ECONOMIC OUTLOOK

MARCH 2002

UNICE ECONOMIC OUTLOOK
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The UNICE Economic Outlook provides a business insight into recent economic developments, based on a survey of UNICE member federations in the 15 Member States of the EU. Qualitative data and forecasts were established in February 2002. Aggregate values are GDP (at PPS) weighted, unless otherwise indicated.

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Table 1: UNICE forecasts

EU-12	**2002**	**2003**
GDP (annual % change)	1.2	2.6
Inflation (%)	1.7	1.7
Unemployment (%)	8.2	8.1
Employee Compensation (annual % change)	2.8	2.1
EU-15	**2002**	**2003**
GDP (annual % change)	1.3	2.7
Inflation (%)	1.7	1.9
Unemployment (%)	7.6	7.5
Employee Compensation (annual % change)	3.1	2.7

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The business climate has improved
Six months have passed since the terrorist attacks in the US. Economically these tragic events worsened an already uncertain economic climate. In the immediate aftermath of the attacks, the business outlook in Europe was extremely bleak among the UNICE member federations. In the intervening period, business expectations have improved; in March 2002, business expectations are clearly more optimistic than they were last September. Nevertheless, the business climate remains negative.
The September 2001 Economic Outlook was published in a climate of great uncertainty – economic uncertainty, but also political uncertainty due to the prospect of military action in response to the terrorist attacks. The picture has now become clearer. The fears over a collapse of consumer confidence have been allayed – consumer confidence has been remarkably solid, in both the US and the EU. The worst case scenario has been avoided.

All is well, then?
This does not mean all is well – far from it. 2002 will be a year of very low growth in most of Europe. In the past months, forecasts for economic growth have been significantly revised down for all major economies. The US played an important role in sustaining EU growth in recent years. It cannot be expected to do so now. While there are signs that the US is emerging from its recession, its adjustment process has not been completed yet. Thus the EU cannot rely upon the US to pull it out of the slowdown. Instead the EU must take more serious steps to becoming its own motor for growth.

"It's the Lisbon process, stupid!"
This will require genuine commitment to the Lisbon reform process, within a stable macro-economic framework.
UNICE's message to the Barcelona Summit UNICE was clear: the programme of economic and structural reforms that was agreed at Lisbon is falling behind schedule. Policy-makers have displayed insufficient conviction in adopting and implementing the measures necessary to make the European economy more flexible and dynamic. Greater progress should now be expected.

And don't forget the macro-economic framework…
A stable macro-economic framework is required for these structural reforms to have their positive impact. The single monetary policy raises the real possibility of price stability and low long run interest rates in the entire euro-zone; the confidence effect for investors will lead to a more dynamic Europe. Sound fiscal policies are a necessary counterpart for macro-economic stability. The Stability and Growth Pact provides for the necessary co-ordination of fiscal policies across the member states. UNICE has been explicit in stressing the importance of the Stability and Growth Pact for long run stability. The recent political compromise over early warnings for Germany and Portugal risked undermining the credibility of the SGP. It has set a bad example, which may have negative consequences for the European economy. Nevertheless, both countries made commitments on fiscal consolidation, which in practice uphold the spirit of the SGP. They should now make clear their commitment to fiscal rectitude.

The introduction of euro notes and coins
The introduction of euro notes and coins is welcomed by UNICE as an important step forward. The change-over proved to be remarkably smooth, with very few problems. Certainly, the widely predicted chaos in the early days of January failed to materialise. Furthermore, there are no concerns about increased inflationary pressures resulting form price hikes during the change-over. On the contrary, the full use of the euro should pave the way for more responsible wage demands, due to the greater ease of comparison between member states, and the increased awareness of international price competitiveness. Given the greater price stability that is in evidence due to the single currency, UNICE expects wage demands to follow a reasonable path in the future.

The main results to be highlighted in the March 2002 Economic Outlook are listed below – they reinforce the policy message outlined above.

- **Economic forecasts are very bleak for the coming year**
- **Nevertheless, sentiment indicators of the business climate have improved compared to September 2001**
- **The international climate – especially the US – seems unlikely to engender sustained growth in the EU**
- **Regulations – especially in the labour market – continue to hamper industry**
- **Labour markets tightness will not be a problem in the near future – but skills shortages remain**
- **Budgetary consolidation must be an on-going project**
- **Structural reforms remain necessary to relaunch the EU economy**

As in previous editions of the UNICE Economic Outlook, the main sources of data are the UNICE members from the EU. The main purpose of the publication is to provide a clear picture of the current business climate in Europe, and the trends that emerge.

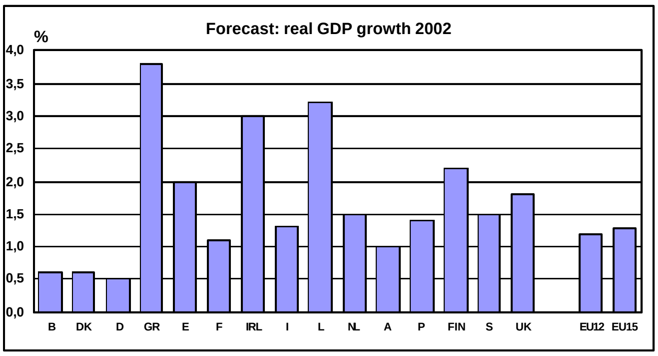
Forecasts

Since the tragedy of 11 September, all major international organisations and forecasting institutes have revised down their estimates for economic growth in 2002 in the EU and the US. The revisions for the EU are significant; in autumn the European Commission forecast a growth rate of 1.4% for the EU15 in 2002, compared to 2.9% previously. The OECD and the IMF make similar forecasts (1.5% and 1.3%, respectively).

UNICE members have also revised their growth forecasts down significantly since the terrorist attacks.

UNICE members expect growth among the EU15 to average only 1.3% in 2002, and 1.2% among the EU12 (the members of the euro-zone). Previously both areas were expected to grow at a rate of 2.3% in this year. (We should note that this previous forecast had itself already been revised down in the months before September. This was recognition that the economic climate had started deteriorating well before the terrorist attacks.)

Chart 1



Among the member states, Greece, Ireland and Luxembourg stand somewhat apart, with expected growth for 2002 around 3% or more. Among the others, there are forecasts of around 2% growth in Spain, the UK and Finland, while in the remainder growth of around 1.5% or less is expected. In Germany, Belgium and Denmark growth rates should be as low ½%.

Sweden is the only country not to see a downward revision of growth forecasts for 2002 (they are unchanged). The largest revisions – two percentage points down – occurred in Ireland and Luxembourg (where growth rates of 5% had been expected). The revision exceeded one percentage point in six others – Germany, Spain, Italy, Belgium, Denmark and Austria.

