BUSINESSEUROPE

ECONOMIC OUTLOOK
AUTUMN 2012

UNCERTAINTY TAKES ITS TOLL ON THE ECONOMY

ECONOMIC SITUATION

- Political and financial uncertainty is taking its toll on business confidence, economic growth and employment.
- GDP growth in 2013 will reach just 0.5% in the EU and 0.1% in the Euro Area.
- Over 700,000 jobs will have been lost by the end of 2012, with our members foreseeing further losses of around 400,000 in 2013. Unemployment in 2013 will reach 11% in the EU (11.5% in the Euro Area).
- Investment remains constrained both by weak confidence and particularly smaller companies and those in the Euro Area periphery facing very challenging conditions in accessing finance.
- Net exports will continue to provide the only significant boost to GDP growth. We expect EU exports to grow by 3.5% in 2013, compared to import growth of 2.3%. Current account surplus in the EU will improve to 0.3% of GDP in 2012, and 0.7% of GDP in 2013.
- A number of Euro Area economies are also reducing their trade deficits, helped by reduction in Unit Labour Costs.
- Fiscal consolidation continues to progress. Public deficit in 2013 will fall to 3.3% of GDP in the EU compared to 6.9% in 2009.

POLICY CONSIDERATIONS

- In order to build confidence, EU leaders need to commit to concrete steps to strengthen the Euro, including greater political and economic integration.
- Fiscal discipline and structural reforms are beginning to show positive effects. Member States need to undertake thorough implementation of ambitious reform programmes in order to increase competitiveness and allow labour costs to better reflect productivity levels.
- Member States also need to further progress with fiscal consolidation plans in order to enhance confidence and therefore long-term growth. Consolidation plans should focus on realising public sector efficiency, including through public-private partnerships, while prioritising growth-enhancing investment and restoring consumer confidence.
- Measure to improve long-term financial stability through bank recapitalization and changes in financial regulation must be implemented in a way that enhances firms' access to finance in order to restore and preserve investment and economic growth.
- We welcome the ECB's recent 'Outright Monetary Transactions' programme, noting the importance that any bond purchases are conditional upon Member States' reform progress. This scheme can play an important role in supporting financial stability and reducing fragmentation in Euro Area financial markets.

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Table 1: BUSINESSEUROPE forecasts

Main Variables	EU27		Euro area	
	2012	2013	2012	2013
Real GDP (annual % growth)	-0,2	0,5	-0,6	0,1
Inflation (%)	2,7	2,2	2,4	1,9
Unemployment (%)	10,5	11,0	10,8	11,5
Current Account Balance (% of GDP)	0,3	0,7	1,2	1,5
government net lending (% of GDP)	-3,7	-3,0	-3,1	-2,4
gross public debt (% of GDP)	87,4	88,9	94,6	96,1
GDP components	EU27		Euro area	
	2012	2013	2012	2013
Private consumption (%)	-0,5	0,2	-1,0	-0,3
Public consumption (%)	-0,3	-1,1	-0,6	-1,4
Gross fixed capital formation	-1,9	0,6	-3,4	-0,3
Exports (%)	2,3	3,5	2,5	3,3
Imports (%)	-0,5	2,3	-1,4	1,7

Source: BUSINESSEUROPE's forecast

Table 2: Forecast largest EU Member States

%	Real GDP Growth		Unemployment		Government Balance (% of GDP)	
	2012	2013	2012	2013	2012	2013
EU 27	**-0,2**	**0,5**	**10,5**	**11,0**	**-3,7**	**-3,0**
Euro area	**-0,6**	**0,1**	**10,8**	**11,5**	**-3,1**	**-2,4**
Germany	0,8	1	5,6	5,7	0,1	0
France	0	0,2	9,8	10,4	-4,5	-3,4
United Kingdom	0	1,4	7,9	7,9	-7	-6
Italy	-2,4	-0,6	10,7	12,1	-2,1	-1,4
Spain	-1,4	-1,4	25	26,5	-7,5	-5,5
Netherlands	-0,5	0,8	5,3	5,75	-3,7	-2,7
Poland	2,5	1,8	10,2	10	-3,2	-3
Belgium	-0,1	0,7	7,4	7,6	-1,9	-1,7
Sweden	0,9	1,2	7,7	8	-0,3	-0,6
Austria	0,8	0,9	4,5	4,7	-3,2	-2,7

Source: BUSINESSEUROPE's forecast

1. POLITITICAL INDECISION HAS DAMAGED BUSINESS CONFIDENCE, INVESTMENT AND GROWTH

The failure in recent years of European leaders to find a decisive and lasting solution to concerns regarding Euro Area debt sustainability is clearly damaging growth and employment outcomes across the entire EU.

