**21st Macro-economic Dialogue at technical level**
**22 October 2009**

12 October 2009

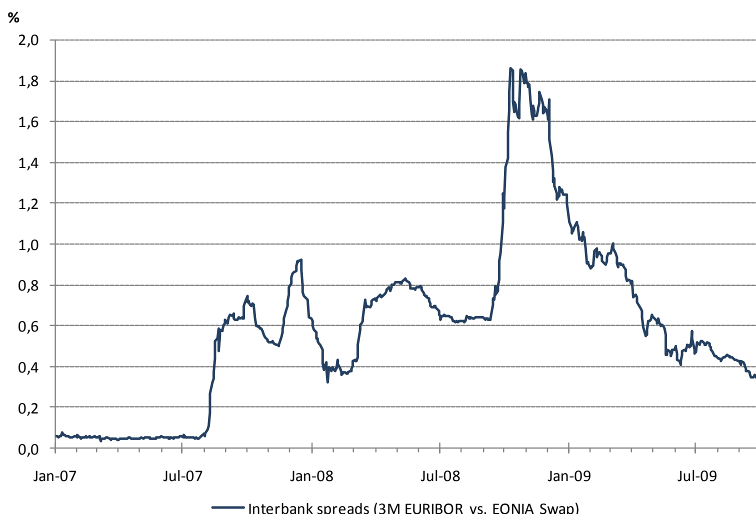
## 1. Tentative signs of economic stabilisation but no room for complacency

Positive second quarter GDP growth in some EU member states and improvements in national, European and global confidence indicators suggest that the recession might be drawing to a close.

Most of the recent improvement in economic conditions can be attributed to the following factors:

1. National governments, central banks and European institutions have enacted substantial support and rescue measures in order to cushion the immediate effects of the financial and economic crisis.
2. Companies have stopped depleting their inventories, following severe contractions in the final quarter of 2008 and first quarter of 2009.
3. Global trade has picked up in recent months, supported in particular by demand from emerging economies.

***Figure 1: Public and central bank interventions have stabilised financial markets***




*Source: BUSINESSEUROPE, www.euribor.org*

Some of these support factors could be considered to be of a temporary nature, while the longer-term repercussions of the crisis will continue to weigh on growth prospects for a considerable period of time.

By the end of 2010, we predict that total investment in the EU will have declined by around 15% from its level in 2008, that unemployment will increase to 11% of the EU's working-age population and that public indebtedness will reach close to 80% of EU GDP.


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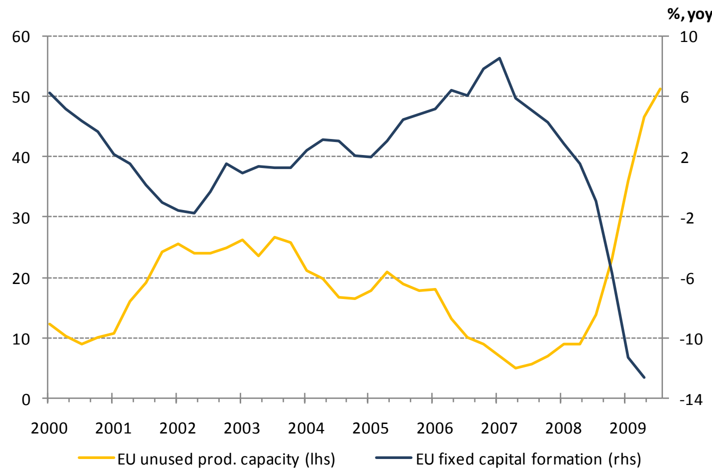
***Figure 2: Capacity utilisation and investment spending in freefall***

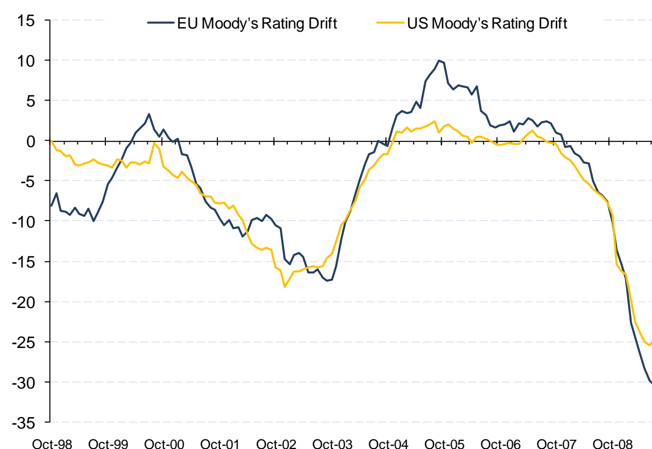



*Source: BUSINESSEUROPE, AMECO, Eurostat*

Indeed, the ongoing correction in fixed capital investment will continue against the backdrop of significant overcapacity, constrained access to finance and corporate bankruptcies.