These growth figures should make clear that 2002 will be a very difficult year. The forecasts for 2003 are more comforting – but also less certain – with a return to higher growth rates expected, reaching 2.6% in the EU12, and 2.7% in the EU15. Although an improvement, this level of growth is certainly no cause for celebration. Every effort needs to be focussed upon increasing the growth potential of the European economy.

It should come as little surprise that inflation is not expected to be much of a problem in 2002 or 2003. Inflation is expected to average 1.7% in both the EU15 and the EU12 in 2002, and then increase marginally in 2003 for the EU15, staying constant in the EU12, in spite of the expected increase in growth.

Only in Ireland and the Netherlands is inflation expected to exceed 3%, although in Spain, Greece and Portugal it will be almost this high. In France the figure is even expected to fall below 1%.

Unemployment in 2002 is expected to be just over 7½% in the EU as a whole, and just over 8% in the euro-zone. These forecasts are the same as those made six months previously; however, this is largely due to a significant decline in the unemployment rate forecast for Spain (where the forecast is over 2 percentage points lower than 6 months ago, which is due to a statistical revision in the calculation). In most other member states the unemployment rate for the year 2002 has been revised upwards – by around one percentage point in Ireland and Germany.

Economic climate

The quantitative indicators make for very uncomfortable reading. The UNICE Economic Outlook also presents sentiment indicators, which focus upon the expectations of members for the coming 6 months.

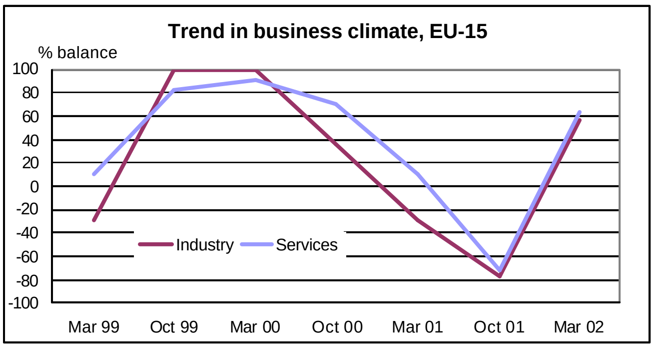
The broad message to emerge from these qualitative indicators is that business confidence is better than it was 6 months ago. UNICE members now have a more positive outlook upon the coming months than they did in the immediate aftermath of the terrorist attacks (when members were last asked this question). However, results in this section need to be seen relative to business sentiment in September 2001 – it would be very surprising indeed if the business outlook had not improved since last September.

The balance chart indicates that a substantially larger share of (weighted) replies expects an improvement than a worsening. The positive balance (the difference between positive and negative replies) stands at over 60% for both industry and services among the EU15, and around 80% for both sectors in the EU12.

This is implies a considerable contrast to the low growth forecasts. These figures should not be misinterpreted – they do not reflect the level of business confidence in absolute terms. The figures reflect *changes* in business confidence.

We can conclude that confidence has improved somewhat in most members. Unfortunately, this is an indication of how low business confidence was in September 2001. Economic conditions have certainly not improved very much since then. But the unusual degree of uncertainty prevailing in September 2001 has declined, and the worst fears have been allayed. This is why business confidence has improved.

Chart 2



Balance charts show the difference between weighted shares of respondents expecting positive developments over the next six months and those expecting negative developments. Changes in this balance can be followed at six-monthly intervals from March 1999, when this survey was first carried out, to March 2002, giving an indication of the trend.

The real economy will not experience this improvement for some time. But these figures do suggest the first signs of a turn-around.

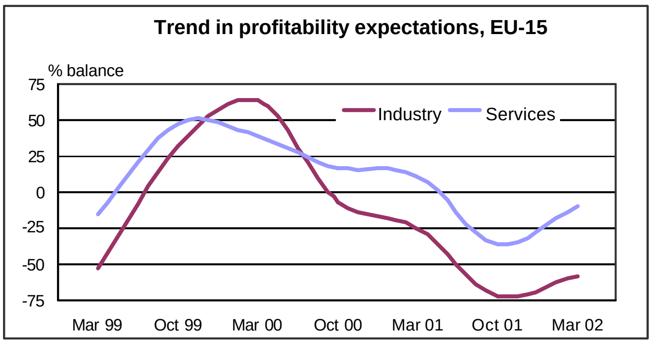
Spain is the only economy where business expectations for the next six months are negative, and even here only for the industrial sector. Industry in Spain will suffer from continued slowdown in external and internal demand, whereas the Argentinean crisis has had a negative impact upon the Spanish banking sector.

Conditions in both industry and services are expected to improve in six member states – these are Germany, France (from a very low level), Italy (where tourism and air transport will remain weak), Austria, Denmark and Greece (excluding the construction sector). In several of these, the prevailing macro-economic conditions are expected to have a favourable impact – low interest rates and inflation, as well the low oil price. Inventories have also been run down over the past months, and when these are replenished there will be some improvement in income figures. A similar statistical recovery will also be seen in the US, as inventories are restocked. A large question mark, however, hangs over the sustainability of recovery in the US, where considerable adjustment appears to remain necessary – given the very low household savings rate, and the continued current account deficit.

Among the other member states, business expectations for the coming months are unchanged for both industry and services in the UK, Ireland, Sweden, Portugal and Luxembourg.

Profitability expectations among the UNICE members differ clearly from the business climate expectations. It is obvious that the improvement in the business climate is not expected to appear in the profitability of enterprises very quickly.

Chart 3



The balance of expectations for profitability is negative for both industry and services in the EU. Again, there has been an improvement in the expectations, but a greater share holds negative expectations than positive. Furthermore, it is here that the differing situations of industry and services become more apparent. Expectations of profitability for industry remain substantially more negative than those for the services sector – even though the business confidence indicator was very similar for the two.

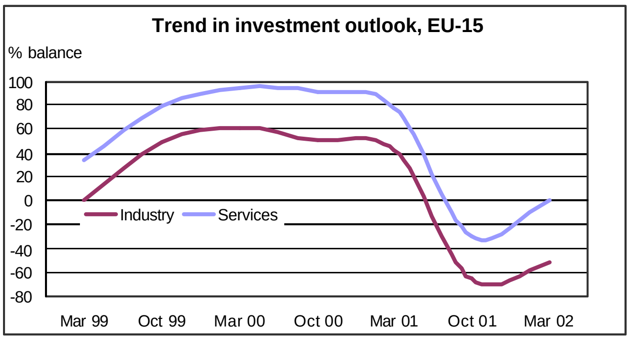
Only in Italy and Denmark are there positive profitability expectations in both sectors. Greece is the only other country where profitability in services is expected to improve, and for industry this is only the case in Austria, where unit labour costs are improving with productivity growth.

In almost half the member states profitability is expected to worsen in both industry and services – Belgium, France, Ireland, Luxembourg, Netherlands, Portugal and Sweden. In another four – Germany, Spain, UK and Finland – a negative profitability trend is expected for industry only.