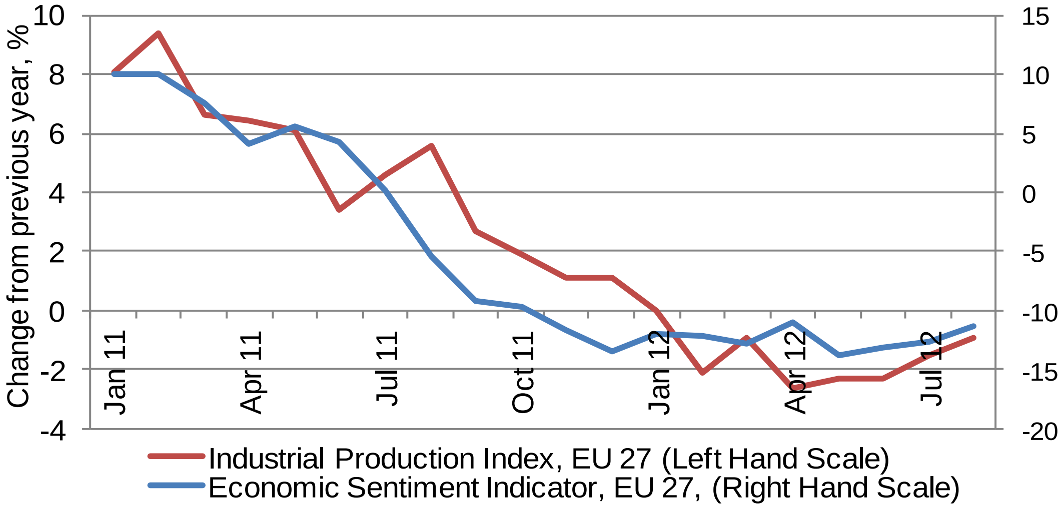
Recent ECB actions in particular and partial progress towards a banking union have reduced the exceptional levels of financial market uncertainty experienced from July 2011 onwards. Having been impacted as part of the negative feedback loop we saw build from 2010, linking political uncertainty to financial market instability, business confidence and growth prospects remain fragile, and -on their turn- negatively affect debt positions and financial instability.

It is clear that activity has fallen through the year across almost the entire EU. For 2012, our members foresee a GDP contraction of -0.2% in the EU for 2012, (-0.6% in the Euro Area). Whilst the economic activity is set to pick up in the course of 2013, leading to a central forecast for 2013 GDP growth in the EU of +0.5% (+0.1% in the Euro Area), growth will only be achieved if leaders build on most recent efforts to both implement structural reforms at Member State level and at EU level to enhance the overall strength of the euro.

Country performance will remain uneven. More specifically, Member States that developed stronger competitive and fiscal positions before the crisis will continue to be more resilient. In 2013, our members foresee GDP growth of +1.0% in Germany, +0.2% in France, +1.4% in the United Kingdom, +0.8% in the Netherlands, +1.8% in Poland, +0.7% in Belgium, +1.2% in Sweden and +0.9% in Austria. At the same time, Italy is expected to contract by -0.6% and Spain by -1.4%.

In more detail, the Economic Sentiment Indicator (ESI) in Europe has fallen to its lowest level since 2009, weighing on industrial production (figure 1) and pointing to a contraction in output in the coming months. Such a trend has been prominent in the most distressed Euro Area countries, but has progressively propagated to the rest of Europe both as a result of tight financing conditions and political instability (or uncertainty) and through falling domestic and export demand. As a result, industrial production in the EU is now a 2.7% lower than one year ago.

