BUSINESSEUROPE

Macro-economic dialogue at technical level
25 May 2009

19 May 2009

POLICY-MAKERS MUST COMBAT SECOND-ROUND EFFECTS OF THE CRISIS

Most severe recession on record:

- The EU economy has now registered four consecutive quarters of negative GDP growth, with the contraction escalating in intensity to reach minus 2.5% during the first quarter of 2009. The collapse in capital spending and exports was particularly important.
- The manufacturing sector is acutely affected, with industrial production and goods export to non-EU countries down 20% y-o-y at the end of the first quarter. Strikingly, intra-EU trade of goods dropped even more severely, by 25% on the year. This illustrates the massive disruptions and trade dislocation created by the financial crisis, including through rising trade financing difficulties within the EU internal market.

Signs of stabilisation on the horizon:

- The most brutal effects on the crisis on economic activity are behind us. This is vindicated by recent confidence indicators, which have increased since March 2009 across most sectors and member states. Financial market tensions have also abated to some extent during the second quarter of the year. However, growth is not expected to return before the start of 2010.
- Remarkably, Europe appears at present more severely hit than the US. Plausible reasons are the EU's exposure to global trade, the slower effect of stimulus measures and higher dependence of the European corporate sector on debt financing.

Lagged effects on the crisis call for strong vigilance:

- Financial sector problems are persisting and will continue to drag down economic activity if not properly addressed. The IMF predicts that losses in the European financial sector will reach around 1 trillion euro by 2010, of which only 290 billion has been disclosed (written down) so far. The impact of the recession on non-performing loans and securities will escalate in coming months, leading to a new round of credit restrictions. More forceful and coordinated action is needed to clean up the balance sheets of commercial banks, restore trade financing and credit flows through both bank lending and wholesale markets.
- Labour market conditions will feel the impact of the crisis with a time lag, affecting confidence and domestic demand throughout 2010. The EU unemployment rate will rise to around 11% next year, from 7% in 2008, with the worst impact observed in Spain, Ireland, Estonia and Lithuania. Priority actions are to prevent corporate bankruptcies, help preserve employment and retrain those losing jobs.

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- The rapid deterioration of public finances is a growing concern and is already reducing many member states' room for manoeuvre. Government deficits with climb to 7.3% of GDP next year with only three countries expected by the Commission to remain under the 3% limit (Finland, Cyprus and Bulgaria). Deficits will be in excess of 10% in Ireland, UK and Latvia. A common exit strategy to high public deficits will need to be defined within EU's Stability and Growth Pact and the Lisbon Strategy, reinforcing the link between the two coordination exercises.
- We must remain vigilant about the further propagation of the crisis in certain countries; in particular those relying heavily on net capital inflows. For member states outside the euro area, EU financial resources must be mobilised effectively and commitments to joining the euro reinforced where deemed appropriate. Within the euro area, safeguards must also be put in place to help the most vulnerable economies if needed. In any event, all member states should avoid taking measures that could aggravate the situation of other countries.

The business community urges policy-makers to respond to these four challenges with urgent, credible and effective actions. This is considered critical to ensure a swift recovery and prosperity in the medium term.

1. Further actions to alleviate the financial crisis

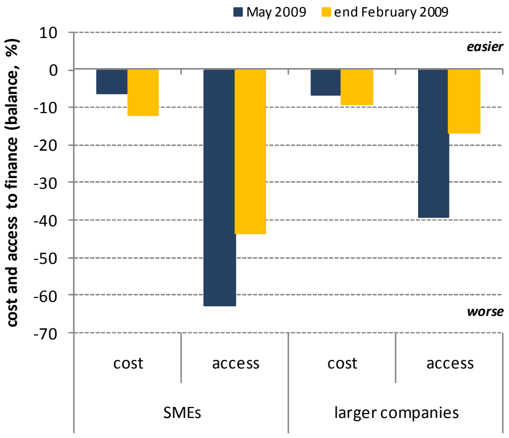
The credit crisis has entered a new phase following two quarters of sharp economic contraction. The pace of credit rating downgrades is rising rapidly and the risk of corporate default in Europe is at high from both an historical perspective and when compared with the US.

In Europe, nearly half of the expected losses in the financial sector relate to non-performing loans and securities of companies resulting from the economic downturn, against less than a fifth in the US. This means that European banks will become more restrictive and selective with corporate loans and will tend to hoard capital to cover the expected losses.

In an environment where external financing is vital to bridge the earnings gap until the recovery, further credit restrictions is creating life threatening conditions for many companies – especially SMEs.

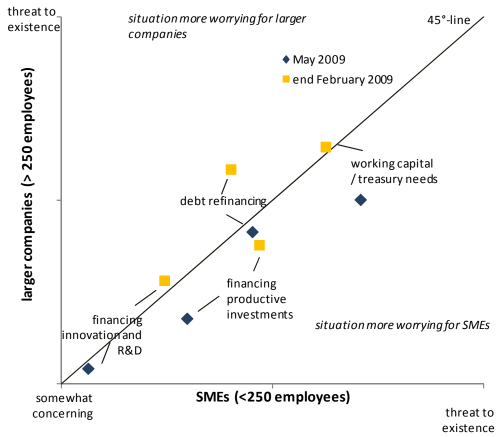
A BUSINESSEUROPE survey conducted in May shows that access to credit has become more difficult in recent months, in particular for SMEs. Meeting working capital needs remains the biggest concern for European companies, with a significantly worsened situation for SMEs.