This reflects the squeeze that profits have come under in the face of a global slowdown. Industry is naturally more affected by swings in the international climate. The world slowdown has directly impacted upon the final prices received by producers, so reducing profitability. Several members note that slower output growth and reduced capacity utilisation have worsened the impact of rapid wage growth.

Investment prospects for the next six months mirror in many ways the profitability expectations. There has been an improvement in the overall expectations – even if only relative to September 2001. The improvement does not prevent the climate from being negative on balance, with expectations for investment in industry remaining strongly negative.

Chart 4

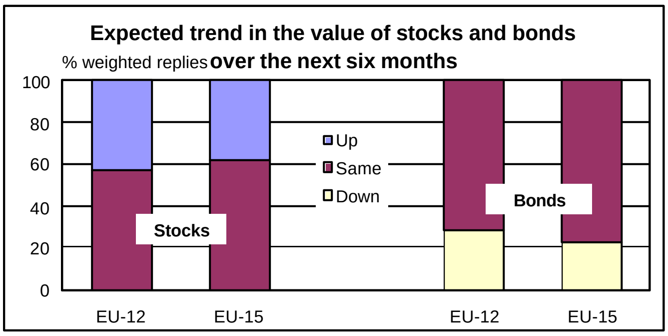


Italy and Denmark are again (as for profitability) the only two countries expecting positive investment trends in both industry and services. In Italy this is significantly due to the new fiscal incentives that have been introduced to stimulate capital accumulation (Tremonti's law). Expectations are also positive for investment in services in Sweden and in industry in Luxembourg.

Nine member states in total expect a negative trend for investment in industry in the coming months. In services, this is the case for only three member states (France, Ireland, Portugal), since most expect there to be no change in investment trends.

The reticence to invest is explained by interlinked factors. The expectation is that lower levels of demand will continue to prevail, leading to low levels of capacity utilisation – making additional investment unnecessary. The underlying factor slowing investment decisions is uncertainty over the future, which reinforces low demand.

Chart 5



The financial market data collected add weight to the idea that the worst of the slowdown may be over. On this evidence it seems the correction that financial markets experienced in 2001 has been completed. None of the federations is expecting a further fall in the prices of stocks or bonds in the coming 6 months.

For stock markets, there is even some optimism; prices are expected to increase in the next 6 months in 7 of the 15 countries, accounting for around 45% of the weighted opinions. These are the federations in Belgium, Germany, Netherlands, Austria, Finland, Denmark and Sweden. The reason for this is that stock market valuations are seen as relatively low, while an improvement in economic conditions is expected later in the year.

For bond prices, the message differs slightly from that for stock markets. The dominant view is that bond prices will not change by much in the coming months, as a stable interest rate climate is established. Chart 5 shows that the (weighted) opinions are strongly biased towards stable bond prices. Germany is the only exception; the increased public deficit is expected to push up long run interest rates slightly, so pushing bond prices down a little.

Six months ago, the UNICE Economic Outlook indicated that European business was bracing itself for recession. The economic climate had been worsening for some time. The terrorist attacks added a large measure of uncertainty to the climate.

It has become clear in recent months that the worst fears have not come true – a full economic crisis has been avoided. The situation remains bad – growth forecasts have been revised down by large increments, and 2002 will see only very limited income growth.

The US economy is not expected to recover quickly by European business. In spite of the first signs of recovery in the US, it is clear that considerable imbalances remain, especially in terms of household saving and the current account. The implication is that the adjustment process in the US is not yet complete.

Europe must take this to heart, and respond. The US was enormously important to EU growth over recent years. Excessively so. In the absence of this stimulus, Europe needs to take the initiative, and become its own motor for growth. This will not be achieved overnight, but it must be the underlying objective in the formulation of economic policy.

Europe needs to make necessary – and widely discussed – structural reforms. Without these, it will fail to achieve greater economic dynamism and responsiveness. It will continue to lag behind the US. The Lisbon process remains the best vehicle for implementing such a positive policy response. Genuine progress in implementing the commitments has been disappointing. Governments have lacked the political determination to make difficult choices. Failure to act more decisively in the coming months will condemn the Lisbon process to failure. Europe's economy would pay the price.

Labour market and wage indicators

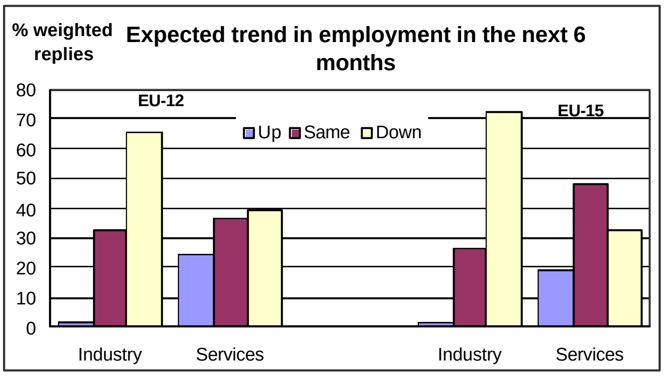
Labour market developments in the European Union will naturally be heavily dependent upon developments in the general economic climate. Six months ago, the great uncertainty surrounding the economy led to negative expectations for employment developments, which were especially marked for industry.

The current climate remains unfavourable to employment growth, and employment losses look set to continue for some time, above all in industry. Among the EU15 over 70% of weighted replies expect industrial employment to fall over the next six months. The figure is a little lower among the EU12. Only in Ireland and Luxembourg is industrial employment growth expected to continue.

In several member states labour productivity in industry is expected to increase in the coming months. In Sweden this is mainly due to staff reductions; in Greece, Belgium and Austria, productivity growth is explained by increased investment. For Belgium and Austria, however, this investment is seen as a direct response to high wage settlements – and so the investment is designed to reduce labour requirements, rather than increase output. In Germany a similar development can be expected, if wage claims (as high as 6.5% in some sectors) are not responsible.

In the service sector, the situation is slightly less negative than in industry. Stable employment levels are expected by almost half the weighted replies for the EU15, although the share is lower for the EU12. Less than 40% in both cases expect further employment reductions. These figures suggest some (limited) optimism, but only when compared to last October's UNICE Economic Outlook, where employment reductions were the most common answer. In his sense, there has been some improvement over the past 6 months.

Chart 6



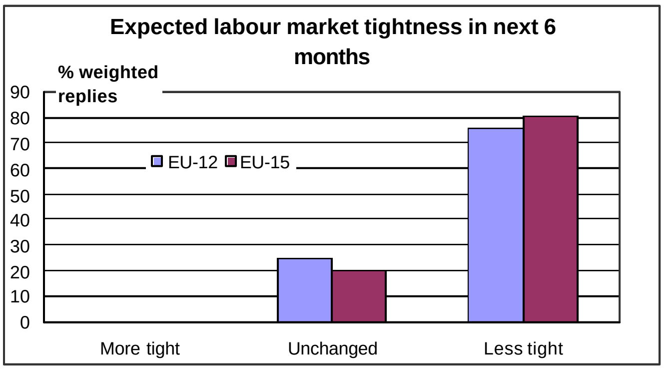
Growth is nevertheless expected in services employment in France (at a reduced pace), Ireland, Greece and Luxembourg.