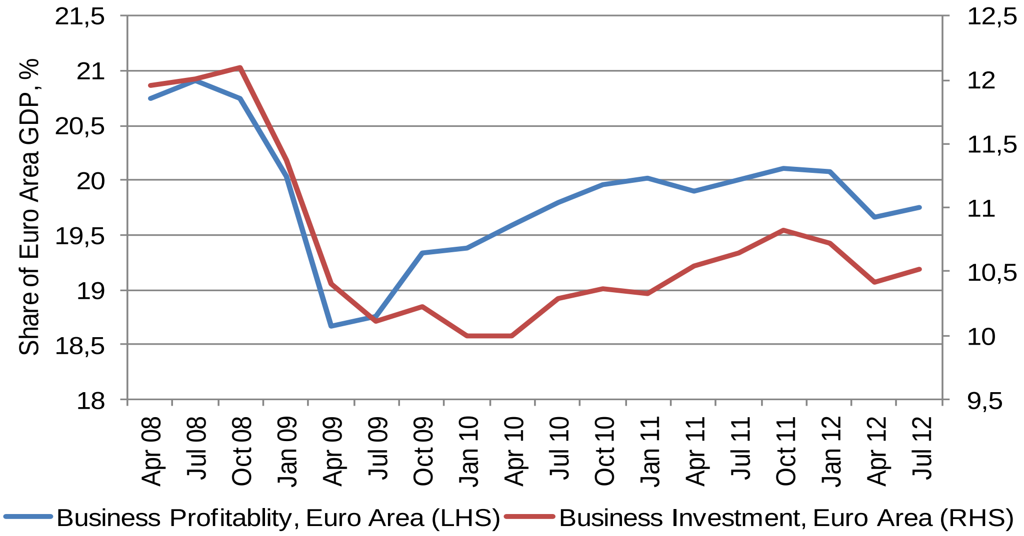
Figure 1: Confidence and investment continue to struggle



Source: Eurostat, European Commission

While many EU businesses' fundamentals remain strong, uncertainty and lack of confidence continue to discourage **investment**. Illustrating this point, figure 2 shows that profitability, while has picked up a little since 2009, it has not been matched by a rise in non-financial corporation investment. This is because instability in financial markets and uncertainty on the supply continue to discourage investment. Our members expect new investment levels to fall by around 2% this year, and to rebound by only 0.6% next year.

Figure 2: Investment has not responded to recovering profitability



Source: BUSINESSEUROPE's calculation on Eurostat data

Whilst essential for building long-term confidence and sustainable growth, it is clear that fiscal consolidation, especially when pursued through tax increases, is weighing on short-term internal demand. Reflecting this, domestic demand in the second quarter of this year fell by an annualized 1.5% in the European Union and by -2.2% in the Euro area. For 2013, our members foresee private consumption to rebound in the EU by only + 0.2% (-0.3% in the Euro Area). Public consumption is expected to contract in the EU by -1.1% (-1.4% in the Euro Area).

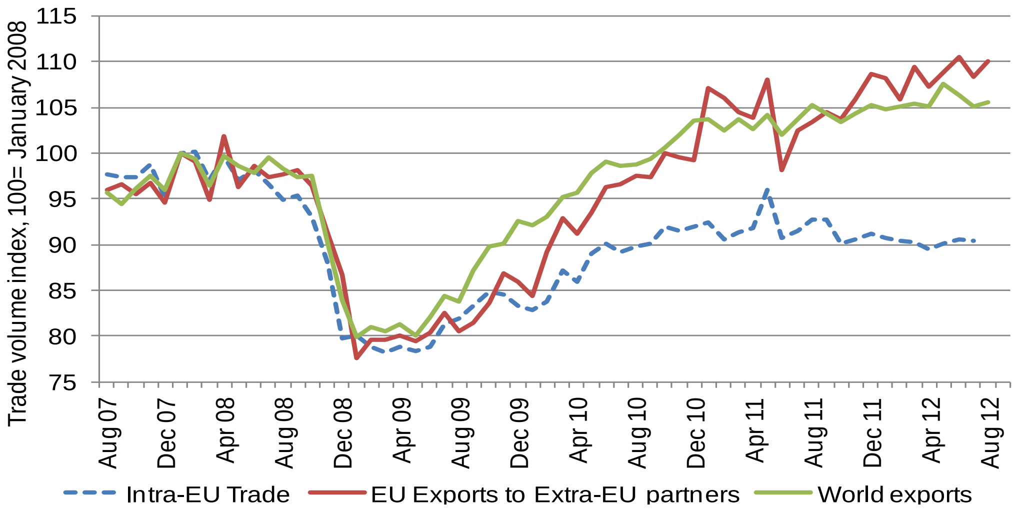
Reflecting this disappointing growth outlook, employment expectations for next few years remain negative. Our members expect unemployment levels to reach 11.0% in the EU and 11.5% in the Euro Area in 2013. This is the highest level observed in almost 20 years, and means that in 2013 more than 26 million people will be unemployed, with unemployment reaching highs of 26.5% and 24.0 % in 2013 in Spain and Greece respectively. Over 700,000 jobs will have been lost by the end of 2012, with our members foreseeing further losses of around 400,000 in 2013.

