ALLIANZ DRESDNER ECONOMIC RESEARCH

The 2008 European Growth and Jobs Monitor

Indicators for Success in the Knowledge Economy

Autumn 2008 Update

In the Shadow of the Crisis: Forecasts for 2009 – and Beyond

23 October 2008

theLisboncouncil
making Europe fit for the future

Allianz

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INTRODUCTION: THE ROAD TO LISBON, MORE NECESSARY THAN BEFORE

The Lisbon Agenda, Europe's growth and jobs programme, has seemingly fallen off the face of the earth since the financial crisis has taken a grip on our continent. Does that mean it is no longer relevant? Does that mean that the need for structural reform or greater investment in human capital has subsided? Hardly. If anything, the pace of reform will need to move up a gear in coming years, as governments struggle to contain budget deficits and prepare for an ageing and declining population.

Now is not a time to take our eyes off the urgent need to create the dynamic knowledge-based economy we set out to build some eight years ago. Now is not a time to renege on creating the low-carbon economy that has the potential to transform the world – and ensure European prosperity and international competitiveness for decades to come. Now is not a time to reduce spending on our most precious resource, our citizens, who rightfully expect a world-class education, along with the opportunity to top up obsolete skills throughout their working lives.

To be sure, this Autumn Update of The European Growth and Jobs Monitor – the bi-annual survey of progress on the road to Lisbon published by Allianz SE and the Lisbon Council – does show signs of damage from the ongoing crisis. And yet – and this has been largely overlooked in the race to beat the pack with gloomy predictions – Europe has made some progress towards becoming the most competitive economy in the world. It may not be because of our own strength as through the relative weakness of others, but the times when Europe could simply be written off as a has-been are over. Not only has Europe become more dynamic, more innovative and more competitive in recent years, but it has also shown that some of our unique characteristics, such as a high savings rate and less financial exuberance as well as a fairly stable universal model of banking, are helpful in these times of financial turmoil. And it is worth noting that a far-reaching approach to solve the global financial crisis has come from European leaders, with the European Commission in an important coordinating role.

At the spring European Council in March 2008, EU leaders called for a reflection period on the future of the Lisbon Agenda, with the aim of making it more successful after the 2010 deadline expires. This reflection needs to take into consideration how Europe's growth and jobs agenda can be more relevant in times of crisis. If the Lisbon Agenda is seen as merely one of many policy processes that operate independently of what is happening in the real economy, it would be a missed opportunity for greater coherence, purpose and impact.

In this Autumn Update of the European Growth and Jobs Monitor, we will assess the damage from the ongoing financial crisis, provide growth forecasts for 2009 and review key indicators of European competitiveness. In the annex you will find a number of accompanying charts, providing recent snapshots of how the financial and economic world has changed in the wake of financial contagion and offering the basis for the conclusions that we draw on Europe's economic outlook in 2009.

IN THE SHADOW OF THE CRISIS

The fallout from the financial crisis is mounting and increasingly threatening the real economy. The credit channel is potentially the main source of infection. On both

sides of the Atlantic, banks have tightened credit standards considerably and lending growth is clearly slowing down.[1] One of the central aims of the coordinated interest rate cut on 08 October was to keep credit, the lifeblood of the economy, flowing.

Red lights are still flashing on the housing markets.[2] Falling house prices hit household wealth, construction activity and employment in this sector. On the positive side, adjustment in the US housing market is already well advanced and the rescue of Fannie Mae and Freddy Mac is starting to feed through in the form of lower mortgage lending rates and some recovery in mortgage applications in the US. In Europe, the housing market picture is mixed, with dark clouds hanging over the UK and Spain in particular.

Pervasive uncertainty and insecurity threatens to harm economic behaviour directly. Businesses and consumers are expressing more and more pessimism as measured by leading sentiment indicators.[3] The surveys show people are especially worried about their savings and jobs. This will undermine consumption. The sales outlook is poor both in Europe and abroad. Companies will probably adopt a cautious approach to investment and staffing decisions.

Twice each year, Allianz and the Lisbon Council measure progress on the so-called Lisbon Strategy, Europe's growth and jobs agenda, in The European Growth and Jobs Monitor. Not surprisingly, the financial crisis and economic slowdown has already translated into lower scores for our main Lisbon Indicator – which tracks progress on Europe's effort to modernise its economies, prepare for future challenges and provide more jobs in the EU15. The overall Lisbon Indicator slipped to 0.9 in the second quarter of this year, down from its high of 1.2 points in the second quarter of 2007.[4]

The labour market is increasingly becoming a source of concern, with unemployment rising in many European countries (though overall the EU has not yet seen as much impact on employment from the crisis as in the US).[5] The overall EU average remains 6.9%, up from the recent low of 6.8% registered in February, March and April. We believe that, with the right policy response, the coming slowdown could prove less long-lived and damaging than today's gloom-mongers would have you believe. But it is important that the right policies be adopted, and that is why the Lisbon Strategy (along with the ongoing effort to improve financial market regulation, ease credit and restore confidence to markets) is so incredibly important. On the positive side, it should also be noted that with the steep drop in the oil price and the slide in the euro, two of the main negative factors holding back European economic performance of late, have become less of an obstacle going forward.

1 See Charts 1 to 3 in the Annex for more on this trend.

2 See Charts 4, 5 and 6 in the Annex.

3 See Chart 7 in the Annex.

4 See Chart 8 in the Annex. The Lisbon Indicator tracks progress on six economic criteria derived from the original Lisbon Strategy. A score of one indicates that a country is on track to reach its Lisbon goals by the original target date of 2010. A score of 0.9 means that Europe as a whole is at 90% of the level where it should be, were it on target to meet the goals by the target date. The six areas we track are economic growth, productivity growth, employment, educational attainment levels, investment and sustainability of public finances. For more on the methodology and data, see The 2008 European Growth and Jobs Monitor (Brussels: Allianz/Lisbon Council, March 2008).

5 See Chart 11 in the Annex.

The result is, assuming the policy response continues to surprise on the upside, we are relatively optimistic. **We forecast GDP growth of 0.7% for the euro area next year, down from 1.2% this year.**[6] Most interestingly, with overall performance weak, the growth gap between individual countries is narrowing. The two biggest EMU economies, Germany and France, will probably be neck and neck in 2009 with a GDP increase of 0.7%, in line with the EMU average.[7] Italy and Spain will record below-average growth – 0.5% and 0.4%, respectively – though even in these two countries we believe that, with the right policy mix, the downturn will not be as sharp as some predict.[8] The UK economy is also likely to grow by around 0.5%.[9]

Interestingly, European countries seem to be converging around a similar level of growth, albeit at a lower level, than in recent years. But it is important to bear in mind that this similarity continues to mask important differences in the underlying economies. As Europe emerges from a period of stagnation, these differences will again become apparent, and will add up to differing levels of growth and prosperity in the respective countries. What's more, a given level of growth means different things for different countries. For instance, growth of about 0.5% in Spain (down from much higher levels) will be felt by the population much more sharply than it would be felt in, say, Italy, which has suffered from slow economic growth for years.

ECONOMIC IMPACT OF THE CRISIS

The financial crisis is a global phenomenon. Both the USA and Europe are already teetering on the brink of a recession. However, vulnerability within the EU varies. A comparison of financial market risks shows that, among the big five EU countries, Germany is in the best position. The UK seems to be most vulnerable. Among our criteria for financial market risks, the situation on the mortgage market is most serious in the UK and Spain; in Italy and France there is also reason to worry but to a lesser degree. As for private household and company indebtedness the UK and Spain are again top of the danger list. With respect to banks' refinancing indicators, the share of domestic debt securities outstanding with maturity of up to one year is problematic in the UK; in Germany the figure is not as high as in the UK but elevated. The German banks' ratio of pre-tax profits to assets is also not particularly comforting. Total bank loans to non-banks as a percentage of bank deposits are relatively high in Italy. For France none of the banks' refinancing indicators seems really critical, but not completely reassuring either, with the traffic light on amber. The Spanish banks look relatively comfortable so far.

Thanks to the resolute action we have seen in recent weeks, there may be a bit of light at the end of the tunnel. Once the severity of the crisis became clear with the default of Lehman Brothers, management has worked well at all levels: the G7, Europe and the individual states have finally acted in a coordinated manner. The EU, the ECB, the European Commission and national governments have demonstratively acted in concert. Potent packages are now in place. The next step is to successfully implement them.

With the help of liquidity injections, interest rate cuts, the recapitalisation of banks by the state and new accounting rules, we believe there is a good chance that the financial market firestorm will be quelled soon and that the global economy will manage to steer clear of a prolonged recession.

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6 This forecast makes us more optimistic than the International Monetary Fund, which revised its growth prediction for the euro area down to 0.2% on 08 October. The OECD and European Commission are expected to revise their growth forecasts downward in the near future. See Chart 14 of the Annex for a summary of our 2009 economic forecasts.

7 In the World Economic Outlook published on 08 October, the IMF takes a more pessimistic assessment, estimating Germany will record zero growth and France will grow at 0.2% next year.

8 The IMF forecasts a recession in both countries next year, with economic growth falling 0.2% on average for the year in Italy and in Spain.

9 The IMF forecasts an 0.1% recession in the UK in 2009.

POLICY RECOMMENDATIONS

Besides crisis management, there are more policy measures that would help to limit the severity of the downturn and restore confidence to the corporate sector and private households. It seems sensible to combine measures capable of having a quick impact and spurring growth in the medium term:

Short run:

- The ECB should cut interest rates even further. Inflation is going down strongly, and there is scope for lowering rates without challenging the ECB's core inflation-fighting mandate. Lowering interest rates to 3% in the next six months seems reasonable.

- Countries without large fiscal deficits (e.g. Germany, Netherlands, Austria, Finland, Sweden) could stimulate their economies by bringing forward planned measures for tax or social security reform or by providing investment incentives.

Long run:

- Countries should continue reform of labour markets to create more jobs and education systems to help raise skill levels. Countries should also continue efforts to encourage productivity growth – through more investment in education and more competition in goods and services markets. Some progress has been made in these endeavours, as we shall discuss in the next section.

Europe has a big chance to substantially influence the shape of tomorrow's financial markets. Its universal bank model is better placed for the post-crisis world than the souped-up investment banking model of recent years. Some conclusions seem clear for Europe:

- The need for a tighter regulatory framework is now beyond dispute. Capital requirements need to be revamped, transparency enhanced and off-balance sheet vehicles abolished. Europe also needs to resolve the issue of pro-cyclicality in accounting standards and capital requirements.

- Europe needs to address the fragmentation of its financial and banking markets (mortgage markets, insurance markets). The financial market upheaval provides the golden opportunity to tackle the lack of integration on this front. The scattered supervisory system has been shown to be inadequate.

As for the Lisbon process, it is essential not to slacken efforts. In a weaker economic environment, growth and employment targets will be that much more difficult to reach. European leaders must not allow a cyclical downturn to discourage them from further pursuing structural improvements to enhance the knowledge base, raise productivity and increase Europe's competitiveness in the world. To the contrary, all of those worried today about the effects and after-effects of the financial crisis should understand now exactly why growth and jobs are so important for prosperity.

LISBON INDICATOR UPDATE: OFF THE HIGHS OF 2007

Following The European Growth and Jobs Monitor published each spring, this update will look at the recent situation for the EU-15 aggregate.