UNICE has for some time made clear that Europe needs greater labour market flexibility. This call for appropriate reforms can only be repeated here. Even if there is a return to higher growth – and this is not looking likely at the moment – labour markets are too rigid to achieve the Lisbon employment objectives.

Labour market tightness

Given the employment and output trends, it is no surprise to see that labour markets are expected to become looser by 80% of weighted replies in the EU15, and 75% in the EU12. Labour markets tend to lag behind output changes, so it is not surprising that labour markets are expected to continue becoming looser by the great majority. The exceptions to this are Italy, Greece, Portugal and Luxembourg, where no change from the current situation is expected.

Chart 7

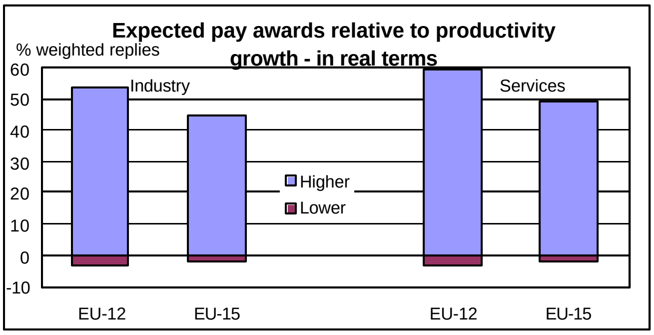


Even as labour markets become less tight, it remains difficult for many companies to find the skilled labour they need. This highlights the structural nature of the problems in labour markets in Europe. Unemployment bottomed out at around 8% when the economic upswing came to an end; at the same time, many companies are unable to fill their vacancies. If Europe can reduce its skills gap, while introducing greater flexibility to labour markets, we may witness consistent employment growth in the future.

The wage response?

The wage response to these poor employment prospects again suggests there is no simple relationship between pay awards and labour market conditions. Most of our weighted replies expect wage rises to be of the same order as labour productivity growth; over 60% of replies thought this would be the case in industry, and over half in services. Among the remaining replies, the trend is very much for wage rises to outstrip productivity growth. In industry this is the case for five member states, and for six in services.

Chart 8



In Germany, France, Belgium and Denmark wage growth is expected to exceed labour productivity growth in both sectors, while in Finland this is only the case in industry, and only for services in Ireland and the Netherlands. For France, it should be noted that this effect applies to aggregate productivity, but not to hourly productivity (following the introduction of the 35-hour working week).

It is surprising that after at least 6 months of slowdown, uncertainty and looser labour markets, a substantial share of federations expect their pay awards to outstrip productivity growth. When pay increases equal productivity growth, central banks will generally become concerned. In part this is due to potential inflationary pressure. Furthermore, where the level of pay awards keeps up with productivity growth, firms have no room to accommodate changes in the underlying economic situation or relative price movements (such as oil price changes). This adds an element of rigidity, which cannot easily be justified. Certainly, agreements imposing pay awards equal to productivity growth would be counter-productive.

Short-term employment prospects remain unfavourable. This should strengthen policy-makers' resolve to improve the functioning of the labour market. Labour market reforms need to seek a more flexible organisation of workforces to enable firms to improve their productivity. But healthy labour markets also require a good supply of adequately qualified labour, in order to help businesses carry out the tasks they need to advance and grow. Neither of these two aspects is currently fulfilled in most EU countries.

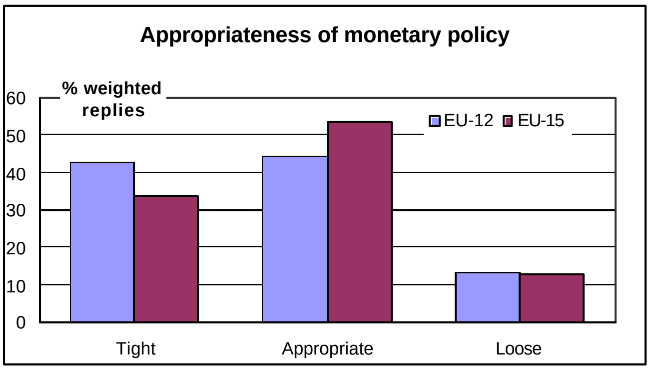
Increased labour market flexibility would push up the potential growth rate of the economy. Companies would be in a better position to respond to opportunities by employing more people. This simple statement hides a deeper dynamic impact; increased company responsiveness leads to higher employment levels. Higher employment, in turn, pushes up the level of demand in the economy, and a virtuous cycle is entered. Such structural changes can lead to higher sustainable growth rates.

Financial and monetary aspects

The ECB has reduced interest rates significantly in several steps since last September.

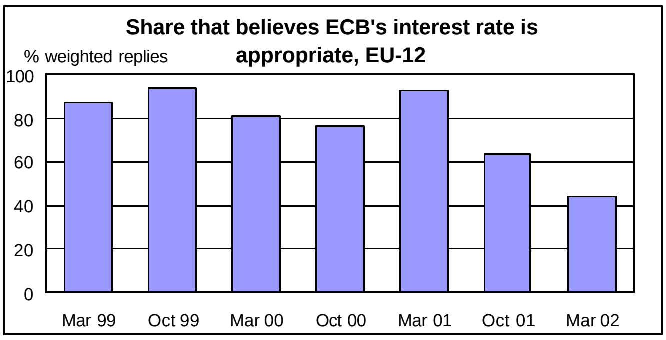
In spite of this relatively active spell of central bank activity, UNICE members from within the euro-zone are split in their view of monetary policy tightness in their countries.

Chart 9



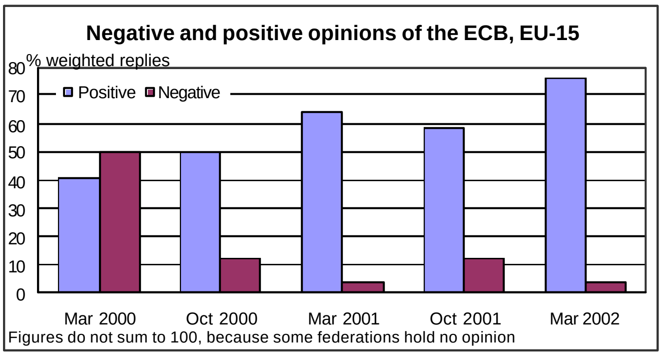
In only three member states is monetary policy held to be loose for national conditions – Spain and Portugal, as well as non-euro member Sweden. In France, Italy and Austria, in contrast, it is thought to be too tight, while in the others – Germany, Belgium, Greece, Ireland, the Netherlands, Finland and Luxembourg, as well as the UK and Denmark – monetary policy is thought appropriate.