2. NET TRADE PRESENTLY THE MAIN BOOST TO GROWTH

It is only through net trade that we will continue to see some positive impetus for growth. Despite uncertainty in the EU, many European businesses remain competitive, leading to an increase in overall global export share; over the last year EU exports rose by 5%, compared to a world export's growth of 1%. Net exports, which are set to benefit from a gradual recovery of global demand, is seen as the only positive contributor to GDP growth in the EU for some more quarters to come.

In contrast, there has been little long-term growth in intra-EU trade. While the latest fall in intra-EU trade is a direct consequence of weak domestic demand in Europe (figure 3), this also highlights the need for greater implementation of the single market and restoration of confidence in de EU.

Figure 3: Exports remain very competitive, but intra-EU trade is contracting



Source: CPB Eurostat

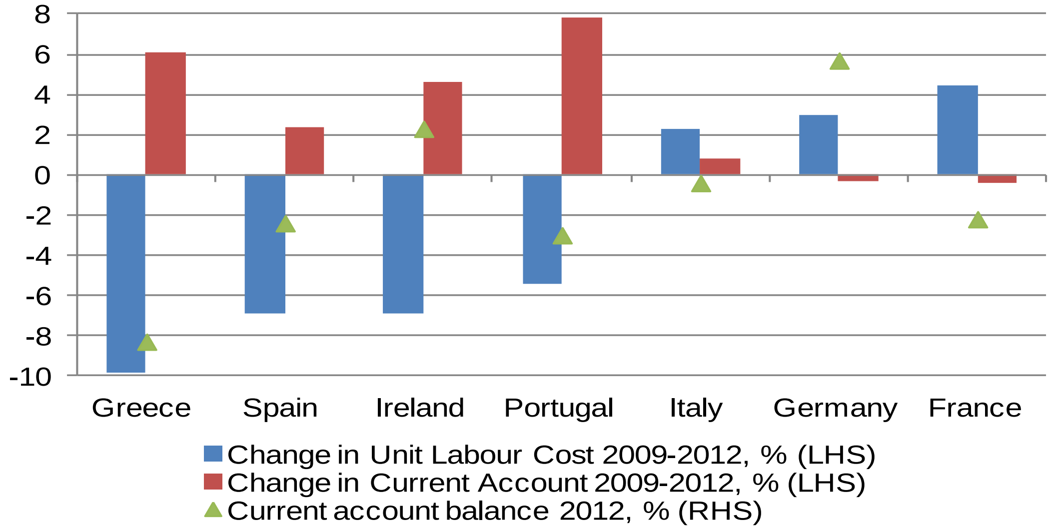
3. MACROECONOMIC IMBALANCES IN SOUTHERN EURO AREA ARE REDUCING

This shift towards an increasingly export-led growth pattern is part of a broader macro-economic adjustment process, with a number of Members States committed to reducing the competitiveness imbalances developed in the years prior to the crisis.

In particular, the Euro Area countries with the highest trade deficits have been improving their current balances (figure 4). Greece, Portugal, Ireland and Spain in particular have started benefiting from bringing their labour costs to a more sustainable level. However, particularly given that part of the observed decline in unit labour costs is due to the shedding of workers, it will be important that policy is supportive of the further improvements in this area.

As our box on fiscal consolidation describes more in detail, EU member states are also making progress in reducing their public deficits. Businesses are looking Government to remain resolute in the coming months in implementing their fiscal consolidation plans.