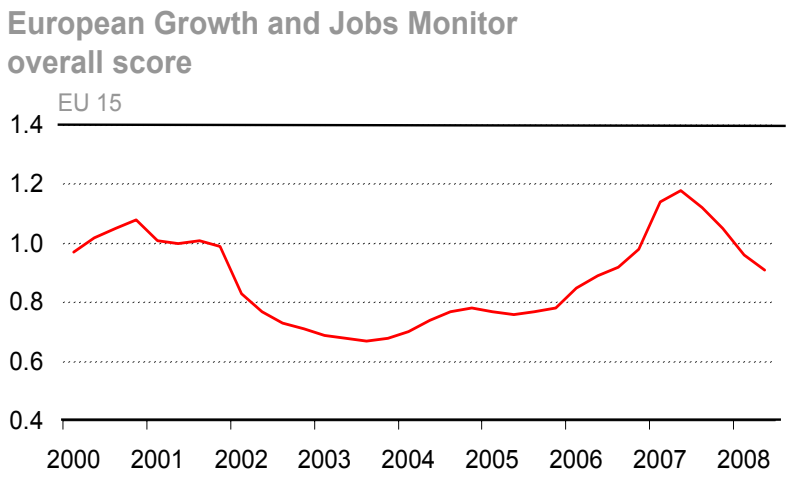
The most important findings:

1. The increasingly challenging economic environment has made achievement of the Lisbon targets more difficult. Economic growth and labour productivity, for example, have registered downturns.

2. However, most of the other components of The European Growth and Jobs Monitor – including the quality of the workforce and the levels of growth-oriented investment – have held steady or continued to improve.

3. The gap in economic growth between the individual member states remains wide. On this measure Italy in particular still lags way behind in the Lisbon Process.

The Lisbon strategy launched in 2000 aims for growth- and job-creating policy reform in Europe. Each year the European Commission evaluates progress on the implementation of national reform programmes, and there is an annual stocktaking of the Lisbon process at the EU's Spring Summit. In our most recent publication entitled "The European Growth and Jobs Monitor: Indicators for Success in the Knowledge Economy," we showed what headway was being made on achievement of the Lisbon targets, taking selected measurement variables as our yardstick.



In the regular, expanded 2008 spring edition of The European Growth and Jobs Monitor, the overall score for the summer half-year 2007 showed the EU-15 countries as a whole on track to meet the Lisbon Agenda targets in that period. At the same time, though, it was becoming increasingly apparent that the road to achievement of the Lisbon targets in 2010 would be tougher as the economic environment grew more challenging. This cautious assessment is now borne out in the interim review for the EU-15 aggregate, which covers the period ending Q2

2008. The overall indicator slipped just below the benchmark to 0.9, after falling off the high of 1.2 points set in the second quarter of 2007. The indicator thus points to 90% target achievement – still no mean feat in times of economic turmoil.

The index drop stems partly from a lower score for the economic growth component. In the first two quarters of the year, growth momentum – at around 2% on average – fell well short of the 3% target level set for economic expansion.[10] Looking back over the Lisbon process so far, we see just how difficult it is to produce sustainably high economic growth. In addition, in the first two quarters of the year, the labour productivity component has slackened quite significantly.[11] To calculate this partial indicator we take the United States (generally considered the world's leading economy on the key measure of productivity growth) as our benchmark, setting the annual rates of change in labour productivity per employee on both sides of the Atlantic against each other as an eight-quarter average. After taking an unexpected and much welcomed lead in 2007, Europe has recently fallen behind America again, partly because the employment trend has sagged more seriously stateside than in Europe. American companies respond relatively quickly to downswing cycles by shedding labour to cut costs. In purely arithmetical terms, this boosts overall productivity.

But other sub-indicators have held up remarkably well – particularly the index components of a less cyclical and more structural nature. Indeed, buried beneath the news of financial turmoil and slowing growth, several long-term indicators of economic performance have held stable – and in some instances continued improving. Employment, for example, remains close to the growth path for a 70% overall employment rate in 2010, although jobs are still not being created as quickly as necessary.[12] The Lisbon Indicator component registering the percentage of tertiary education graduates also continues to point north, meaning the quality of our workforce is improving.[13] Likewise investment activity as a ratio of machinery and equipment spending is getting better, as companies postpone some spending commitments but continue to make other investments in areas that count.[14] In other words, the metric of the knowledge base and the implementation of technology has continued on a steady upward path in the EU-15 countries, giving us grounds for a relatively optimistic assessment of Europe's future prospects. Finally, the indicator reading for the sustainability of public finances as measured by the primary balance and the public debt level also held broadly firm in the first six months of this year with a score above one.[15]

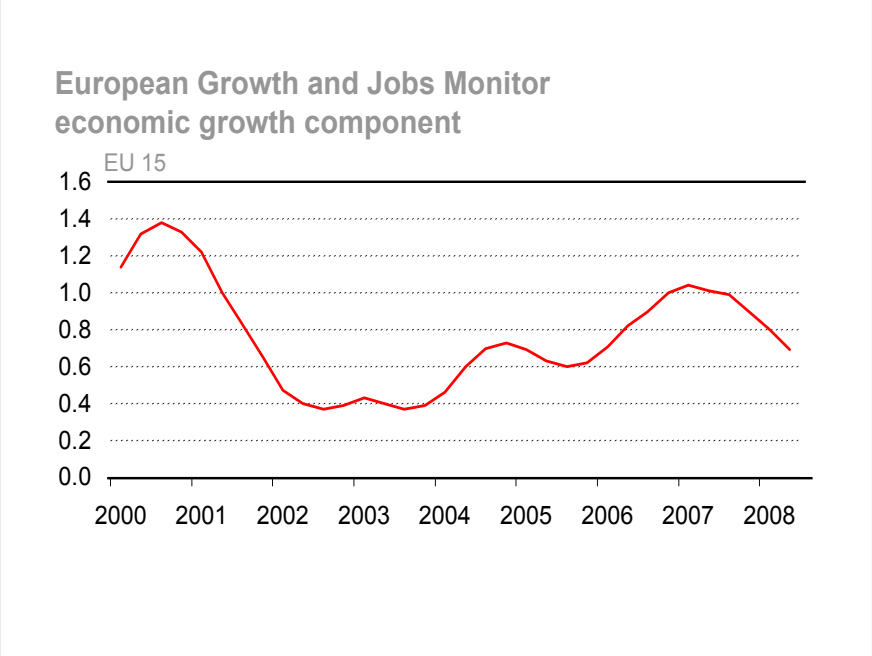
Wide gap in economic growth among the member states

Economic growth undoubtedly plays a key role as an underlying determinant of all indicators in **The European Growth and Jobs Monitor,** quite simply because high economic growth makes realisation of the other targets in the Lisbon process that much easier. Mainly exogenous stress factors, such as the strength of the euro and the surge in commodity and energy prices, as well as the havoc wreaked by the financial crisis, have made it increasingly difficult for most EU member states in recent months to realise 3% economic growth. After several quarters with scores of more than one, the indicator, which benchmarks current economic growth against the 3% target level (on a four-quarter average), has slipped back to 0.7 for the EU-15 area.

10 See Chart 19 in the Annex.
11 See Chart 20 in the Annex.
12 See Chart 21 in the Annex.
13 See Chart 22 in the Annex.
14 See Chart 23 in the Annex.
15 See Chart 24 in the Annex.

What is so surprising, despite the adverse global economic situation, is the persistently wide gap between individual country scores, which even increased a little at the last count. In some cases national developments are driven more powerfully by domestic factors. This is particularly evident at the opposite ends of the country scoreboard – in Poland and Italy. With a permanently high indicator reading above 2, which translates into economic growth of more than 6%, Poland is still way ahead in terms of economic growth, managing to sustain the dynamic pace of catch-up. At the other end of the scale, Italy can muster no more than a score of 0.2. Its chronically poor performance, particularly relative to the other big EU countries, is due to home-made structural weaknesses (corporate structure, production structure, barriers to market entry) in its domestic economy, which limit its potential growth and crimp its international competitiveness through rising unit labour costs.

Econometric studies by the European Central Bank show that the synchronicity of economic cycles has increased since the early 1990s in line with deeper EU integration, especially in the euro area. The four biggest EMU members – Germany, France, Italy and Spain – in particular exhibit quite high co-movement in economic fluctuation. This suggests that the growth differentials may have their origins less in cyclical and far more in structural factors, in other words they stem from differences in trend growth. In addition to demographic trends, differences in structural reforms are also given as an explanation. In a cyclical downswing like the one we are experiencing, structural weaknesses are cruelly exposed. One possible approach would be to invest more in human capital and in research and development to raise Italy's overall output to a higher technological plane; currently this is too low compared to its international competitors. Another weak spot is the labour market, which continues to be excessively rigid.



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Overcoming the crisis

Lisbon indicator update

Chart 1

Lending standards in the US tightening sharply

Lending standards for corporate loans (large & medium)

net balance for „stricter“

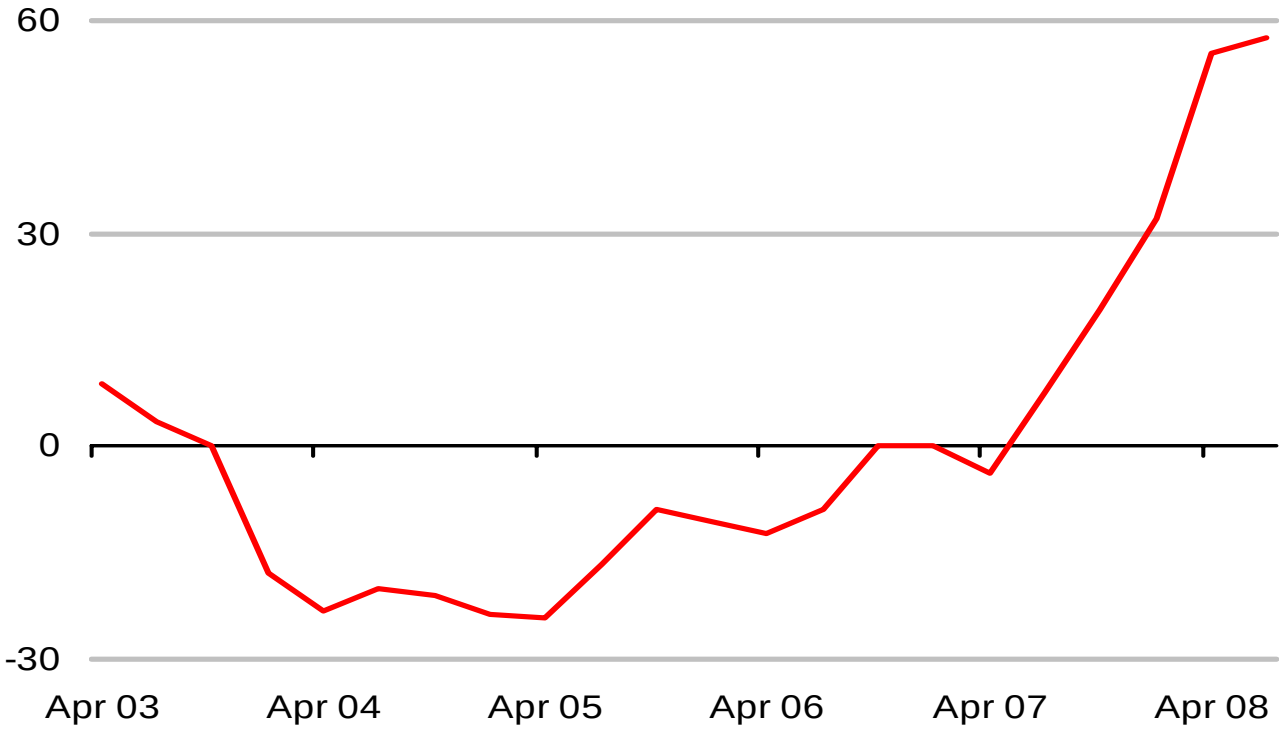
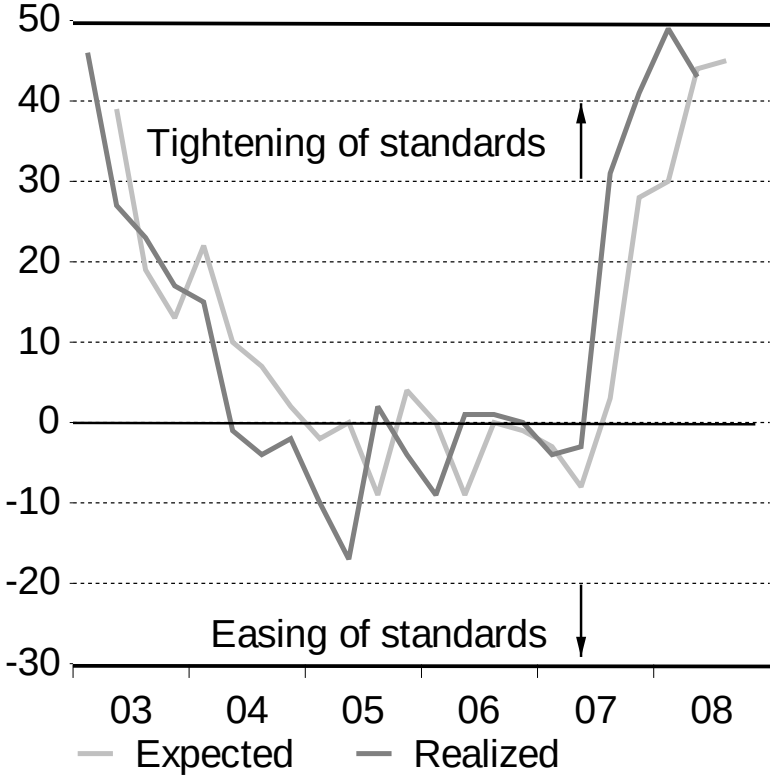