Chart 10



This means that among euro-zone members, the share believing monetary policy is appropriate is at its lowest point since this question was first asked. This is a continuation of the trend that started in the October 2001 Economic Outlook, when the share had already declined to a relatively low level. At only 44% of weighted opinions, this is the first time the share has fallen below 60%.

Chart 11



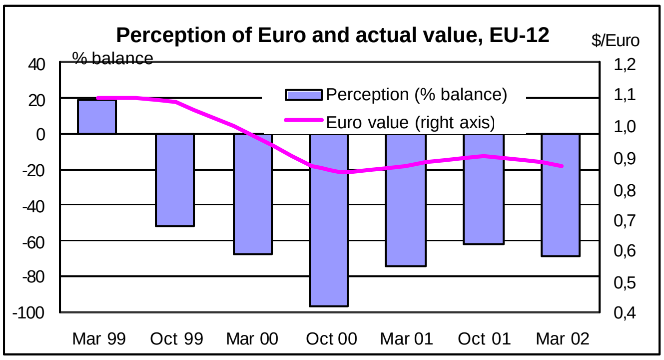
Nevertheless, when asked what their impression of the ECB in general is, the great majority of UNICE members have a positive impression. This share has increased fairly consistently over time, and reaches over 75% in this survey. The share with a negative opinion of the ECB remains very small. Thus, in spite of the diversity of opinion on the appropriateness of the interest rate for national economies, the ECB appears to be building itself a good general reputation.

However, the ECB continues to be criticised for inadequate communications, or a lack of transparency in its decision-making by UNICE's members. This point has been raised in several previous issues of the Economic Outlook, and is still cited as a negative point, even by those with a favourable opinion of the ECB. Continued poor performance in this area will come at a cost in the long run – communications are an integral part of the activities that a modern central bank needs to carry out.

The value of euro and its perception
The value of the euro increased for a brief spell at the beginning of 2002, following the successful introduction of the euro notes and coins. Since then it has fallen back to less than 90 US cents. Among the UNICE members a clear majority continue to see the euro as undervalued against the US dollar. Over two thirds of weighted replies see the euro as undervalued, compared to 30% who feel it is appropriately valued, while the euro is not seen as overvalued against the dollar in any member state.

These figures represent a continuation of previous trends, both in the perception of the euro, and in its actual value.

Chart 12



Budgetary policy in member states

In the last UNICE Economic Outlook, concern about the state of public finances in the EU was made clear. In particular, UNICE recommended respect of the Stability and Growth Pact condition that public finances should balance over the economic cycle. This means that governments should be taking advantage of the good economic conditions, in order to lay the foundations for consolidated public finances. In many member states this opportunity was not taken during the last economic upswing. This explains the difficulties being experienced in some EU member states at the moment.

In February, Germany and Portugal avoided receiving early warnings for missing the budget deficit targets in their Stabilisation programmes by a wide margin. The conditions for making such an early warning were fairly clear; a political compromise was reached to avoid the warning being issued.

UNICE has repeatedly made clear how important the Stability and Growth Pact is. Where there is one centralised monetary policy, determined in Frankfurt, while budgetary policy is established at the national level, there is the risk that an inappropriate policy-mix results. This needs to be avoided by effective policy co-ordination. The Stability and Growth establishes the framework for the co-ordination of budgetary policy. Its credibility is a key element of monetary union. If the rules of the SGP are undermined, the benefits of the single currency diminish.

The political compromise reached in February's ECOFIN Council runs the risk of undermining confidence in the SGP; this is why UNICE made clear that such a compromise was a mistake. Nevertheless, the commitments made in terms of future budgetary policy enshrine the spirit of the SGP, which goes some way to limiting the damage. Clear steps should now be taken to respect these commitments.

Views diverge among UNICE members on the way Stability (or Convergence) programmes are being implemented. Among the EU15, over 40% of (weighted) replies held a negative view of the implementation, and an equal share held a positive view – among the EU12, over half the replies are negative.

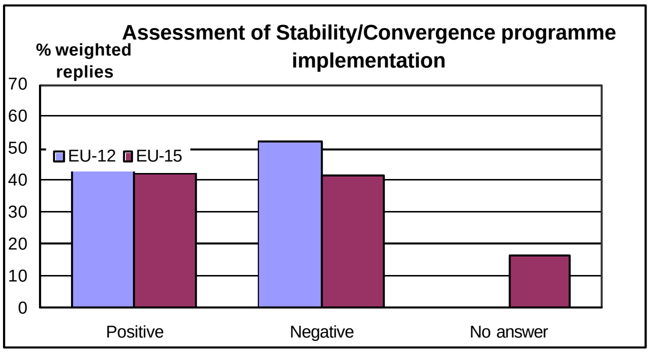
It is disconcerting that so many should feel the Stabilisation (or Convergence) programmes are not being well implemented. These programmes remain one of the building blocks of monetary union.

The negative views are explained by several factors. In Germany the deficit targets appear particularly difficult to meet without imposing additional taxes; it should be noted that the situation in Germany is unusual, in particular due to the heavy burden that East Germany currently represents for public finances. In France a lack of political determination renders the target excessively optimistic. In Ireland the budget surplus is expected to disappear and become a small deficit, in spite of projected output growth of 5%.

In Greece we can note the need for a more transparent budget, in order to assess the Stabilisation programme.

Member federations consistently make the point that structural reforms are a necessary accompaniment to the targets established in Stabilisation or Convergence programmes. This message cannot be repeated often enough. Sustained structural reforms are the necessary accompanying policy to budgetary consolidation. The two policies interact – sound budgets make structural reforms more effective, while structural reforms make it easier to achieve a consolidated budget.

Chart 13



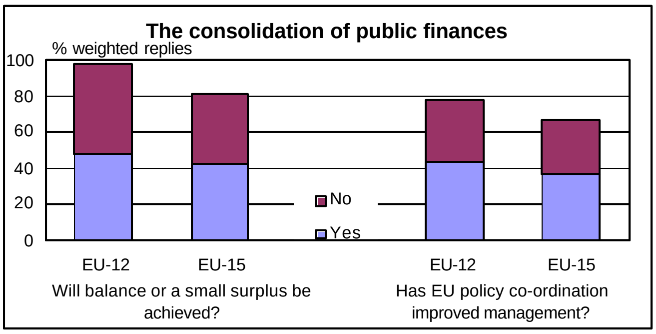
Several member states will be holding elections in the course of the coming months; in several of these, there is the possibility of expenditure increases before the elections. Funding such increased expenditure risks imposing additional taxes, either on business or on labour. In any case, such simple electoral gambits do not help the long run economic performance of the economy and will hopefully cease to be part of common political practice. Elections are coming up in France, Germany, the Netherlands, Ireland, Portugal and Sweden, as well as in and Finland in 2003.