Figure 4: Improvements in cost competitiveness are benefitting current account positions



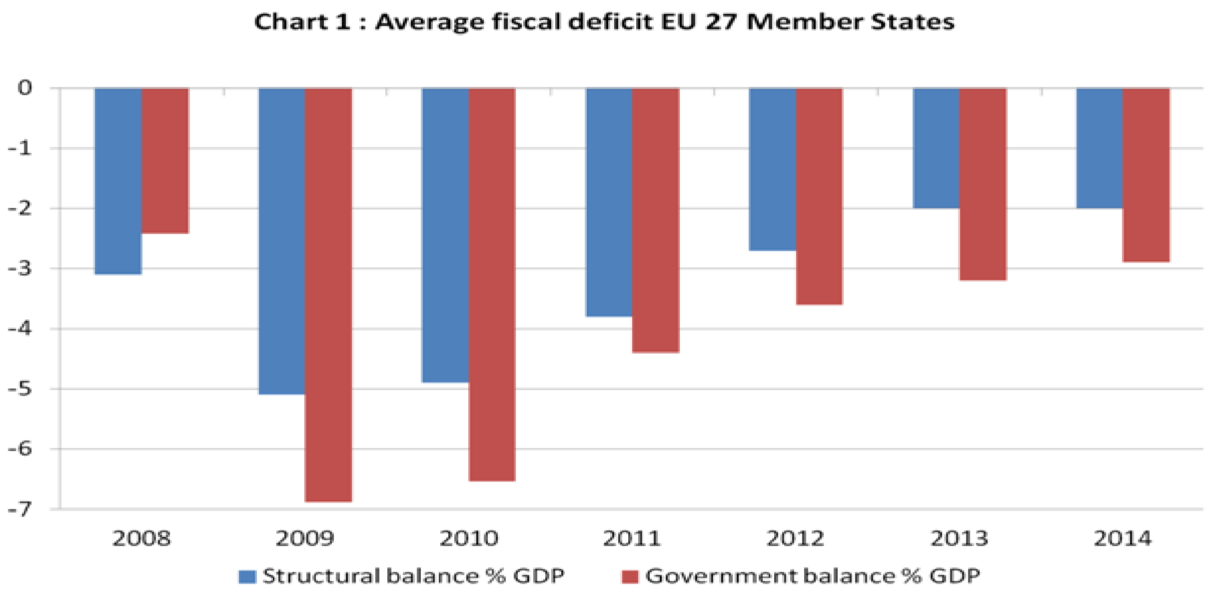
Source: Eurostat, Ameco

FOCUS: COMBINING FISCAL SUSTAINABILITY AND GROWTH

Despite strong endorsement from both the European Commission and the IMF, the importance of fiscal consolidation continues to be questioned. But an analysis of public deficit data shows that far from being 'self-defeating', Member States fiscal consolidation continue to progress, contributing to increase confidence and, when coupled with progress in competitiveness–enhancing structural reforms, the sustainability of public finances. Average budget deficits of EU Member States are expected to fall to -3.6% by the end of this year, compared to -6.9% in 2009.

As Chart 1 shows, Member States are making significant progress in reducing their underlying structural deficits. Around two third of the deficit reduction between 2009 and 2012 came from falls in public expenditures, one third from an increase in public revenues.

But with 21 countries still subject to the excessive deficit procedure, further efforts are still required regarding fiscal consolidation in the coming years.



Source: European Commission

Fiscal consolidation efforts are a prerequisite to restore confidence, reduce the pressure on interest rates and regain growth-conducive conditions in the EU, particularly given the negative long-term impact on public finances of an ageing society and associated pension and health care expenditures.

But how can Member States put in place fiscal consolidation strategies that best support growth? European Commission and OECD analysis, as well as BUSINESSEUROPE's own taskforce on public finances[1] both point to the importance of fiscal consolidation efforts reducing expenditures through increasing public sector efficiency. This can enable reductions in expenditures which can alleviate the tax-burden on the economy whilst maintaining high quality public services, particularly when opportunities for contracting-out and public/private partnerships are fully explored. Government also needs to ensure spending reviews prioritise areas which can support growth and investment, such as education, innovation, infrastructures, energy or ICT.

While fiscal consolidation should focus primarily on reducing spending, the structure of the tax revenue can also be redesigned in a way that is more growth-conducive: increase on taxes on labour and capital, which can do most damage to growth prospects, cannot be a solution.