Chart 2

Lending standards also tighter in euro area

Bank Lending Survey:

Changes in credit standards for enterprises (net percentages)



Bank Lending Survey:

Changes in credit standards for housing (net percentages)

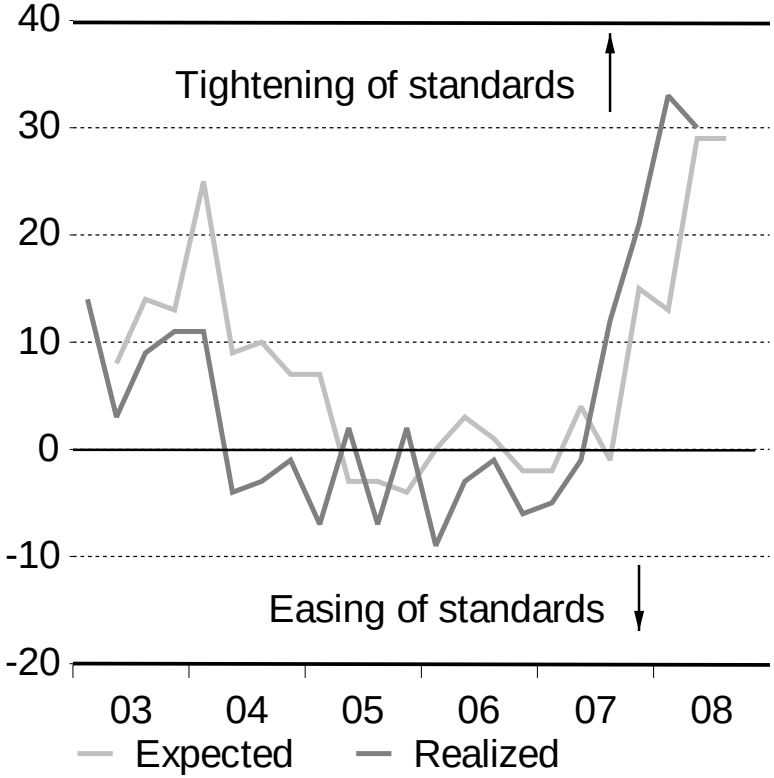


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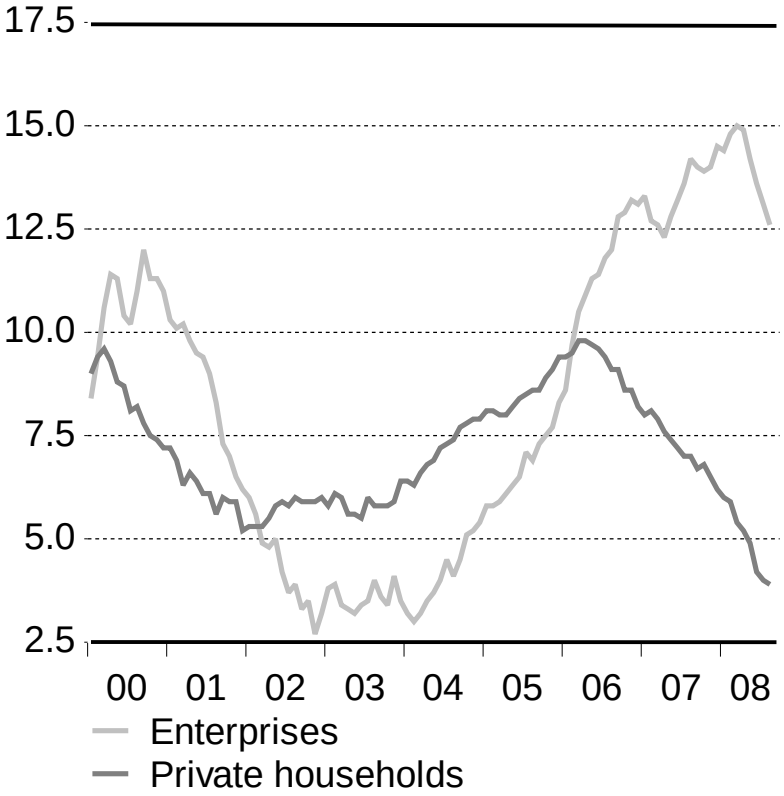
Chart 3

Lending down noticeably

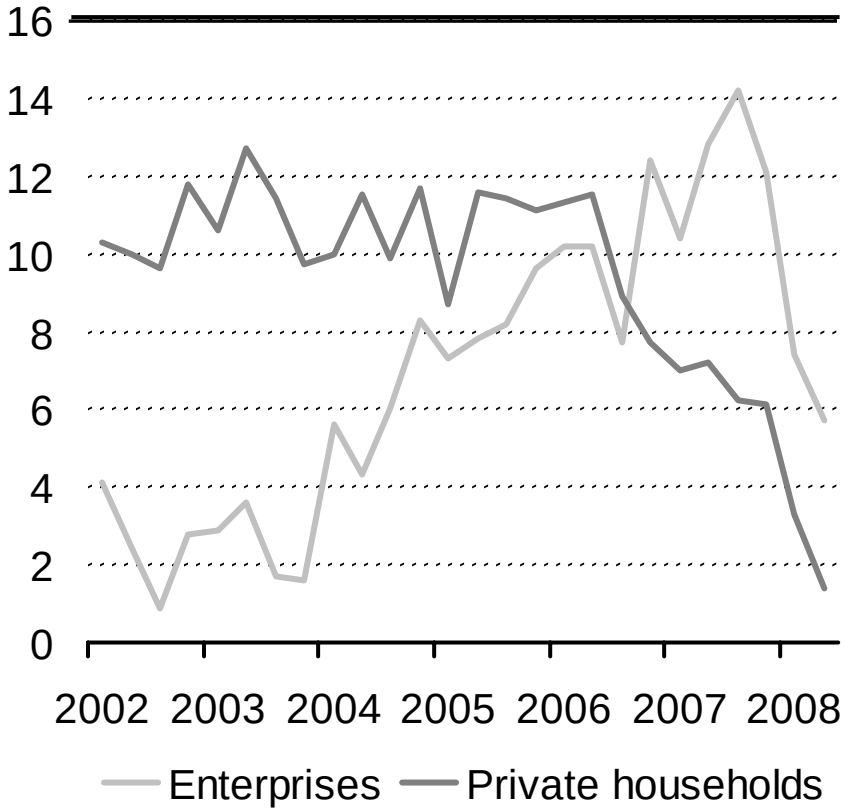
Euro area:

Loans
percentage change over previous year



USA:

Credit market debt*
annualised change in %



* Capital market and banks.

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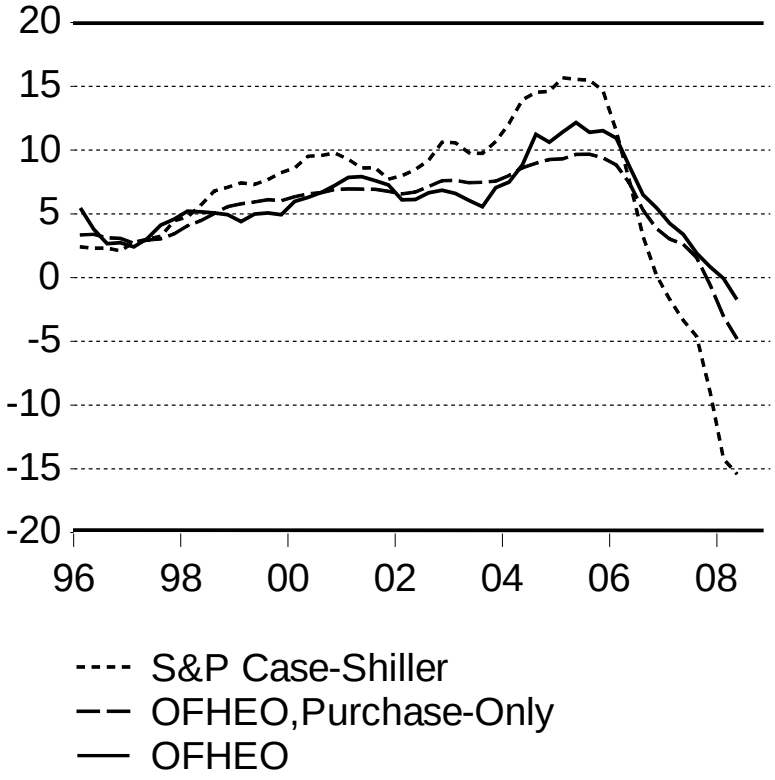
Chart 4

US housing market: Adjustment...