There is concern in the UK that additional spending commitments – which could well be announced this summer in a spending review.

The Stability and Growth Pact includes the specific objective of balancing public finances over the medium-term, or running a small surplus. This essentially asks governments to run consolidated budgets, which balance over the economic cycle.

Most UNICE members believe public finances are on target to achieve balance over the cycle. This is the case in 10 member states, while in the UK the deficit should be limited to 1% of GDP.

Chart 14



Unfortunately, the three member states where such a balance appears unlikely – Germany, France and Ireland – together account for practically 40% of Union output. The shortcomings in these three make it very difficult to be positive about the extent of consolidation in the EU.

In Germany and France the necessary expenditure reforms are not yet being implemented, while in Ireland a deficit has taken the place of earlier surpluses.

In many of the other member states, where public finances should balance over the cycle, this is dependent upon achieving relatively ambitious budgetary targets. UNICE welcomes this ambition in setting targets; it remains necessary, of course, to follow ambition up with actions. Ambitious targets for deficit reductions, furthermore, should not be achieved in a counter-productive way – such as by increasing taxes. Deficit reductions require expenditure reform – this is where ambition is best placed. In terms of the growth projections, which underpin the deficit targets, realism is the appropriate path to follow – realistic projections ensure the least disruption in expenditure reform.

Has co-ordination at the EU level improved the management of public finances?

A surprisingly small share of answers to this question holds that the management of public finances has been improved by co-ordination at the EU level (Chart 14).

To a considerable extent, this reflects the negative interpretation of the recent political compromise designed to avoid an early warning being issued against Germany and Portugal. Thus there are shortcomings in the application of the disciplinary mechanism.

Beyond this, however, the broader context of policy making has had a beneficial impact. The peer group pressure exerted by the common assessment of expenditure plans has instilled greater discipline and fiscal rectitude in most member states. As a result, fiscal policy is now more predictable and more stable, in most member states.

Where there is a single currency – or significant interdependence between regions – actions in one country affect conditions in the others. In order to support EMU, the SGP attempts to introduce a minimum degree of fiscal rectitude. Such a move is necessary and welcome; the rules underlying this system need to be respected, else credibility will be lost. UNICE calls on member states to sustain, and where necessary increase, their efforts at budgetary consolidation. But this needs to be accompanied by an equal effort at implementing structural reform. These remain the two prongs of economic policy that UNICE expects from policy-makers.

BOX: *Investment*

Investment is fundamental to the process of economic growth – over time it determines the supply-side potential of the economy, and hence, its growth potential. Investment supports the economy through several channels.

Investment is required at the first level, to maintain – or increase – the existing capital stock. By renewing the capital stock, investment also performs a further key task: it transfers technological progress into the production process. New equipment will embody technological advances. Unless technological progress is embodied in new investment, it will have no economic benefit.

Increases in the capital stock over time also have a dynamic effect upon productivity, which will lead to higher employment and higher wages across the economy as a whole.

Thus it is clear that policy-makers need to be sensitive to the determinants of investment.

The EU's investment performance over the last 10 years is generally seen as lacklustre. Over the 1990s investment in the euro-zone grew at annual average rate of 2%. In order to meet the income growth target of 3% per year, estimated investment growth of 4-6% per year will be required. This highlights the importance of investment to overall economic performance. How can such an increase in the rate of investment growth be achieved?

Comparison with the investment performance of the US is instructive. Investment growth in US was clearly higher than in the EU over the 1990s.

The level of investment is generally well-explained in the EU and the US by three (traditional) macro-economic variables – profitability, the relative price of capital, and the cost of raising capital. These variables fail, however, to explain the divergent growth path of investment between the two regions over recent years. Investment growth in the US has been more responsive to changes in macro-economic conditions. How is this explained?

Structural factors. The EU continues to face greater structural rigidities, which inhibit the responsiveness of investment to business opportunities. While ICT investments explain some of the difference in performance, it is clear that companies in the US face a more **investment-friendly climate**. How can the EU improve its own climate?

The micro-economics matter

A stable macro-economic framework (including consolidated public finances) remains a necessary condition for growth. Within this there is considerable scope for structural reforms to improve the micro-economic conditions, such as:

- A more efficient – integrated – financial market, including an effective stock market, will ease financing difficulties;
- Labour market reforms to improve the flexible use of resources;
- Corporation tax reductions increase returns earned on capital investment;
- Completion of the single market project, increasing competition and removing entry barriers in sheltered sectors, which will offer investment opportunities.

This calls for renewed vigour implementing the Lisbon process and the Financial Services Action Plan.

The public sector accounts for 12% of total investment in the euro-zone. It bears the heavy responsibility of establishing the framework conditions for investment and growth. The quality of public expenditure, as much as its level, is the vital consideration for future growth potential.

Public expenditure carries most of the burden of educating the future workforce. It is difficult to overstate its importance for continued growth. Governments need to ensure that the intangible aspects of training and education can meet the needs of the future. (Ironically, these activities tend to be excluded from official investment data.)

The appropriate level of public sector investment, however, needs to be carefully considered. The taxes needed to finance public investment distort market incentives, and so introduce a clear cost. Furthermore, diminishing returns have been experienced in public investment, which reduce its effectiveness. In most EU countries, however, the quality of public expenditure would be improved by a shift towards investment, without increases in the tax burden.

Europe has every interest in providing itself with a more investment-friendly environment. To do so will require continued reforms in both financial markets, labour markets and product markets. Governments should be preoccupied with creating the framework conditions for a dynamic investment climate.

Tax and regulatory burden

The levels of both tax and regulatory burdens continue to hamper the dynamism of European industry. This theme has received considerable attention at the EU level. In the last edition of the UNICE Economic Outlook, an apparent divergence in the way governments treat these two areas – taxes and regulations – was noted. Governments appeared more willing to impose new regulations than to increase taxes. This trend is repeated here.

The graph indicates the broad picture that emerges well; while practically no increases in business taxes are expected (the UK is the one exception), around half the weighted replies indicated that regulations have increased, to the detriment of competitiveness.

Regulations have increased in Germany, France, the UK and Belgium; again we can note that some of the largest member states are failing to implement reforms that go in the direction of allowing business to get on with its work.