Figure 1: Cost and access to finance



Source: BUSINESSEUROPE Economic Outlook (Spring 2009 & May Update)

Figure 2: Companies problems in access to finance



Source: BUSINESSEUROPE Economic Outlook (Spring 2009 & May Update

BUSINESSEUROPE has appreciated the role of EU institutions in alleviating the financial crisis in recent months:

- The ECB decided on 7 May 2009 to reduce interest rates further to 1.0% and to extend non-conventional monetary policy measures. These include the EIB's participation in the euro system's monetary policy operations, the purchase of euro-denominated covered bonds and the extension of maturity up to one year of liquidity provided through full allotment and fixed-rate tender to commercial banks.
- The EIB has increased the envelope of support measures for SMEs to 30 billion euro for the period 2009-2011 and improved the attractiveness of its products with risk-sharing schemes or mezzanine financing.
- The Commission has planned to frontload payouts of structural funds, recommended an increase in the Medium-Term Assistance Facility to 50 billion euro, temporarily eased state aid rules and is following up on de Larosière proposals to reinforce financial market supervision.

However, BUSINESSEUROPE recommends further steps to resolve the crisis. It is essential that

- The ECB considers the direct purchase of corporate debt instruments if credit conditions do not significantly improve in coming weeks;
- The EIB improves its risk-sharing facilities and puts in place, together with the Commission and member states, an EU-wide scheme to resolve credit insurance and trade financing difficulties;
- The Commission and member states to reinforce a common approach to cleaning up the balance sheet of commercial banks in distress. In this context, a common methodology and comparable assumptions should be agreed to operate financial stress tests in commercial banks and to develop comparable solvency evaluations.

2. Follow-up to Employment Summit

BUSINESSEUROPE welcomed the main conclusion of the EU Employment Summit, which emphasise the need to better coordinate economic, employment and social policies; to avoid protectionism; to implement structural reforms; and to ensure the long-term sustainability of public finances.

Flexicurity is given a prominent place among the messages resulting from the Summit. We welcome in particular the recommendations on working-time flexibility, labour cost reduction and up-skilling.

We are pleased to see that the first action proposed at the Summit promotes working-time flexibility, whereby ESF money could be used to pay for temporarily redundant employees' training programmes. This allows companies to save on the costs of redundancies and new recruitment when the economy recovers and allows workers to enhance their employability. Furthermore, the proposed action to upgrade skills at all levels is significant. Investments in education and training are essential to prepare for the next economic upswing and in the long run for an innovative and sustainable economy.

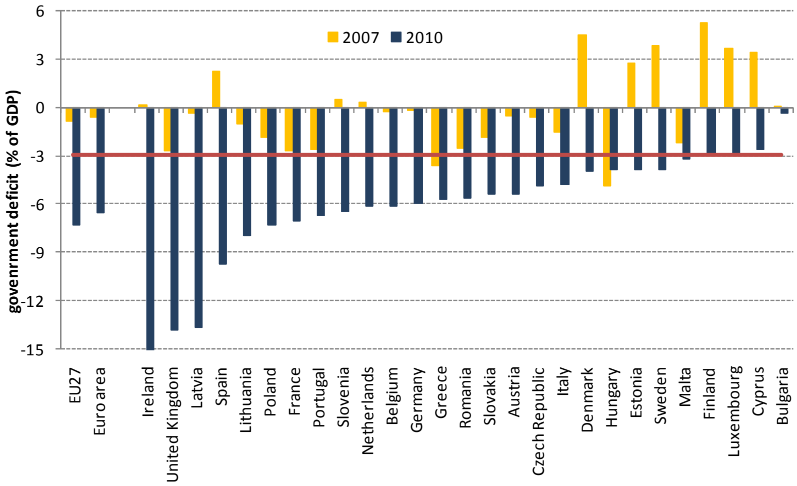
The business community welcomes in particular the call for further efforts to create a friendly environment for entrepreneurship and to foster job creation. All proposals mentioned in this regard at the Summit are fully supported, in particular lowering non-labour costs, investing in research and infrastructure and using the common principles of flexicurity to address rigidities in labour markets.

Looking forward, BUSINESSEUROPE calls on the Commission and the EU Council to ensure that the upcoming communication and Council conclusions will address both the economic and the social side of the crisis and will not exclusively focus on social remedies to fight unemployment.

3. Sustainability of public finances

Governments' reluctance to use good times to consolidate public finances and their excessive reliance on revenue windfalls has proven fatal. Evaporation of tax receipts because of the financial and economic crisis and the adoption of discretionary support and guarantee schemes have triggered a rapid and sharp deterioration of public finances in all member states, prompting markets' doubts regarding their sustainability.