US house price indices (nationwide)
percentage change over previous year



Housing starts
mn units, annual rate

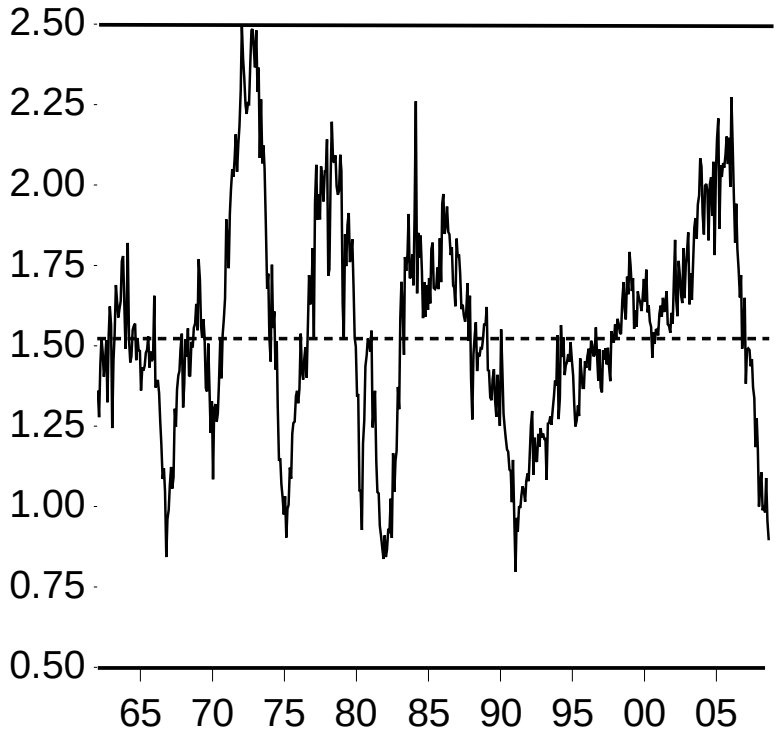


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Chart 5

... well advanced

New detached houses (quarterly)
construction starts "for sale" and sales

Market for new detached houses
stock of unsold units, in thsd.

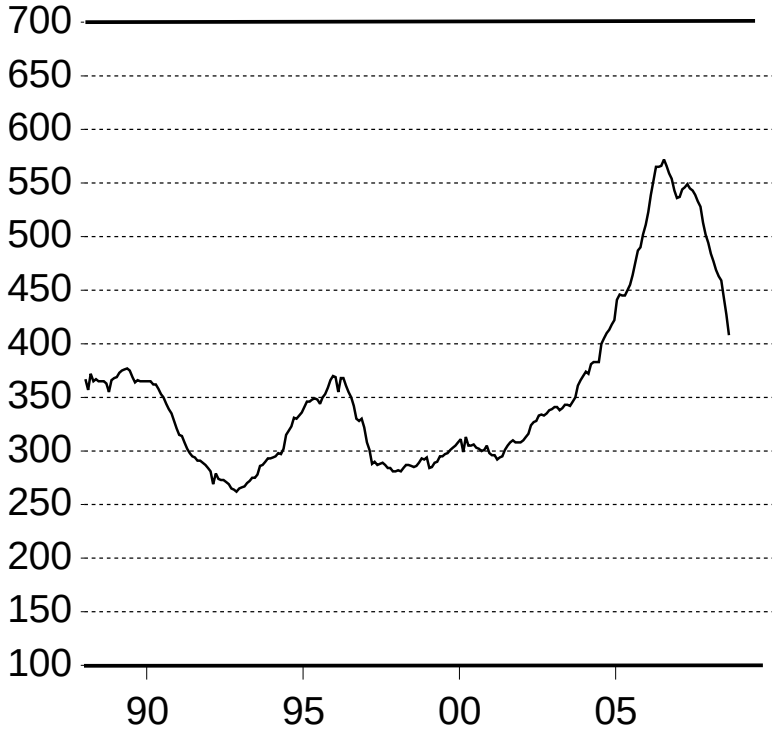
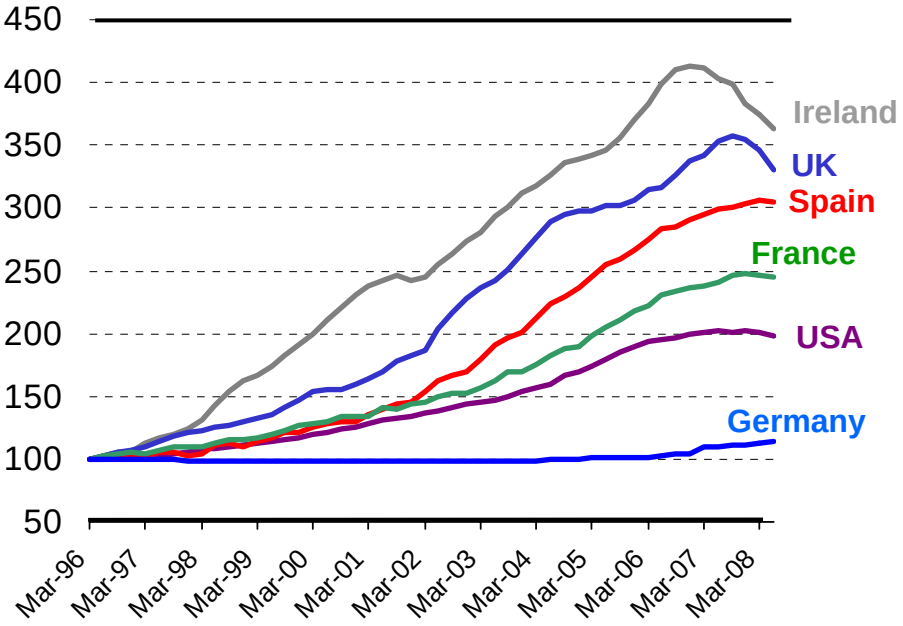


Chart 6

Embattled construction sector in the euro area

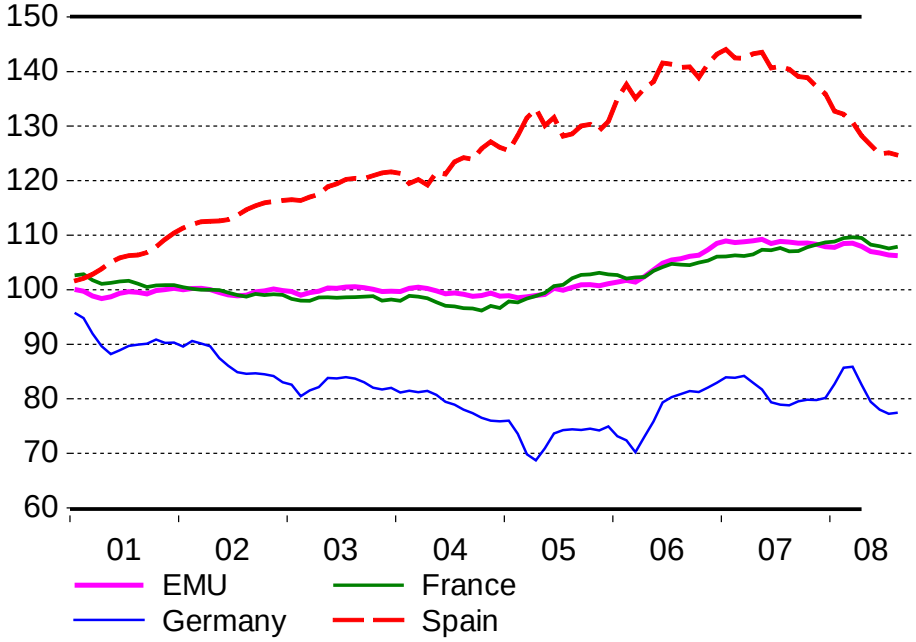
International house price indices

Q1 1996 = 100



Construction production

index 2000 = 100, 3-month moving average



Examples of indices used:
USA: OFHEO Index, Ireland: Permanent tsb Index, UK: Nationwide Index, France: INSEE.

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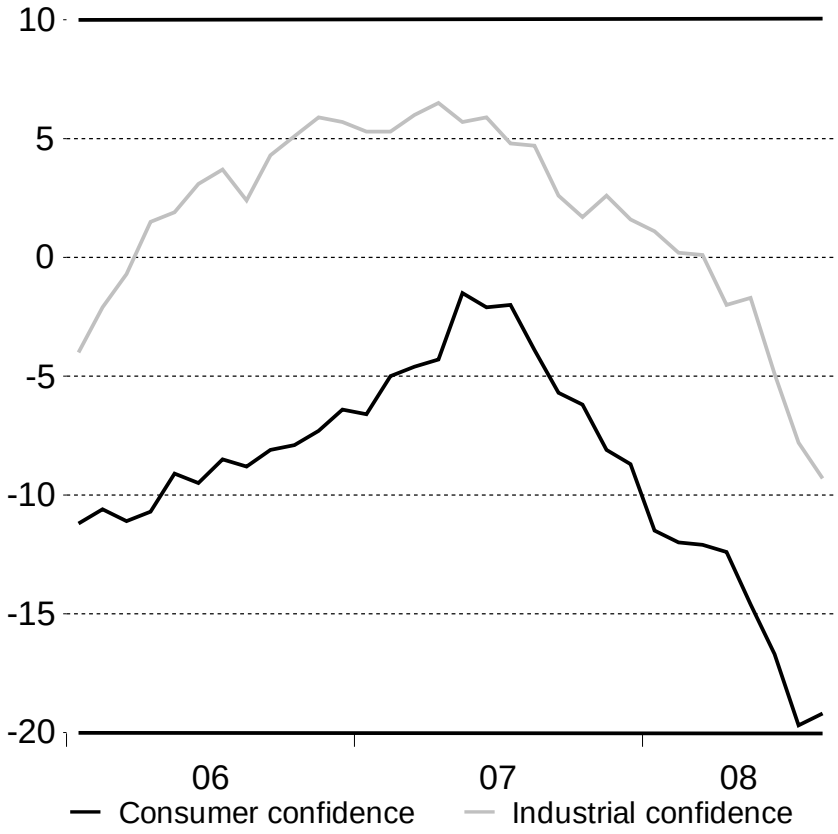
Chart 7