[1] Combining fiscal sustainability and growth: a European action plan, 2010.

Ireland provides a recent example of how appropriate consolidation efforts can quickly deliver significant results. Firstly, the introduction of an independent fiscal advisory body, multi-annual expenditure ceilings and an enhanced fiscal data reporting has strengthened fiscal discipline and credibility. In addition, fiscal consolidation measures themselves have focused on increasing the efficiency of public expenditure through streamlining efforts in the public sector while preserving its social cohesion.

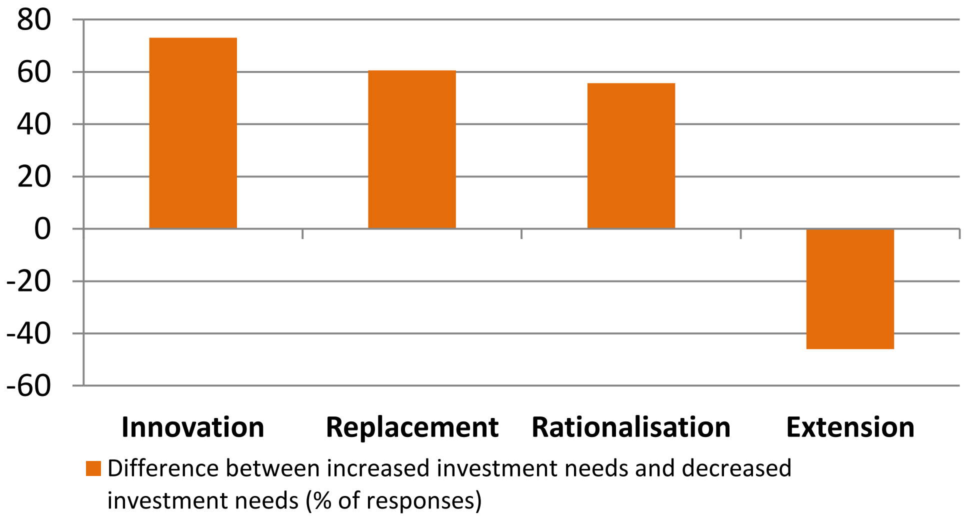
As a consequence, excluding one-off bank recapitalisation costs, the Irish deficit is expected to fall to -8.4% this year and -5% in 2014 from -11.5% in 2009. Markets have responded positively to these consolidation efforts, as a consequence of which, Ireland will benefit from lower borrowing costs, further helping the return to a sustainable public finance position and long-term sustainable growth.

4. ACCESS TO FINANCE IS BECOMING INCREASINGLY CHALLENGING

The restoration of long-term economic growth in Europe will also be dependent upon the ability of businesses to access funds for investment at realistic terms. Figure 5 indicates that although many firms lack the confidence to invest for expansionary purposes, investment funds remain key to enable firms to make essential investment, particularly related to innovation, to remain competitive and retain market share.

Strengthening prudential regulation of banks and insurance companies will increase the cost of borrowing for businesses. Implementing rules should therefore be calibrated correctly to avoid unintended consequences for businesses and the wider EU economy. In particular, medium and long term financing activities with long maturity or low profitability will be affected. These costs should be considered in the light of the likely effect of the wider range of new legislation such as the new rules on derivatives and securities.

