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The crisis and beyond
Mitigating the negative impact on potential output

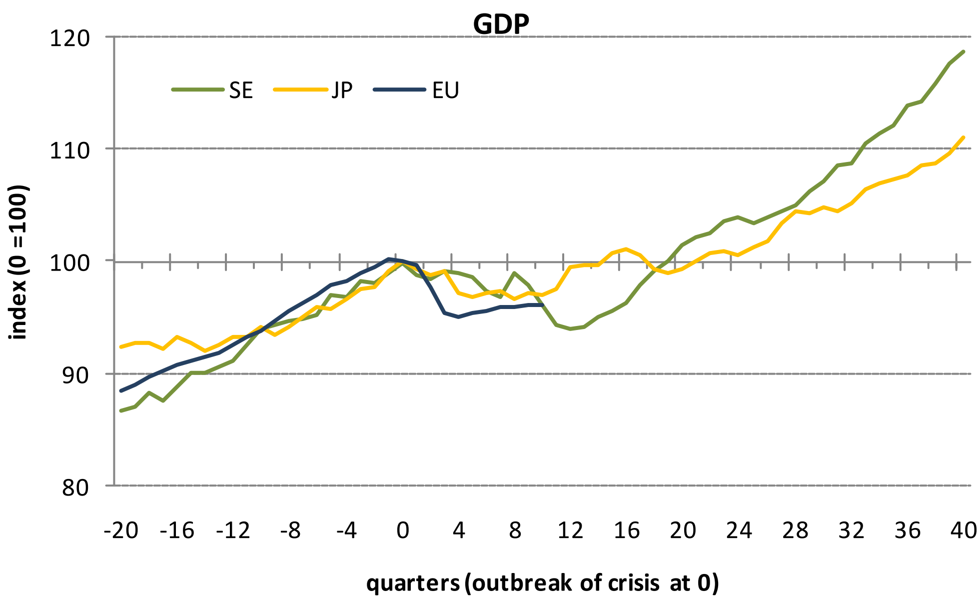
Business is concerned about the lasting damage this crisis could inflict on the EU's growth potential. With entire business sectors and industries profoundly affected, a reduction in supply-side capacity as well as erosion of the tax base and public finances has been inevitable in the short term.

But the scope of future policy responses will be vital in determining the final outcome on the welfare of European citizens, the sustainability of social systems and Europe's position on the international stage.

The contrasting experience of Sweden and Japan with banking crisis during the 1990s demonstrates that a lasting recovery is only possible if credit flows are restored and far-reaching reforms enacted.

In Japan, banks were allowed to hide losses for too long and reforms were too slow. As a result, Japanese businesses, households and ultimately public finances suffered major losses. Weak growth and deflationary pressures persisted over a protracted period, often referred to as "Japan's lost decade".

Figure 1: Evolution of GDP levels following banking crises



Source: BUSINESSEUROPE, Eurostat, OECD

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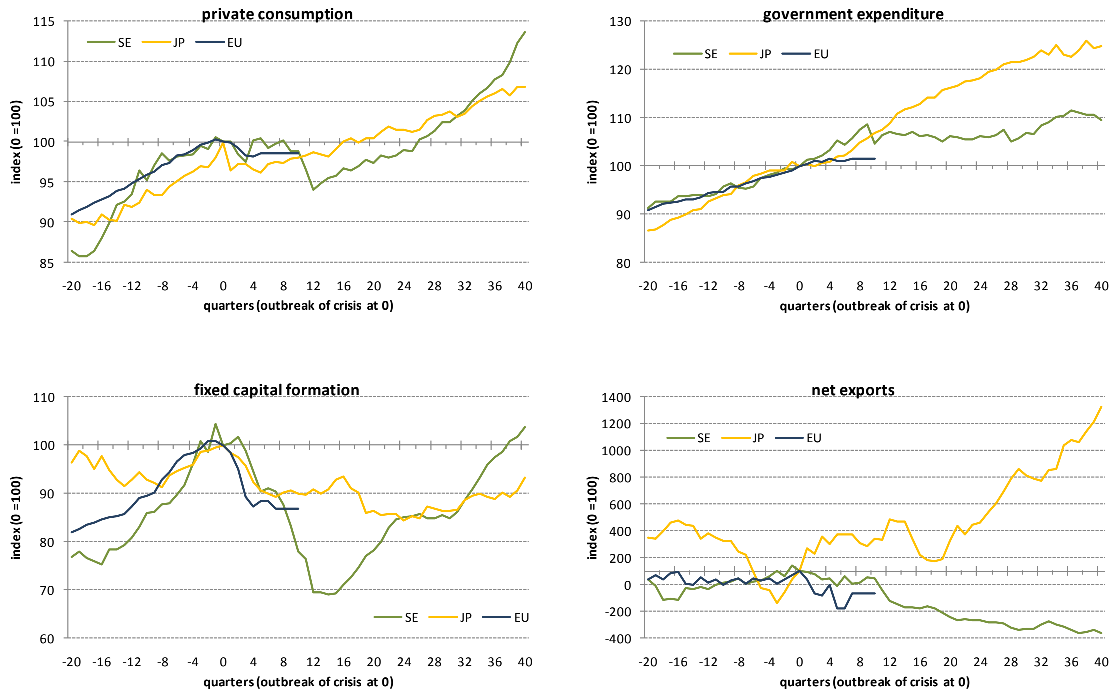
In contrast, the banking crisis in Sweden in the early 1990s was managed with much stronger determination. In addition to massive and timely interventions to stabilise the financial sector, during and immediately after the outbreak of the crisis the Swedish government introduced structural reforms. Pension and social security reforms were launched and product market deregulation promoted.