Uncertainty spreading

EMU: Sentiment plunging

EU Commission survey indicators



EMU: Sentiment plunging

purchasing managers‘ index (PMI) manufacturing

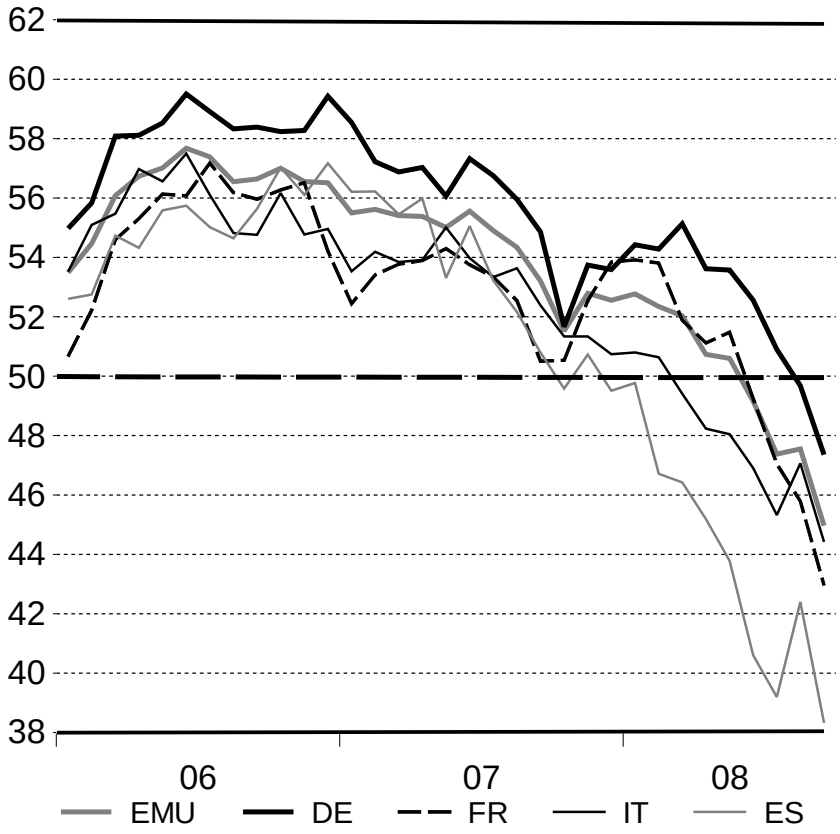


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Chart 8

European Growth and Jobs Monitor overall score

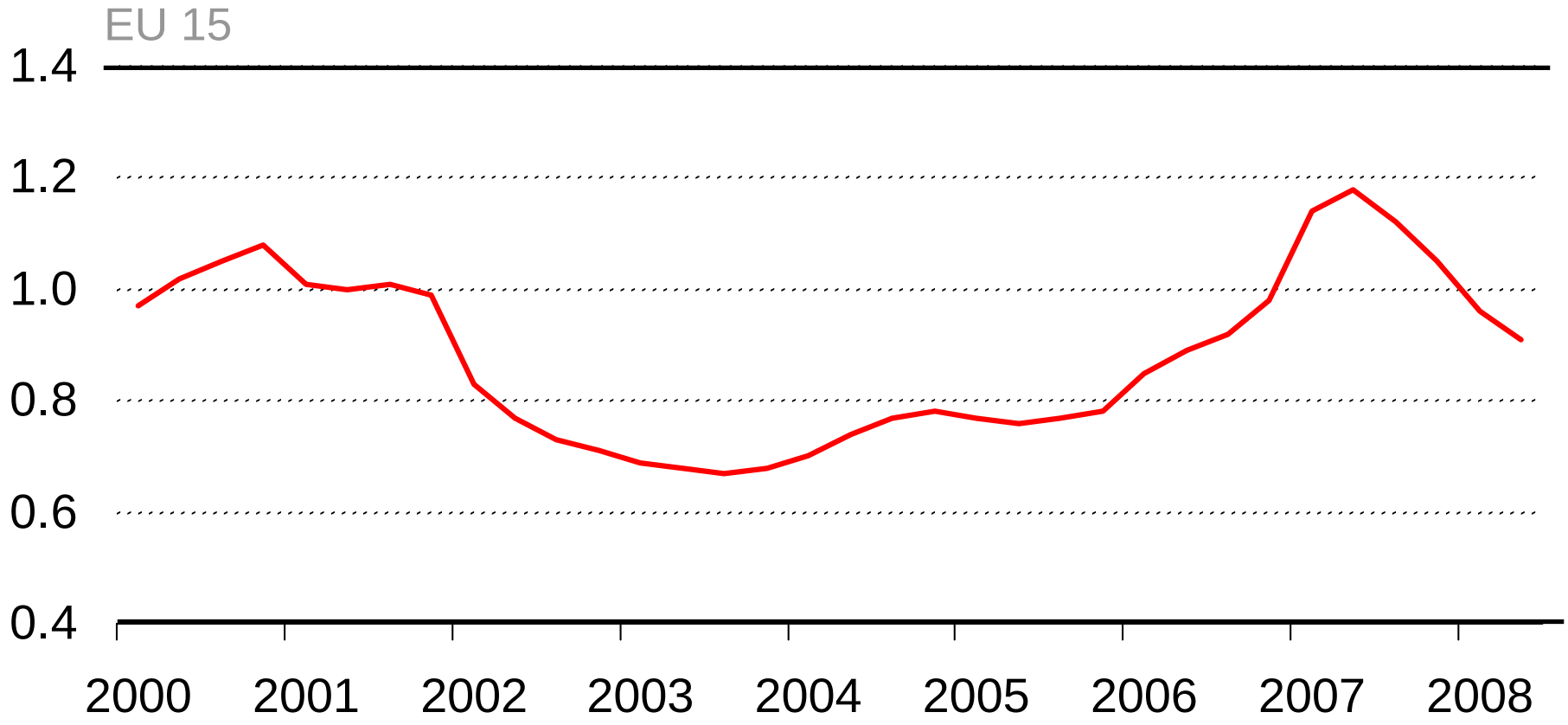
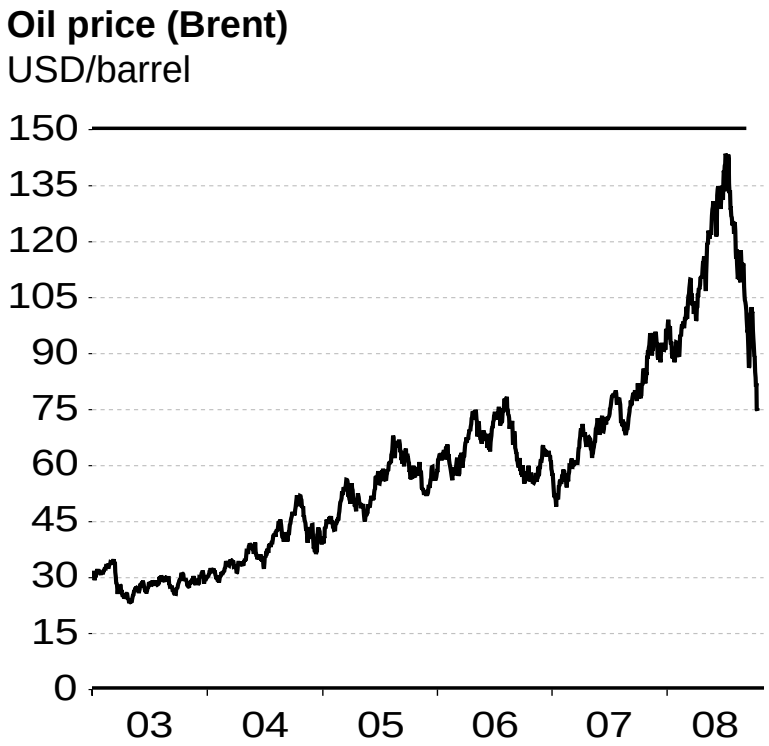


Chart 9

Sharp correction in commodities/exchange rates



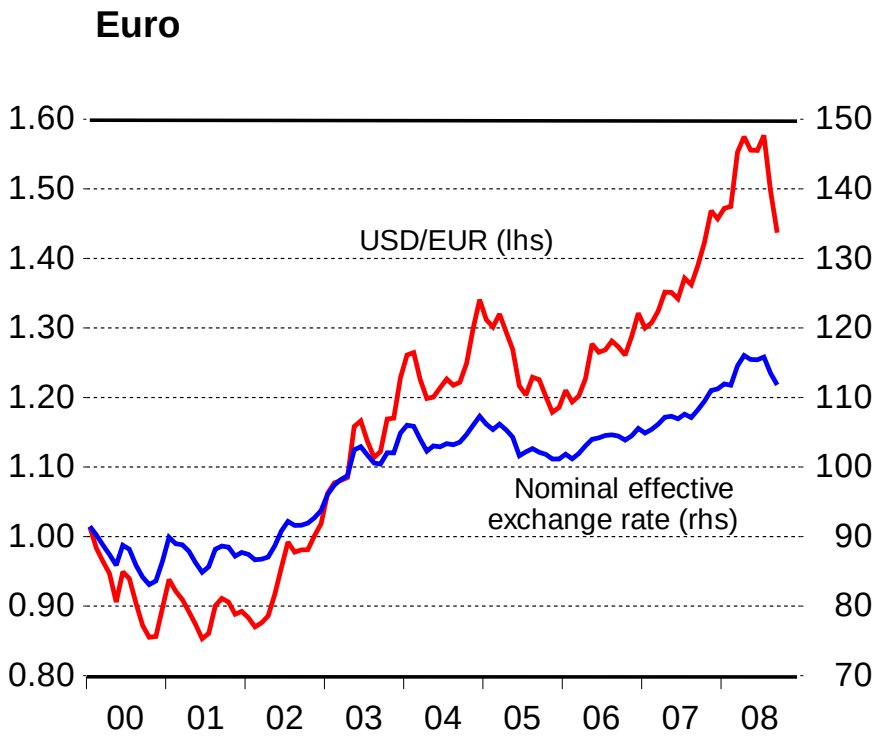


Chart 10

EMU: Outlook for growth and inflation

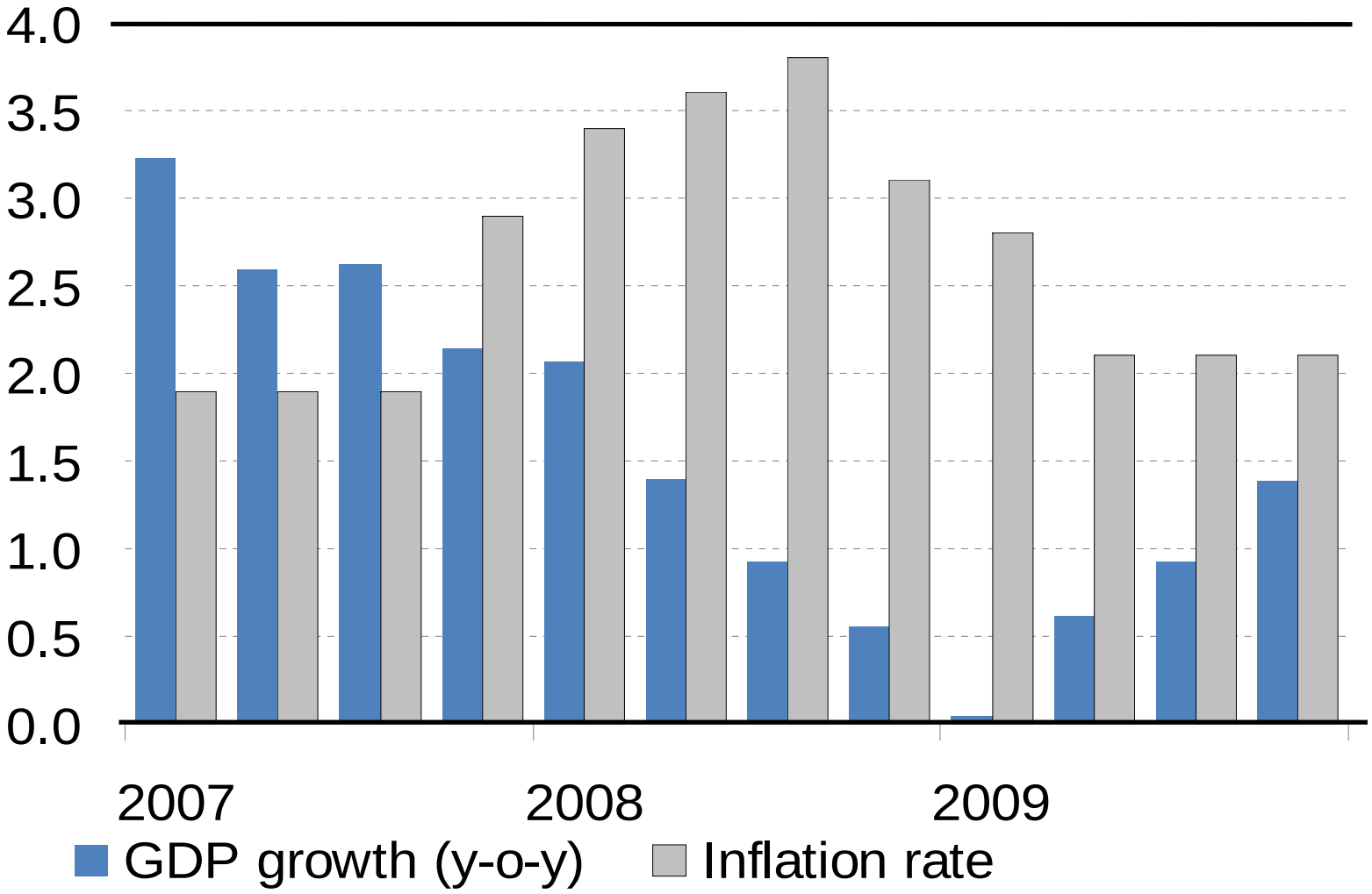
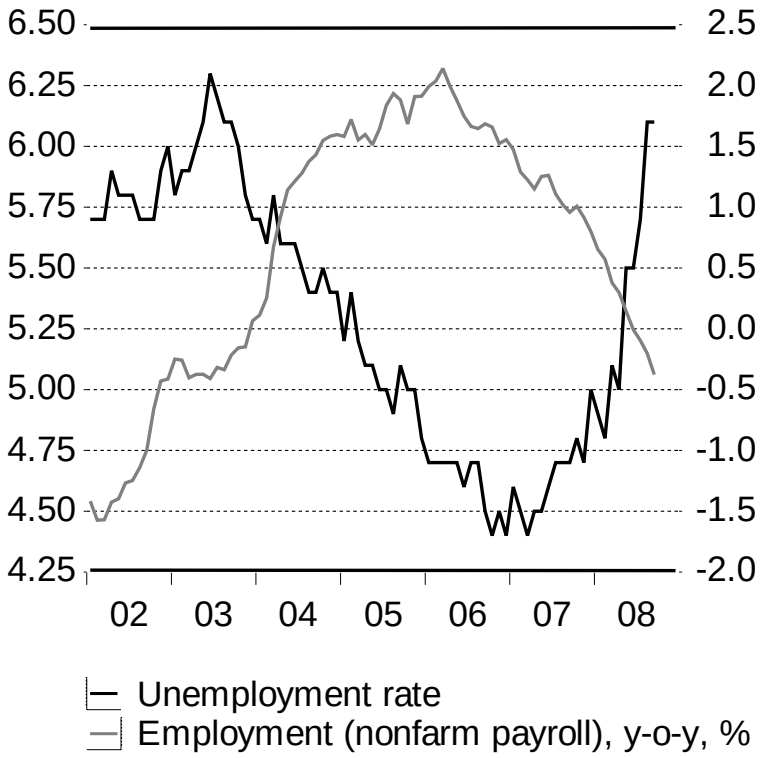