Figure 5: Companies' most important investment needs

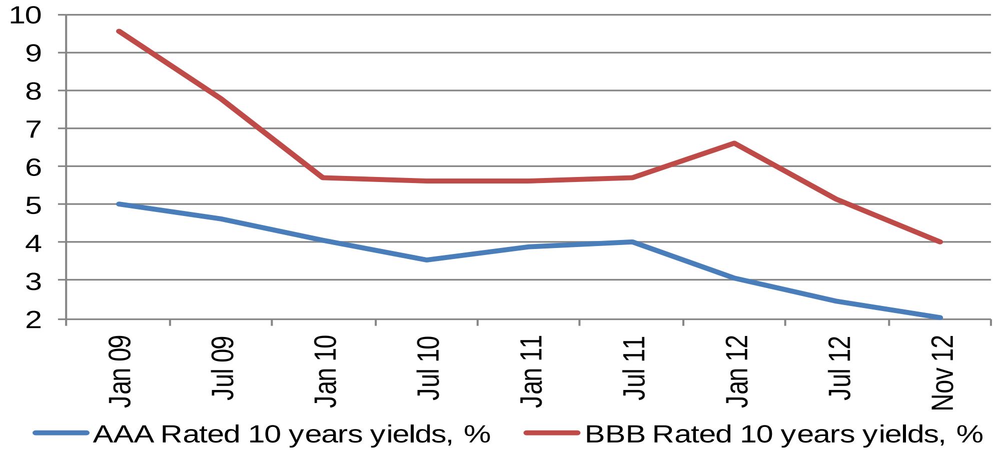


Source: BUSINESSEUROPE members' survey

Firms' ability to access finance continues to diverge according to both company size and location.

Many larger firms have benefitted through the second half of the year from improvement in corporate bond markets, with, as figure 6 indicates, rising prices leading to lower yields, making it easier for large firms to raise funds through this route.

Figure 6: Falling Corporate Bonds yields in the Euro Area

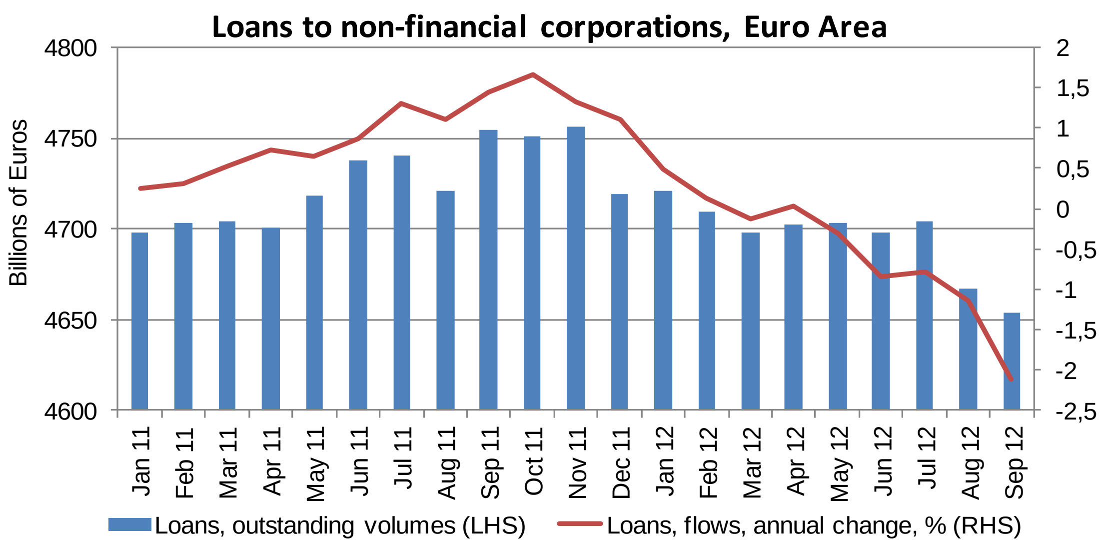


Source: Macrobond

However, for the vast majority of smaller firms, access to finance through bank lending has becoming more challenging.

Figure 7 shows that net lending to non-financial corporations has been fallen dramatically as the year has progressed. Whilst falling demand for funds from companies due to a lack of confidence and weak domestic demand is clearly playing a role in these lower lending outcomes, it is also the case that supply conditions have tightened. In particular, the ECB latest bank lending surveys continue to estimate a significant tightening of credit standards applied to the approval of loans to enterprises. This tendency has strengthened over the third quarter of 2012, as indicated by 15% of banks surveyed (up up from 10% in the second quarter of 2012).