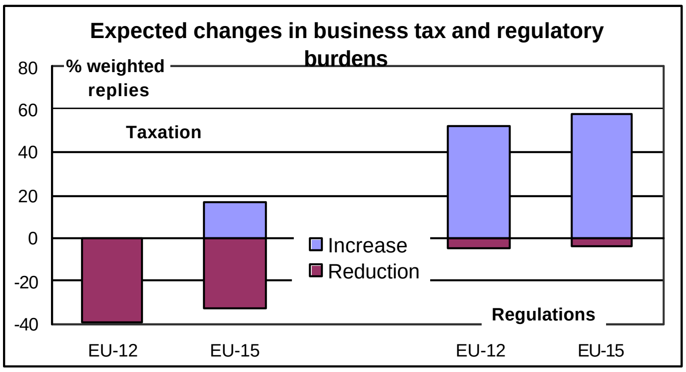
In France, the UK and Belgium regulations have increased in particular in the labour market, which impedes its efficient functioning. In France this takes the form of the extension of the 35-hour working week to small companies. One of several measures in the UK's new Employment bill is the requirement for employers to consider all requests for flexible working, and provide a justification where this is turned down. In Belgium, a new law makes companies automatically responsible for cases of bullying at work. Furthermore, there is a proposal to make more difficult the legal procedure for preventing workers from damaging company property in cases of industrial dispute. In Germany, on the other hand, increases in the burden have taken the form of road tolls for lorries, the burden related to the eco-taxes and high costs for e-businesses.

Only in Austria and Greece has the regulatory burden declined in recent months; in Greece this took the form of an improvement in e-communication. In Austria there was some progress towards speeding up permit procedures for investment in factories, as well as moves towards a one-stop-shop principle.

The UK is the only member concerned about possible business tax increases; some modest increases (such as a new tax on quarrying – the aggregates tax) will be implemented in April. Furthermore, the government's spending review this summer may well lead to expenditure increases, which the business sector may have to fund, such as through new green taxes.

On the other hand, several member states are expecting business tax reductions; limited reductions in the burden are expected in Spain, Italy and Luxembourg, as systems are reformed, while in the Netherlands a slight fall in the company tax rate (35% to 34.5%) will be supplemented by marginally lower social contributions. In Greece taxes should fall, as tax incentives are offered for creating new jobs.

Chart 15



Thus it is clear that governments are still active in many countries in terms of new regulations, which make the business climate more difficult for businesses. It is a welcome step that policy-makers appear less willing to burden business with additional taxes. However, an increased regulatory burden has an equivalent impact to tax increases – it prevents business from going about its work. It will make it harder to create growth and employment.

Main risks over the next six months

Elections are coming up in France, Germany, Ireland, Portugal, Sweden, the Netherlands, and Finland. This could have a significant impact on the political landscape in the EU. Furthermore, it risks causing considerable policy stagnation in many member states over the coming months, as attention is focussed upon election campaigns. This is clearly a concern to the business world, as reforms remain important for economic progress.

In most member states the extent of economic recovery in the US remains a key consideration, for its effects on economic confidence and on external demand. There will be some recovery in the US, purely because inventories have to be built up again, but beyond this, the situation remains unclear.

Several members – in France, the UK, Finland and Sweden – specifically point to the economic situation in Germany as a concern and a factor for growth in the coming year.

The stable macro-economic framework – including the low interest rates – which currently prevails in the EU, is seen by most as an appropriate setting for growth to pick up again.

Military conflict – either in the Middle East or more generally the war on terrorism – is highlighted as a factor that may affect the business climate. There is concern that instability could be caused, or the oil price could be affected, in several member states, including Germany, Italy, Ireland and Finland.

The price of raw materials, again including oil, is also seen as important in Belgium and Austria.

The level of wage claims is seen as a having a potentially negative impact in Germany, the Netherlands and Belgium.

In several member states the state of public finances is highlighted as a potential risk for the business climate, including France, the UK and Ireland.

Several other factors that could influence the economic climate in the coming months are noted by UNICE member federations.

In France and Finland there is particular concern about the level of high-tech investment, with Finnish companies more specifically concerned about 3G-network investments in Europe.

Spain, Germany, and Belgium express concern about the extent and spread of the crisis in Argentina.

In Ireland, the increase in insurance costs could have a negative impact upon recovery. Furthermore, there is evidence of over-borrowing in the personal and corporate sectors.

Stock markets are viewed as important for the recovery, with Italy notably concerned about renewed price falls in the US, whereas Finland is more hopeful of a return to growth domestically.

Consumer confidence is a source of concern for Germany, Italy and Finland.

Public sector investment in the Olympic games looks likely to provide a positive stimulus to the Greek economy.

List of UNICE member federations surveyed in the Economic Outlook:

BDI	Germany
MEDEF	France
CONFINDUSTRIA	Italy
CEOE	Spain
VNO-NCW	Netherlands
IBEC	Ireland
CIP/AIP	Portugal
VOI	Austria
FEDIL	Luxembourg
TT/PT	Finland
VBO-FEB	Belgium
CBI	UK
DI	Denmark
FGI	Greece
SVENSKT NARINGSLIV	Sweden