Chart 11

EMU labour market only moderately affected so far

USA: Sharp increase in unemployment



EMU: Unemployment rate increasing slightly

Chart 12

EMU current account balance in good shape

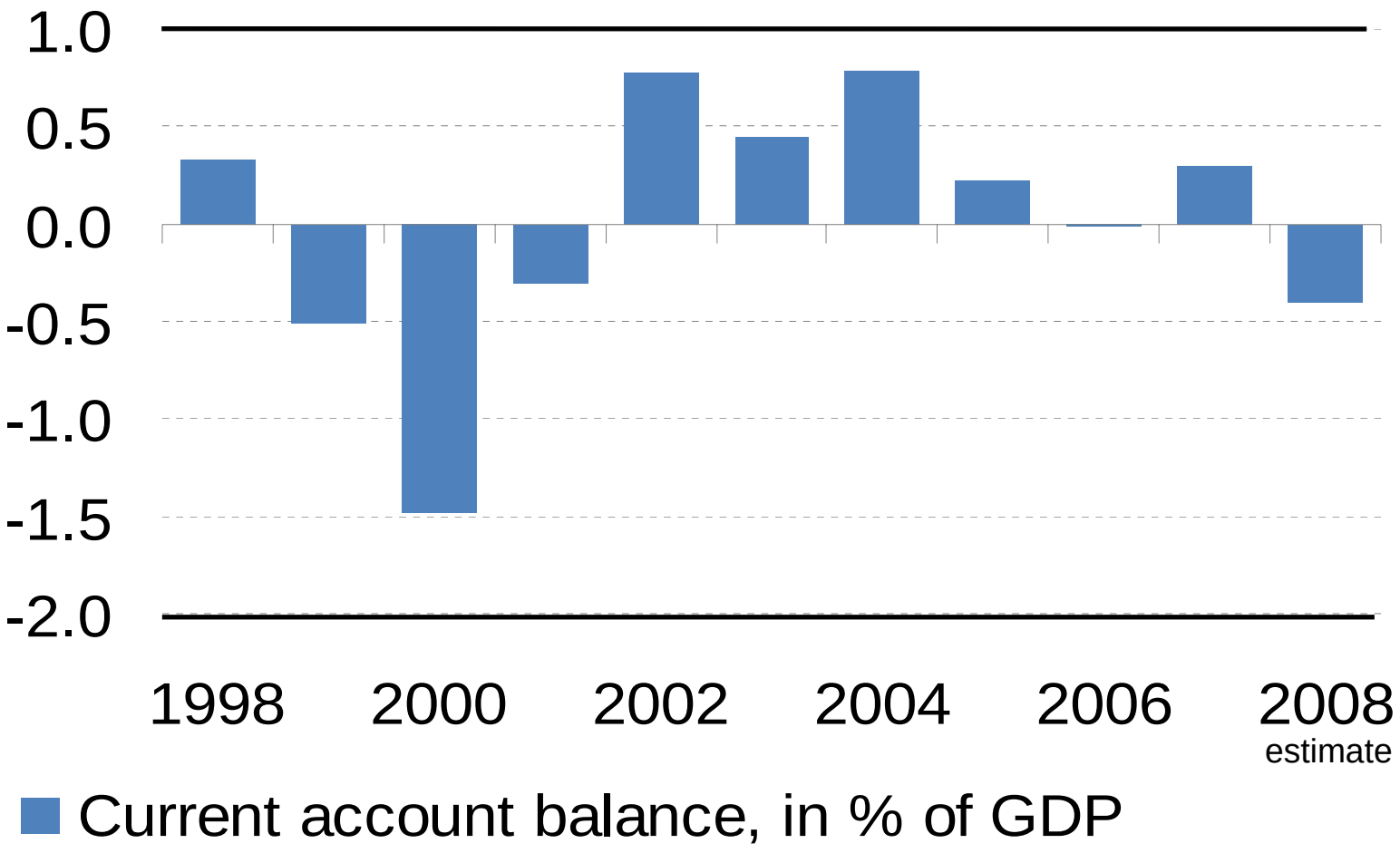
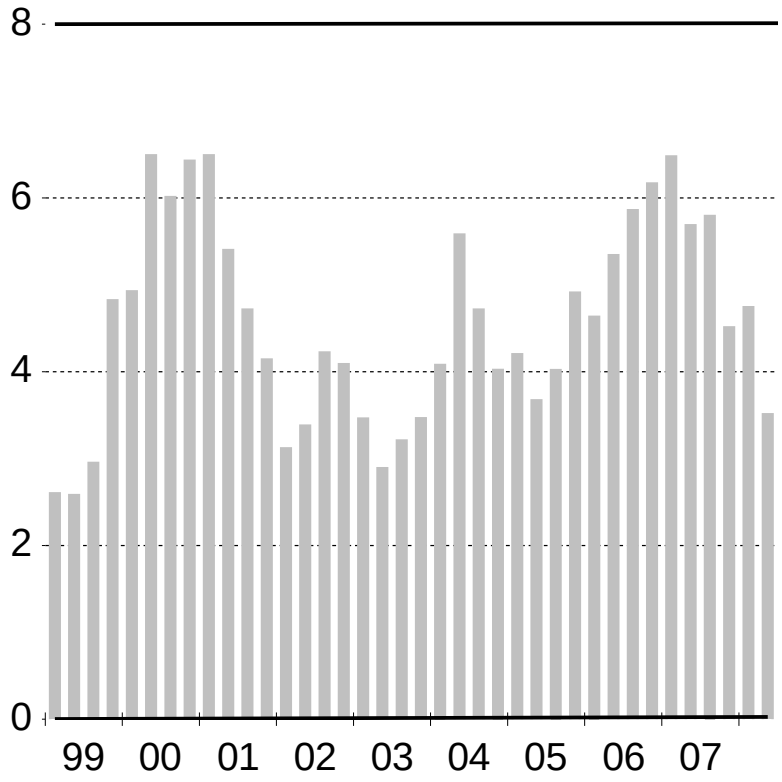


Chart 13

Corporate profits still on a high level

Euro area:

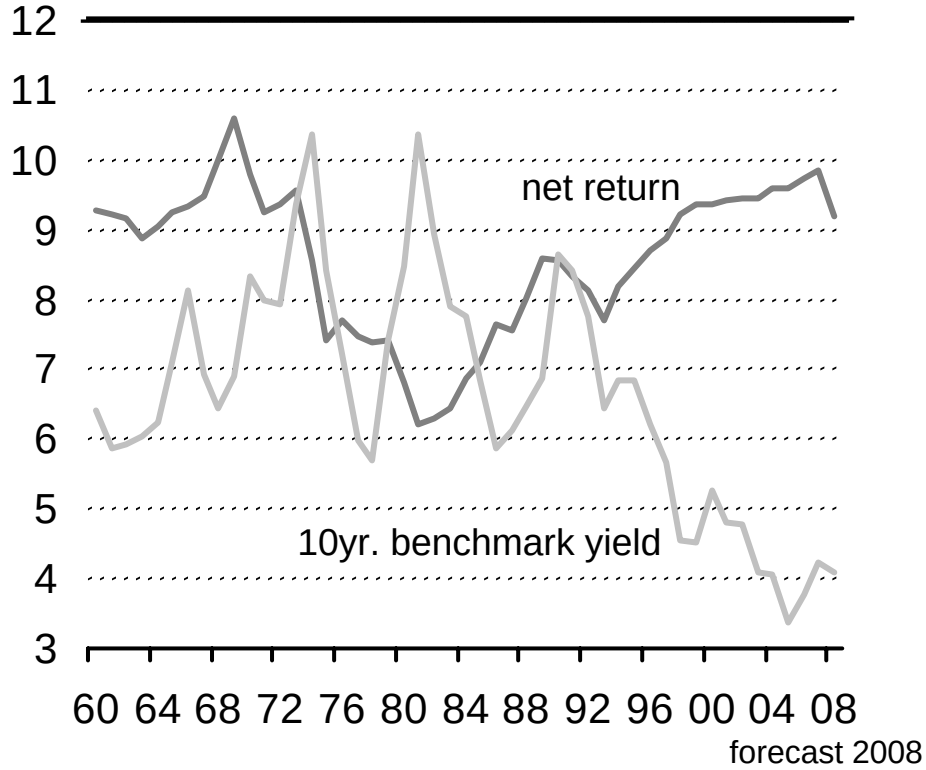
Gross operating surplus
percentage change over previous year



series until 2008Q2.

Euro area:

Net return on capital*
in %



* Ratio of gross operating surplus less depreciation of capital to net capital stock.