Figure 3: A rapid deterioration of public households



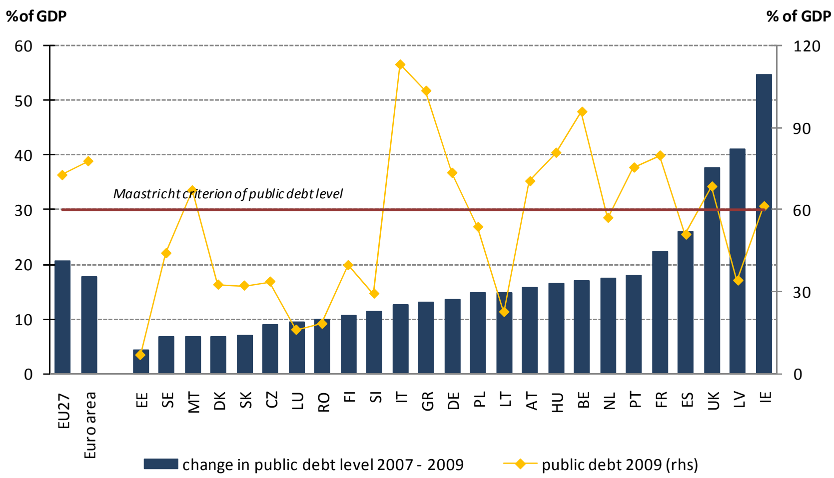
Source: BUSINESSEUROPE, Commission AMECO Database

The aim to achieve balanced budgets in the short term is unrealistic. However, as demographic pressures start to show their effects a clear commitment to fiscal discipline in the medium- to longer-term is needed to spur future confidence, private investment and domestic demand in general.

European business therefore considers that the political debate should look beyond immediate relief for the economy. In the current situation, two aspects are essential:

a) Member states and the Commission must find credible and coordinated exit strategies from support and guarantee schemes.
b) Member states must enhance the credibility of the Stability and Growth Pact and the Lisbon strategy, reinforcing the link between the two. The disappearance of budgetary provisions to face the impact of demographic ageing implies a renewed focus on growth-enhancing and cost-cutting reforms.

Figure 4: The impact of the financial and economic crisis on debt levels



Source: BUSINESSEUROPE, Commission AMECO Database

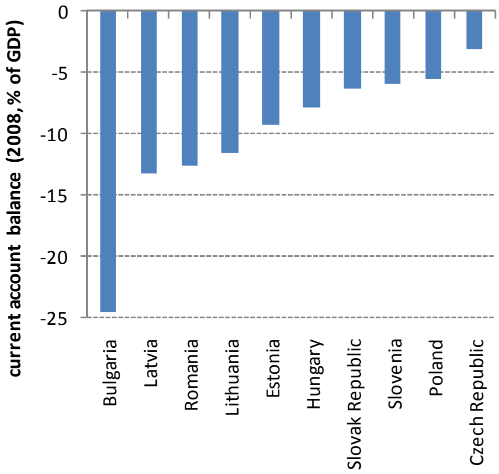
BUSINESSEUROPE therefore recommends that:

- Governments commit credibly to reach balanced budgets and sustainable public finances in the medium- to longer term, in line with the letter and spirit of Stability and Growth Pact.
- Member states must pursue structural reforms. Both the medium-term budgetary objectives the adjustment path towards them should be conditioned on the intensity of reform efforts. Particular emphasis should be put on a reduction of long-term liabilities through further pension and health care reforms and the modernisation of public administration and public services.
- The quality of public expenditures must also improve, with a clear focus on competitiveness enhancing areas like research, innovation and education. Reaching the R&D expenditure target of 3% of GDP could boost GDP by 5% over the medium term.
- Member States need to reform tax systems in order to spur entrepreneurship, SME development and innovation with for example tax deductibility for R&D investment, education and training expenditures, etc.

4. Countries facing severe consequences of the crisis

The economic situation in several central and eastern European member states is particularly dire. Although macroeconomic fundamentals differ, most central and eastern European member states share a high dependence on foreign capital inflows, a domination of foreign banks in national financial markets and pegged exchange rates combined with limited currency reserves, which increase the risk of speculative attacks.

Figure 5: Current account balances in central and eastern member states



Source: BUSINESSEUROPE, IMF

Figure 6: High dependence on foreign currency loans in eastern Europe

Source: National central banks, Deutsche Bank Research

As these member states do not benefit from the collective shield of the euro, several countries have already been forced to apply for assistance. Hungary (15.7 billion USD), Latvia (2.35 billion USD) and Romania (17.5 billion USD) have received IMF support.

The EU has stepped up its facility for countries that need to cope with balance of payments difficulties. On 8 April, 2009, the ceiling was increased to 50bn EUR. Hungary, Latvia and Romania also benefit from assistance under this scheme. In the present context, it is also important that strong commitments exist to further enlarge the euro area, hence providing a credible anchor of stability to future participants. Within the euro area, safeguard measures should also be put in place to support member states in difficulties, if needed.