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	B	D	EL	E	F	IRL	I	L	NL	A	P	FIN	EU-12	DK	S	UK	EU-15
Forecasts 2002																	
Real GDP (annual % growth)	0,6	0,5	3,8	2,0	1,1	3,0	1,3	3,2	1,5	1,0	1,4	2,2	1,2	0,6	1,5	1,8	1,3
Inflation (%)	1,7	1,4	2,8	2,7	0,9	3,5	1,5	2,4	3,3	1,6	2,7	1,7	1,7	1,7	2,0	1,9	1,7
Unemployment (%)	7,3	8,0	10,5	10,3	9,3	4,9	9,4	2,8	3,8	4,2	4,3	9,2	8,2	4,9	4,4	5,2	7,6
Nom. compensn of employees (annual % growth)													2,8				3,1
Forecasts 2003																	
Real GDP (annual % growth)	3,2	2,7	4,0	3,0	2,0	5,0	2,6	5,7	2,5	2,5	2,3	3,0	2,6	2,0	3,2	2,7	2,7
Inflation (%)	1,0	1,3	2,5	3,3	1,2	3,0	1,7	2,2	2,5	1,7	2,2	2,2	1,7	1,9	2,2	2,3	1,9
Unemployment (%)	7,3	7,8	9,8	9,4	9,7	4,5	9,0	2,8	4,5	4,0	4,7	9,0	8,1	5,1	4,2	5,3	7,5
Nom. compensn of employees (annual % growth)													2,1				2,7
Question 1	**Trend in business climate over the next 6 months**												Ind/Ser				Ind/Ser
positive	Ser	Ind Ser	Ind Ser		Ind Ser		Ind Ser		Ind	Ind Ser		Ind	81 77	Ind Ser			66 63
negative				Ind									11 0				9 0
neither pos nor neg	Ind			Ser		Ind Ser		Ind Ser	Ser		Ind Ser	Ser	8 23		Ind Ser	Ind Ser	25 37
Question 2	**Trend in profitability over the next 6 months**												Ind/Ser				Ind/Ser
positive			Ser				Ind Ser			Ind			22 22	Ind Ser			20 19
negative	Ind Ser	Ind		Ind	Ind Ser	Ind Ser		Ind Ser	Ind Ser		Ind Ser	Ind	75 34		Ind Ser	Ind	79 30
unchanged		Ser	Ind	Ser						Ser		Ser	2 44			Ser	2 51
Question 3	**Trend in investment over the next 6 months**												Ind/Ser				Ind/Ser
positive							Ind Ser	Ind					20 20	Ind Ser	Ser		17 20
negative	Ind	Ind			Ind Ser	Ind Ser			Ind		Ind Ser	Ind	64 24		Ind	Ind	70 19
unchanged	Ser	Ser	Ind Ser	Ind Ser				Ser	Ser	Ind Ser		Ser	16 57			Ser	13 61
Question 4	**Level of exchange rate with**												H/A/L				H/A/L
USD	Low	Low	Appr	Low	Appr	Low	Low	Low	Appr	Appr	Low	Low	0/32/68	Appr	Low	Appr	0/43/57
GBP	Low	Low	Appr	Low	Low	Low	Low	Low	Low	Low	Low	Appr	0/4/96	Appr	Low	na	0/5/78
JPY	Appr	Low	na	High	Appr	Low	Low	Appr	Appr	Appr	Appr	Appr	11/37/49	Appr	Appr	Appr	9/50/39
Euro	Low	na	na	Appr	na	na	na	na	na	na	na	na		Appr	Low	High	
others: SEK	na	na	na	na	na	na	na	na	na	na	na	High		na	na	na	
Question 5	**Stance of monetary policy**																
tight					yes		yes			yes			42				34
appropriate	yes	yes	yes			yes		yes	yes			yes	44	yes		yes	53
loose				yes							yes		13		yes		13
Question 6	**What is your opinion of the ECB (conduct of monetary policy favourable to business, transparency)**																
positive	yes	yes	yes	yes	yes		yes		yes		yes		93	yes			76
negative						yes				yes			4				4
no answers								yes				yes	2		yes	yes	21
Question 7	**Compared to 6 months ago, SME's cost/access to capital for business development is**												C A				C A
higher / more difficult	C A	A			C A					A	C A		26 57				21 46
same		C	C A	C A		C A	C A	C A	C A	C		A	72 43	C A	C A	C A	78 54
lower / less difficult												C	2 0				1 0
Question 8	**Trend in government bonds yields and stock market prices over the next 6 months**												U/S/D				U/S/D
Stock mkt prices	up	up	same	same	same	same	same	same	up	up	same	up	43/57/0	up	up	same	38/62/0
Govt bond yields	same	down	same	same	same	same	same	same	same	same	same	same	0/72/28	same	same	same	0/78/22

	B	D	EL	E	F	IRL	I	L	NL	A	P	FIN	EU-12	DK	S	UK	EU-15
Question 9	**Trend of total tax burden on business in the past 6 months**																
increased		yes			yes				yes				54				43
decreased						yes					yes	yes	6				5
unchanged	yes		yes	yes			yes	yes		yes			40	yes	yes	yes	52
Question 10	**Trend in total tax burden on business in the next 6 months**																
increase													0			yes	17
decrease			yes	yes			yes	yes	yes				39	yes			33
no change	yes	yes			yes	yes				yes	yes	yes	61		yes		51
Question 11	**What is your assessment of the budgetary policy programme for 2001?**																
positive	yes			yes		yes	yes	yes					36	yes			30
negative		yes	yes		yes				yes	yes		yes	62		yes	yes	68
no answer											yes		2				2
Question 12	**Implementation of the Stability & Growth Pact: what is your assessment of your country's multiannual stability programme?**																
positive	yes		yes	yes			yes	yes	yes	yes		yes	48	yes	yes		42
negative		yes			yes	yes					yes		52				42
no answer													0			yes	17
Question 13	**Regulations that harm competitiveness have increased, decreased or not changed?**																
Increase	yes	yes			yes								52			yes	58
No change				yes			yes	yes	yes		yes	yes	41	yes	yes		37
Decrease			yes							yes			5				4
Question 14	**Overall trend in employment**												U/S/D				U/S/D
Ind: past 6 mnths	Down	Down	Same	Down	Down	Up	Down	Up	Down	Down	Down	Down	2/2/96	Down	Down	Down	1/2/97
Ind: next 6 mnths	Down	Down	Same	Same	Down	Up	Same	Up	Down	Down	Down	Down	2/33/65	Down	Down	Down	1/26/73
Ser: past 6 mnths	Up	Down	Up	Up	Up	Up	Down	Up	Up	Down	Up	Up	49/0/51	Down	Up	Up	58/0/42
Ser: next 6 mnths	Same	Down	Up	Down	Up	Up	Same	Up	Same	Same	Same	Same	24/37/39	Down	Same	Same	19/48/33
Question 15	**Expectation of labour markets over the next 6 months**																
more tight													0				0
unchanged			yes				yes	yes			yes		25				20
less tight	yes	yes		yes	yes	yes			yes	yes		yes	75	yes	yes	yes	80
Question 16	**Evaluation of labour productivity**												Ind/Ser				Ind/Ser
high	Ind		Ind		Ind Ser	Ind				Ind			31 20				24 16
average	Ser	Ser	Ser	Ind Ser		Ser	Ind	Ind Ser	Ind	Ser		Ser	37 52	Ind Ser	Ind	Ind Ser	50 59
low		Ind					Ser		Ser		Ind Ser	Ind	33 28		Ser		26 25
Question 17	**Wage growth compared productivity growth plus expected inflation:**												Ind/Ser				Ind/Ser
higher	Ind Ser	Ind Ser			Ind Ser	Ser			Ser			Ind	54 60	Ind Ser			44 49
same			Ind Ser	Ind Ser		Ind	Ind Ser		Ind	Ind		Ser	43 35			Ind Ser	51 44
lower								Ind Ser			Ind Ser		3 3				2 2
One-off questions																	
A	**Will public finances achieve balance (or a surplus) over the medium-run/the economic cycle?**																
Yes	yes		yes	yes			yes	yes	yes	yes		yes	48	yes	yes		42
No		no			no	no							50				40
no answer											no ans		2			no ans	18
B	**Has policy co-ordination at the EU level improved the national management of public finances?**																
Yes	yes		yes	yes	yes	yes				yes		yes	43		yes		37
No		no							no				34	no			29
no answer							no ans	no ans			no ans		22			no ans	34
C	**How will consumer confidence develop over the next 6 months?**																
Positively							pos	pos	pos	pos	pos	pos	33	pos	pos		30
Negatively				neg		neg							12				10
no answer	no ans	no ans	no ans		no ans								54			no ans	60
D	**The crisis in Argentina will affect business in your country:**																
Positively													0				0
Negatively				neg									11	neg			10
No impact	none	none	none		none	none	none		none	none	none	none	89		none	none	89