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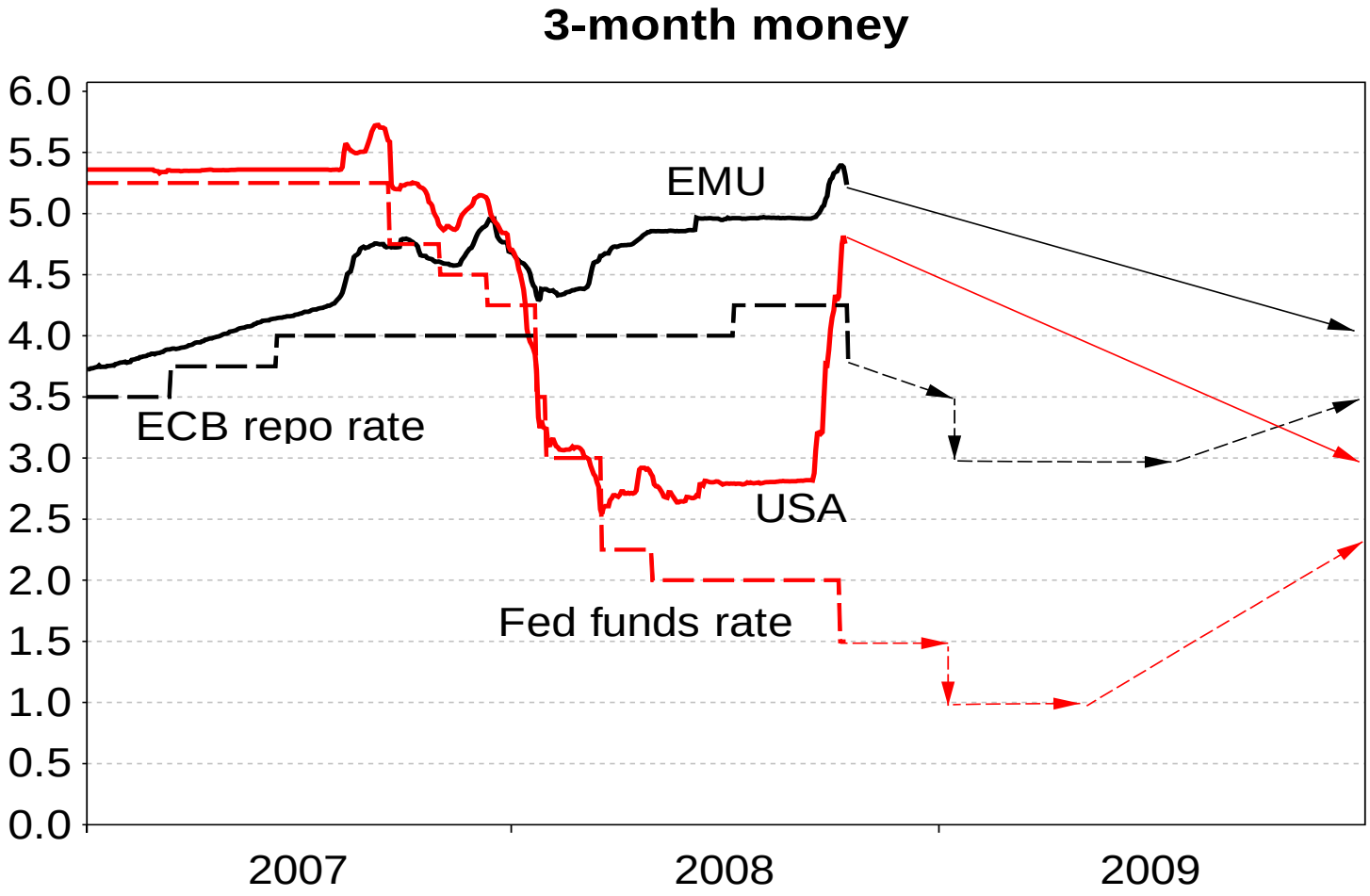
Chart 14

EU economic outlook 2009

	Gross domestic product, real percentage change over previous year				Consumer prices percentage change over previous year			
	2006	2007	2008	2009	2006	2007	2008	2009
Euro area	**2.8**	**2.6**	**1.2**	**0.7**	**2.2**	**2.1**	**3.5**	**2.3**
Germany	3.0	2.5	1.8	0.7	1.8	2.3	3.0	2.1
France	2.4	2.1	1.0	0.7	1.9	1.6	3.5	2.1
Italy	1.9	1.4	0.1	0.5	2.2	2.0	3.6	2.4
Spain	3.9	3.8	1.4	0.4	3.5	2.8	4.4	3.1
United Kingdom	2.9	3.1	1.0	0.5	2.3	2.3	3.6	2.0

Chart 15

Interest rate outlook 2008/2009



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Fallout from the financial crisis

Economic repercussions and outlook 2009

Overcoming the crisis

Lisbon indicator update

Chart 16

Vulnerability within the EU varies widely

comparison of financial market risk

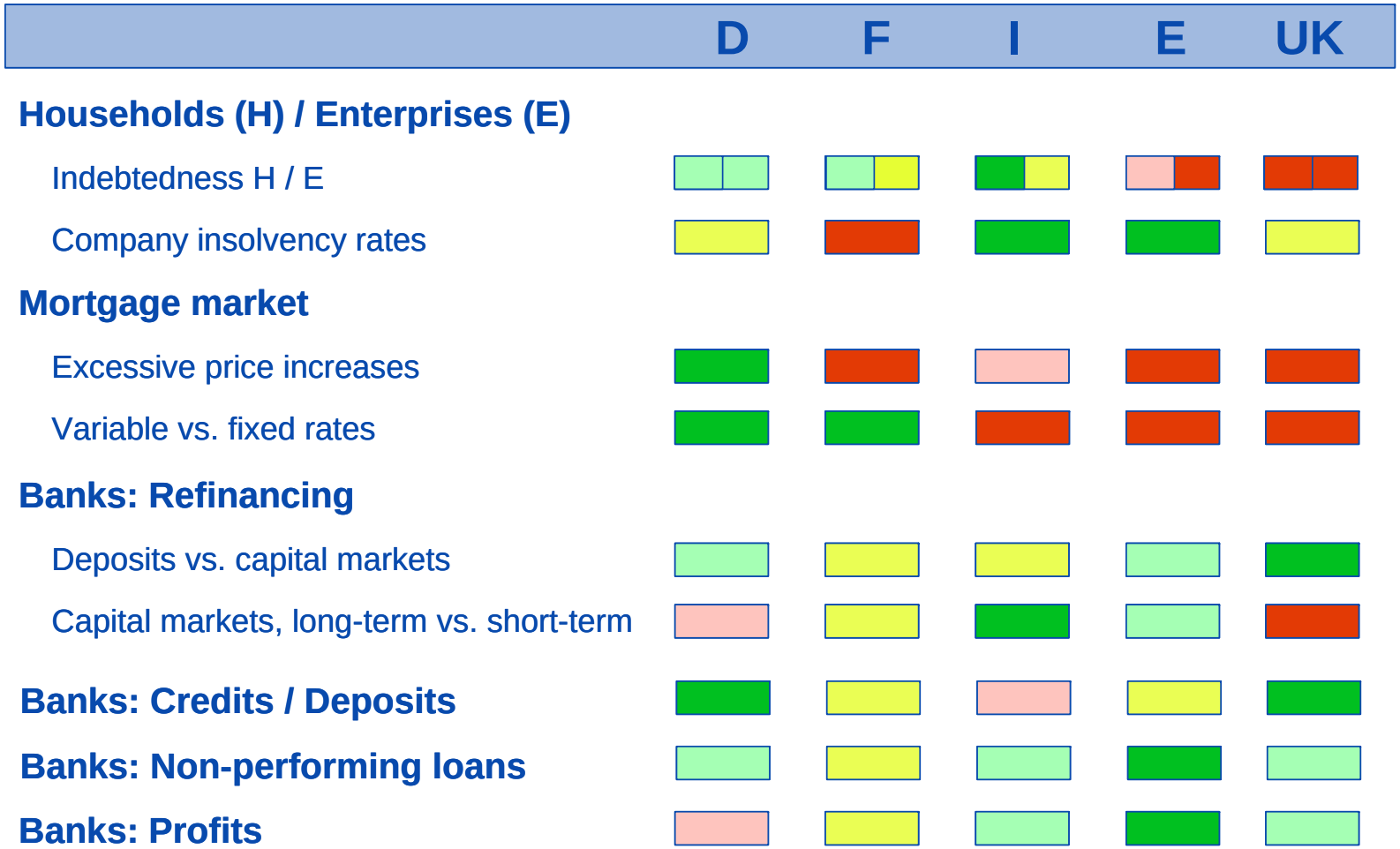

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Chart 17

Crisis management: Measures and proposals for Europe

- Coordinated national rescue plans to stabilize the financial sector across Europe
  - guarantees on debt issuance
  - recapitalization
  - liquidity measures (e.g. collateral rules) by central banks
  - protection of depositors (expansion of deposit insurance systems)

- Rate cuts by ECB

- Steps towards a European supervisory authority

- More integration of Euro financial markets

Global: More leeway for banks in valuation of securities, less pro-cyclicality in capital requirements, more transparency of shadow banking system and rating agencies

