attitude of alertness must be encouraged, in order to correct imbalances before a crisis erupts.

A sound international banking and financial system, a necessary condition for world economic stability

Liberalisation of capital movements requires more transparent ground rules at international level. However, measures seeking to control capital flows through taxes or obstacles to mobility are not desirable. Such measures are incapable of correcting the cause of the problem and erect a barrier to trade. Furthermore, they render access to finance more difficult for the countries which put them in place.

It would be useful to study certain measures such as publication of statistics and more transparent and reliable accounting rules in emerging countries, or a strengthening of prudential banking and financial controls. In addition, it is desirable to extend the prerogatives and resources of the Bretton Woods institutions without increasing the risk of moral hazard, which is clearly harmful to financial stability. At European level, it would be appropriate to develop coordination of prudential rules (notably with the Basle Committee) and to reflect on desirable developments in the present arrangements for banking supervision in Europe.

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