Whereas the (socialist) Swedish government succeeded in reducing deficits and stabilising expenditure within the first years following the outbreak of the crisis, Japanese expenditures rose out of proportion, contributing to a ballooning public debt of more than 150% of GDP.

Fixed investment spending plunged in Sweden after the crisis, mainly due to a correction in housing investments (bursting of housing bubble and end of subsidies to the sector). Investments in the industry sector recovered relatively fast and total capital formation was very dynamic in the second half of the 1990s, in contrast with a prolonged period of disinvestment in Japan.

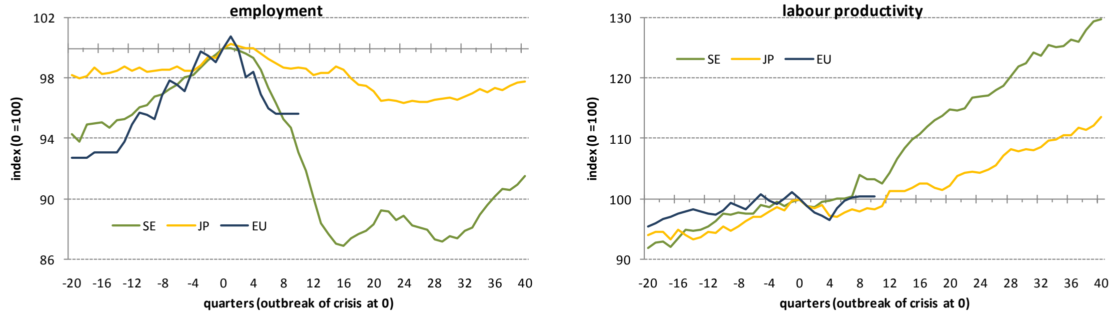
Figure 2: Breakdown of GDP



Source: BUSINESSEUROPE Economic Outlook, Eurostat, OECD

These developments allowed for a strong rise in productivity levels in Sweden, but employment was slow to recover due to the late implementation of labour market reforms. Reforms of tax and benefit systems, non-wage labour costs and minimum wages later opened up the Swedish labour market and allowed for rising employment rates.

Figure 3: Impact of crises on employment and labour productivity



Source: BUSINESSEUROPE, Eurostat, OECD

As the comparison between Japan and Sweden suggests, policy decisions to fight the banking crisis can have a significant impact on consumption behaviour, productivity growth, employment and overall economic prosperity.

Although it is still too early to judge the impact of the current crisis on Europe's potential output, BUSINESSEUROPE member federations representing almost 90% of the EU's GDP expect that the loss in the potential output level will increase over time compared with the pre-crisis situation.

This will have a serious effect on:

a) Public finances

Ensuring the medium- to longer-term sustainability of public finances will be more difficult in a context of weaker potential growth rates. In fact, the Stability and Growth Pact requirement of maintaining public debt below 60% of GDP builds on the assumption that public finances will be sustainable in the medium term if nominal annual GDP growth attains 5%. However, with lower potential output, this reasoning no longer holds and debt levels can easily spiral out of control. The effects of demographic ageing will amplify the problem even further. Appropriate policy measures therefore need to reduce long-term government liabilities, increase the effectiveness of public administration and implement growth-enhancing reforms (including tax reforms) in order to rebuild the tax basis (instead of merely raising tax rates which will further dampen the EU's growth potential).

b) Monetary policy

With lower potential output and higher uncertainty regarding the actual size of the output gap conducting monetary policy will become more challenging. The impact of the crisis on potential output will have far-reaching consequences for the optimal monetary policy stance and interest rate levels in the coming quarters. In the presence of this level of uncertainty, it appears particularly crucial to anchor inflation expectations at 2% and express symmetric concerns as regards risks of inflation and deflation.

c) Design of structural reforms

The upcoming reform agenda will have to take into consideration the common challenges arising from the present crisis (cost of capital, public finances, unemployment) but also consider the need to tailor member states' strategies to develop a balanced growth path. This includes due consideration of macroeconomic imbalances in the design of structural reforms. In a recent report entitled "Putting Europe Back on Track", BUSINESSEUROPE has spelled out its expectations on how the crisis should help redesign Europe's Growth and Jobs Strategy post-2010.