With the pace of credit rating downgrades reaching its highest level in over a decade, a growing number of European companies will still see credit restrictions intensify in coming months. This will lead to a self-feeding spiral of financing difficulties leading to a growing pace of corporate bankruptcies and losses on banks' balance sheets.

***Figure 3: Companies' credit downgrades more important in Europe***




*Note: Rating drift calculated as upgrades minus downgrades/rated issuers*

*Source: BUSINESSEUROPE, Moody's*

## 2. Insufficient steam to lift labour market conditions

BUSINESSEUROPE's member federations expect almost 10 million jobs to be lost in the EU27 over the period 2009-2010, with close to 6.1 million this year alone. In absolute figures, Spain (minus 1.9 million) and the United Kingdom (minus 1.5 million) alone account for more than 1/3 in all EU job losses this year and next.

But it is Ireland and Lithuania that will feel the most severe effects of the crisis on labour market conditions, with employment levels forecast to fall by a total of almost 13% and 11% respectively.

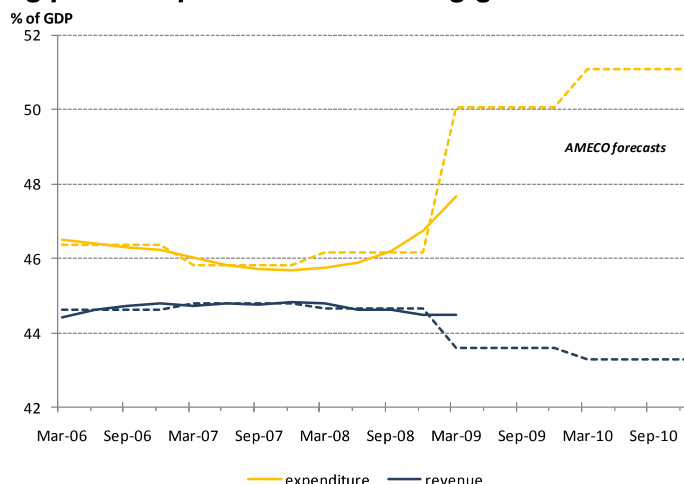
## 3. Ensuring sustainability of public finances

Business is increasingly concerned by the evolution of public finances in the EU. At the same time as expenditures have skyrocketed due to the working of automatic stabilisers, the fall in economic activity has induced a severe contraction of the tax basis. Government deficits are thus expected to grow substantially and structurally compared to pre-crisis levels, leading to ballooning public indebtedness.

With the impact of demographic ageing to be felt in coming years, governments must commit credibly to reforms fostering growth and job creation, the sustainability of social systems and the effectiveness of tax systems.

The business community is worried that governments will excessively focus their consolidation strategies on tax increases, which would significantly dent EU's hope of a sustained economic revival.

***Figure 5: Surging public expenditure and falling government revenues***



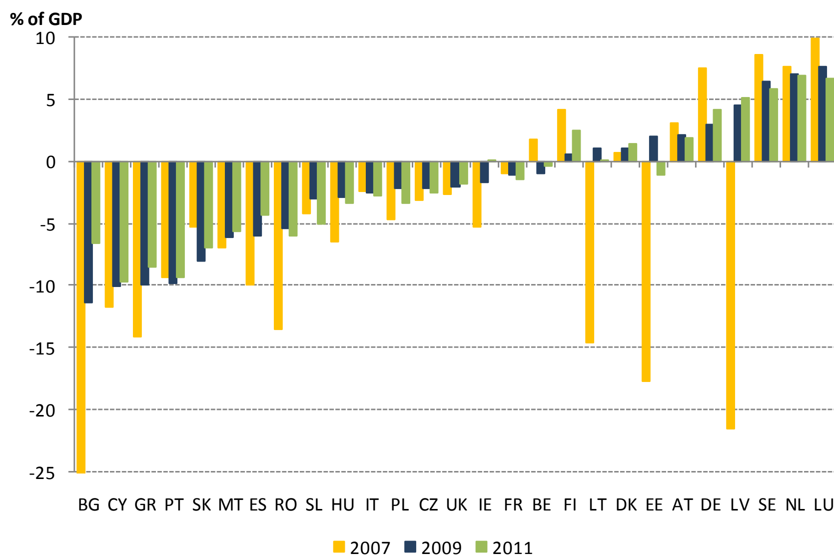

*Source: BUSINESSEUROPE, AMECO, Eurostat*

## 4. Persisting macroeconomic imbalances

The economic crisis will contribute to at least a temporary reduction in current account imbalances, both within the EU and at the global level. For example, the sharp economic contraction in the Baltic States is expected to lead to lower external deficits while surpluses in Austria, Germany, the Netherlands or Sweden will fall. The contraction between 2007 and 2009 is particularly significant in Germany.