Figure 7: Credit flow to businesses remains weak

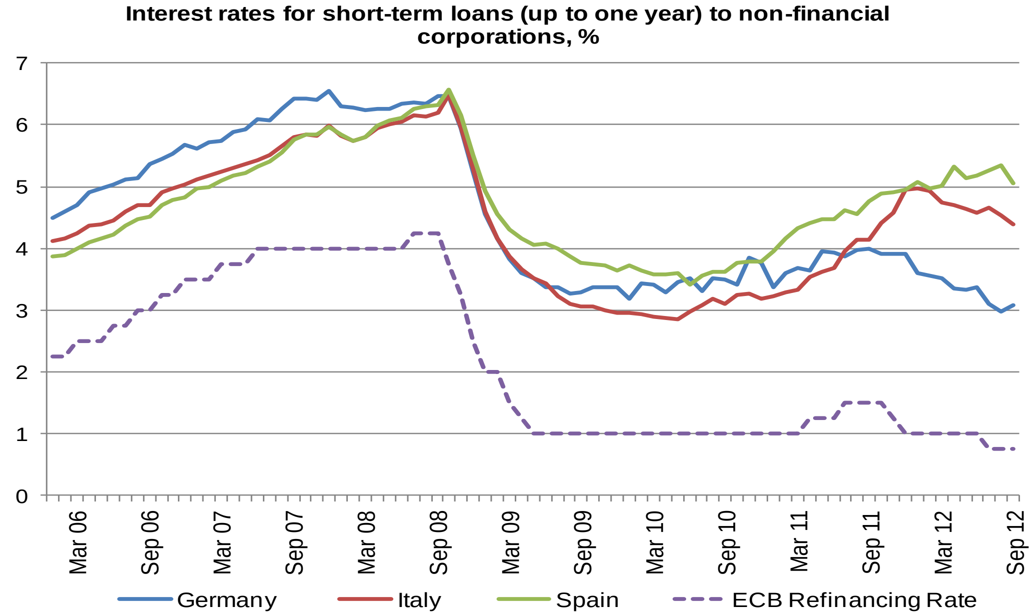


Source: European Central Bank

At a country level businesses observe a worrying trend towards falling integration of EU financial markets. Reflecting this uncertainty, since the outset of the sovereign debt crisis, the interest rate asked by banks to non-financial companies for short-term loans in the Euro Area has considerably diverged (figure 8).

At the same time, the transmission of the ECB lending interest rate to businesses' borrowing cost has weakened. As figures 8 illustrates, the latest reductions of the ECB lending rate, which is typically the main determinant of short-term interest rates, had not a homogeneous impact to the same type of businesses amongst the Euro Area.

Figure 8: Disparities in lending conditions in the Euro Area are a growing source of concern



Source: European Central Bank

In addition, cross-border lending between financial institutions fell from a 30% of the total outstanding loans to a current 24%. This is the highest fragmentation observed over the last 3 years.

Differences in lending costs to a large extent reflect differences in companies' funding costs in different countries, in turn reflecting differences in the broader structure of interest rates resulting from dramatic differences in Government borrowing costs.

The announcement in September of the ECB's programme of conditional bond purchases, its Outright Transactions Monetary (OTM) program, can play an important role in reducing such cross-country differences in borrowing costs, and it will be important that the ECB continues to monitor this key indicator in the coming months.

While financial market confidence has improved since the announcement of the programme, strong divergences remain between euro area government's borrowing costs. For example, 10 years sovereign bonds yields are presently around 5.7% in Spain and 4.8% in Italy, compared to 1.4% in Germany and 2.0% in France. Such a divergence reinforces the importance of European leaders pressing ahead with the implementation of structural economic reforms at all levels. This will restore competitiveness and growth, and thereby financial stability.

WHO ARE WE?

BUSINESSEUROPE IS THE CONFEDERATION OF EUROPEAN BUSINESS, REPRESENTING SMALL, MEDIUM AND LARGE COMPANIES. OUR MEMBERS ARE 41 LEADING BUSINESS FEDERATIONS FROM 35 COUNTRIES WORKING TOGETHER TO ACHIEVE GROWTH AND COMPETITIVENESS IN EUROPE.

WHAT IS THE ECONOMIC OUTLOOK?

THE ECONOMIC OUTLOOK TWICE A YEAR PROVIDES A BUSINESS INSIGHT INTO RECENT AND PROJECTED ECONOMIC DEVELOPMENTS IN EUROPE, BASED ON A SURVEY OF BUSINESSEUROPE MEMBER FEDERATIONS.

ANSWERS TO THIS SPRING'S QUESTIONNAIRE WERE RECEIVED BY EARLY APRIL.

MORE DETAILED RESULTS AND INDIVIDUAL MEMBER STATE FORECASTS ARE PUBLISHED ON OUR WEBSITE [WWW.BUSINESSEUROPE.EU](http://www.businesseurope.eu)