However, a sound rebalancing of the global and European economy compatible with a swift return to growth will only be possible through well targeted reforms and consistent macroeconomic policies.

***Figure 6: Current account imbalances have started to correct***

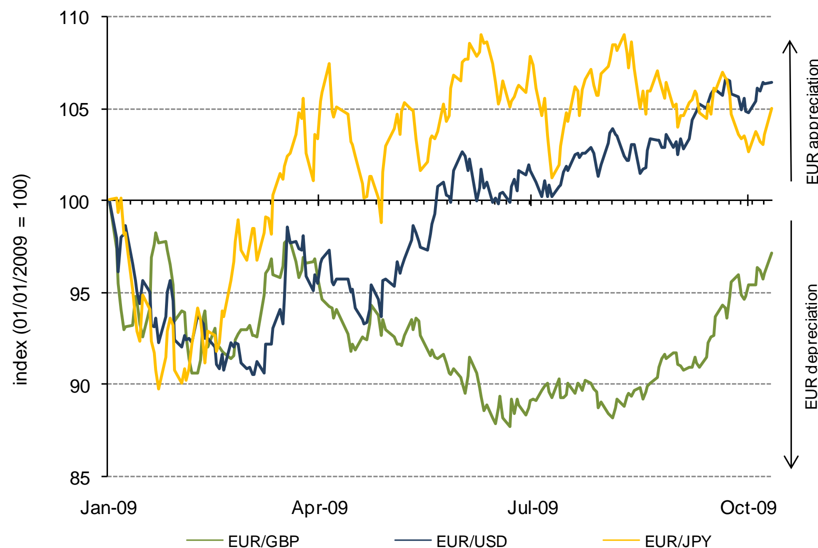



*Source: IMF (WEO October 2009)*

At the global level, a steady decline of the dollar and subsequent appreciation of the euro against most of its trading partners' currencies could signal a disorderly unwinding of global imbalances.

The impact of the rise in the euro's value is equivalent to a tightening of monetary conditions. Beyond its dampening effect on growth it will significantly complicate the exit strategies from exceptional interventions from governments and central banks and could affect the international consistency of these strategies.

*Figure 7: Steady euro appreciation against dollar and sterling*




*Source: BUSINESSEUROPE, ECB*

## 5. Challenges to be addressed

Against this economic situation, the following issues need to be addressed urgently.

a) Restore access to finance

Exit strategies for public interventions in the financial sector should be based on coordinated criteria. The appropriate sequencing of the different exit options needs to be evaluated. In BUSINESSEUROPE's opinion, it would be most appropriate to withdraw fiscal stimulus before monetary and financial support measures.

Bank intermediation plays a much more significant role in continental Europe than in the USA. It is therefore essential for the competitiveness of the European economy that exit strategies to state interventions are properly designed. Similarly, new rules for bank capital requirements will need to be proportionate and mindful of their effects on the supply of credit. A thorough impact assessment, including the interactions between individual proposals on companies' future access to finance will be vital for economic prospects in the EU.

b) Drive the consolidation of public finances through structural reforms

With the impact of demographic ageing to be felt in the near future, confidence in the sustainability of public finances must be restored. However, withdrawing stimulus measures prematurely or merely reverting to tax hikes would obliterate any hope of a sustained economic revival.

Structural reforms are a precondition for a lasting return to growth, job creation and healthier public finances. These must create a more attractive environment for entrepreneurship and innovation, address rising unemployment and boost skills for the upturn.

c) Create the condition for better labour market conditions

Current measures to support labour markets, such as short time arrangements, need to remain temporary. Converting them into permanent policies will have lasting consequences for the functioning of labour markets and the broader economy.

Member states should implement the principles of flexicurity – combining the flexibility employers need to meet changing circumstances with security for workers by supporting them between jobs and providing skills training. As part of this, social protection systems should be modernised to promote mobility and attract more people into the labour market. Hourly labour costs must be contained to favour a swift return to job creation. Tax and benefit systems should also be reformed to encourage active searching for work while providing adequate income support for those who remain outside the labour market.

d) Address macroeconomic imbalances to support high sustainable growth

Macroeconomic imbalances need to be addressed at both the European and the global level. Sharing the single currency makes policy coordination among euro-area member states even more important.

The process of rebalancing growth will have to be driven by targeted reforms aimed addressing domestic weaknesses and coordinated through a workable system of economic governance at both EU and global level.