Fallout from the financial crisis

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Chart 18

European Growth and Jobs Monitor overall score

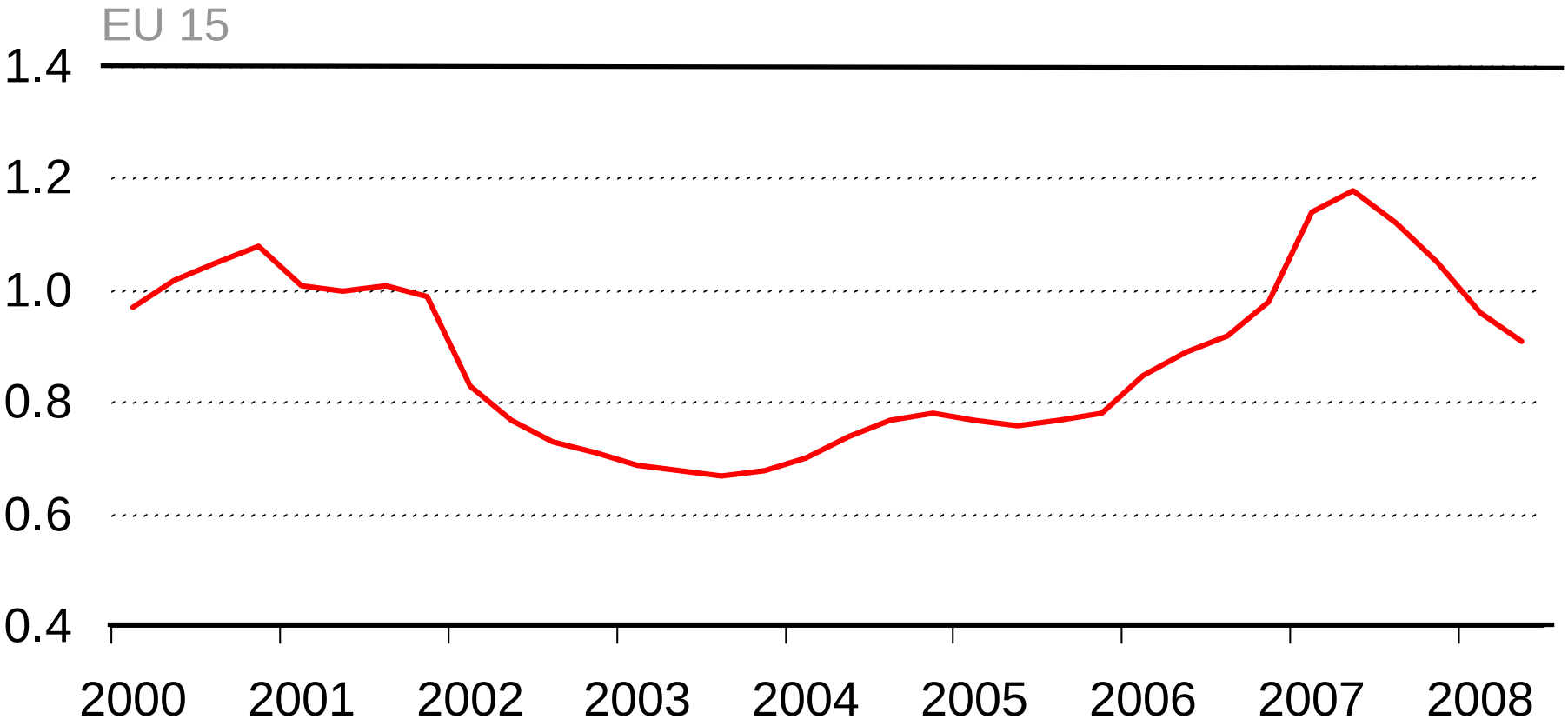


Chart 19

European Growth and Jobs Monitor economic growth component

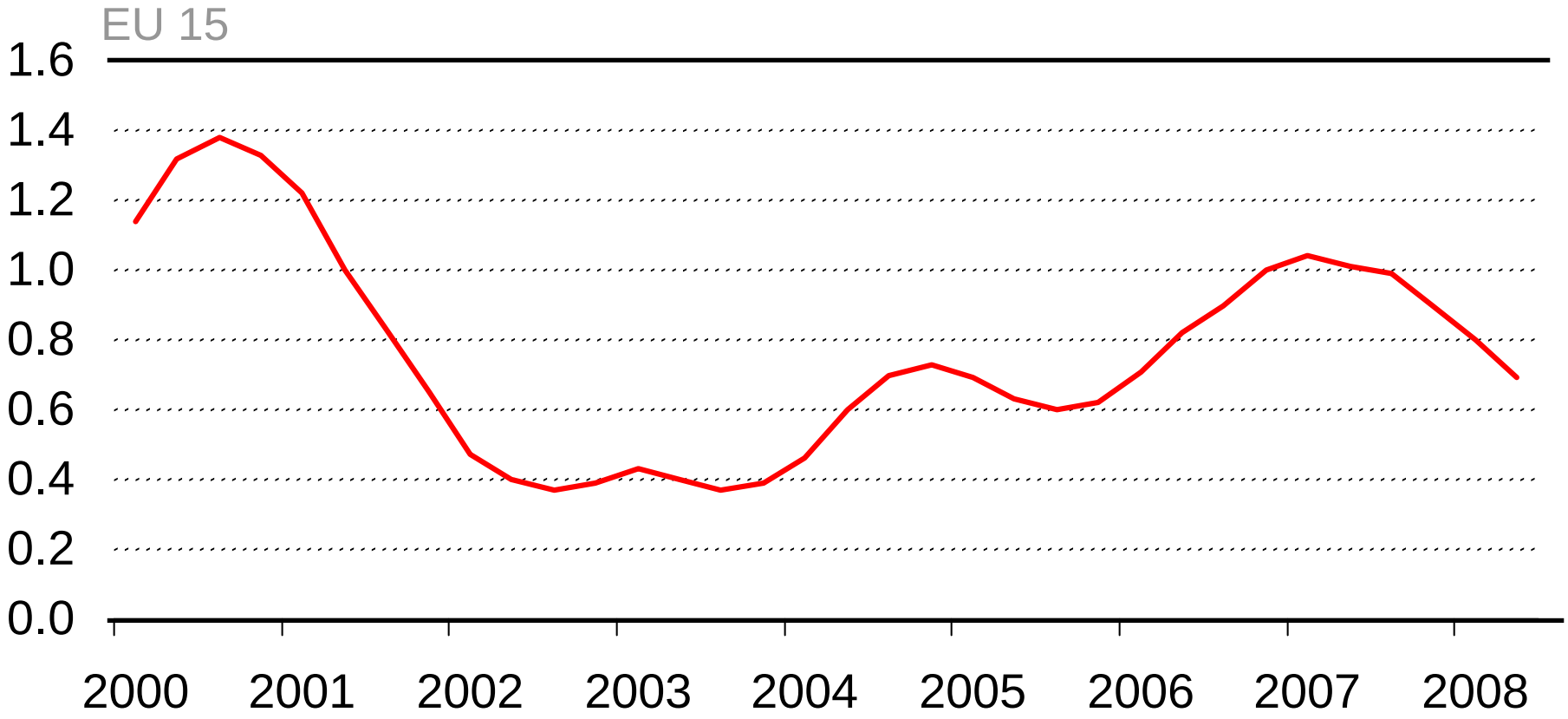


Chart 20

European Growth and Jobs Monitor labour productivity component

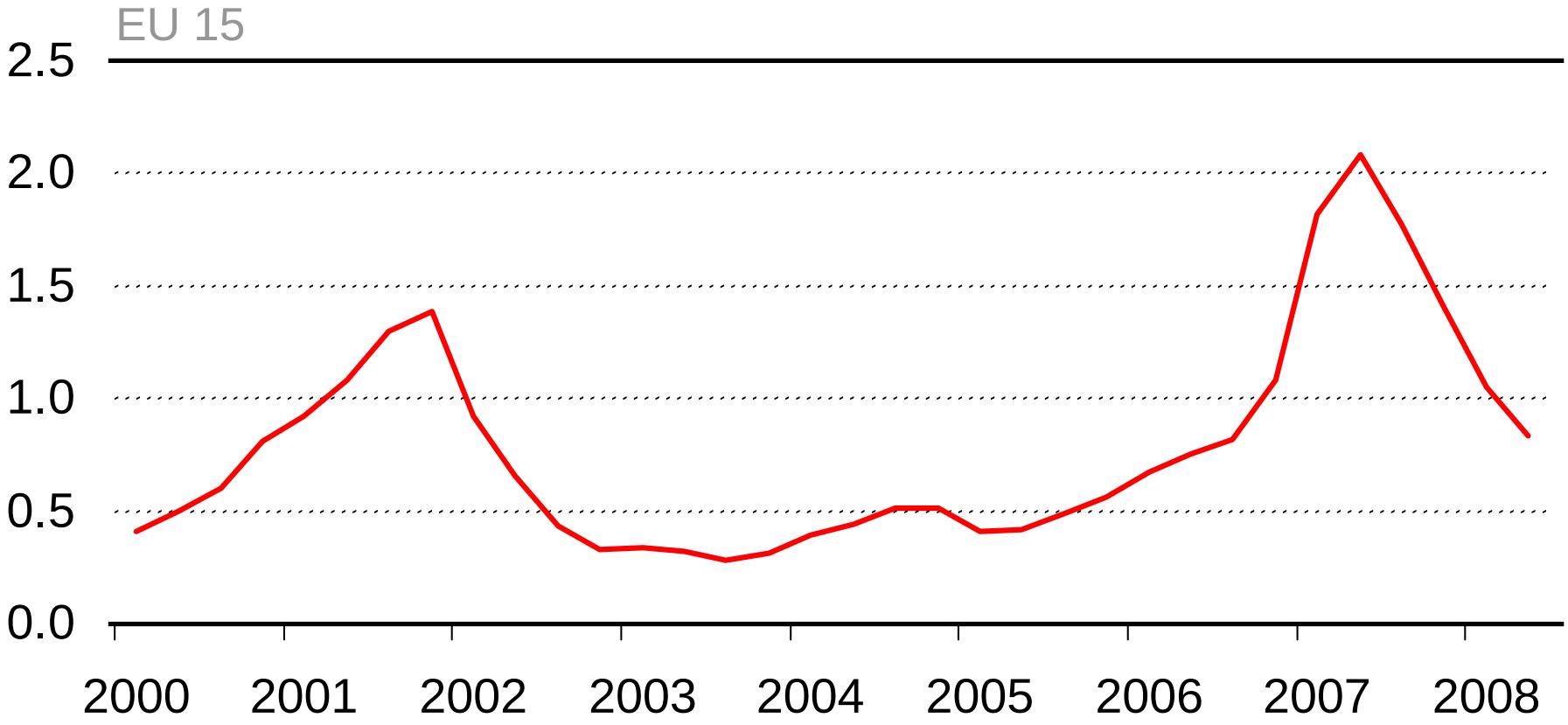
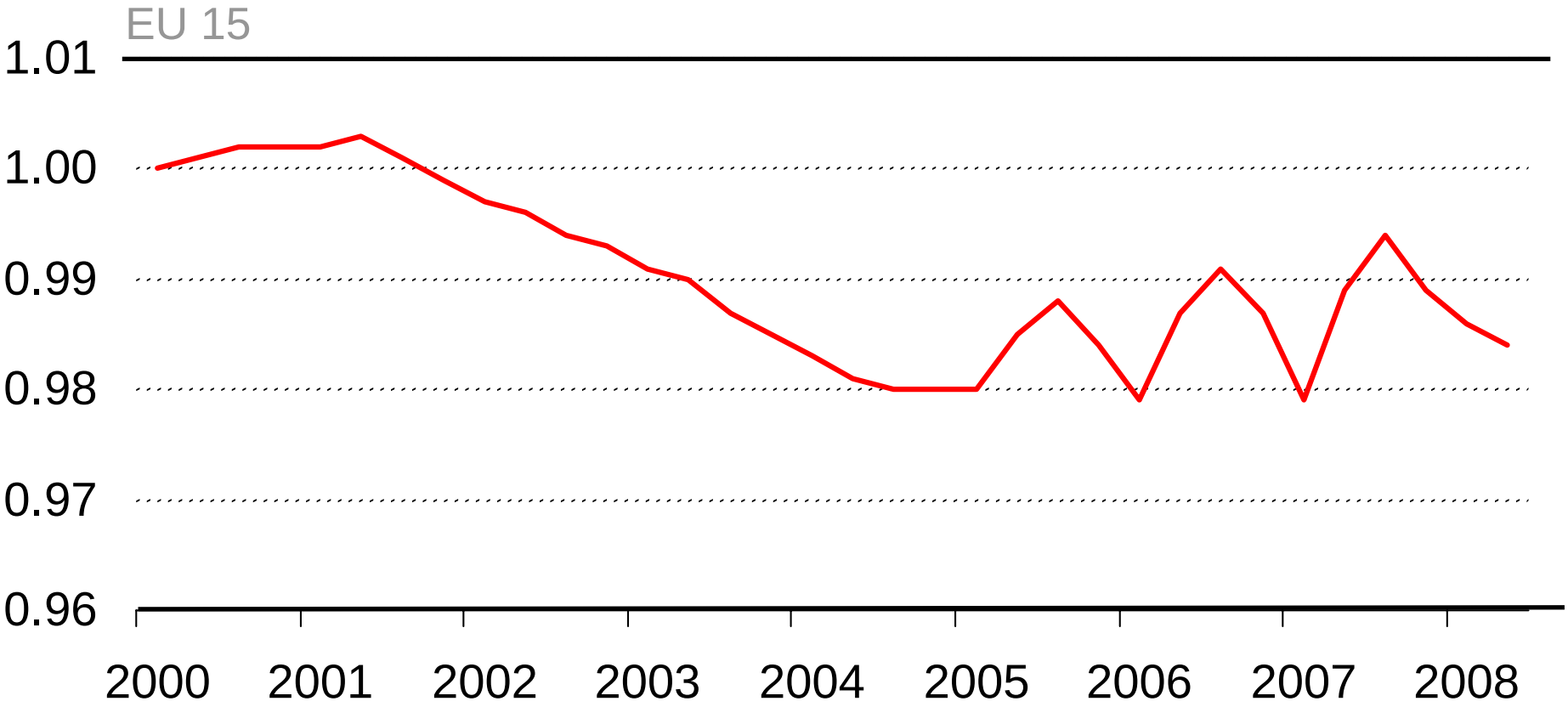


Chart 21

European Growth and Jobs Monitor employment ratio component



Interpolated annual figures 2000 - 2004, seasonally unadjusted quarterly figures starting 2005.

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Chart 22

European Growth and Jobs Monitor employment by tertiary education component

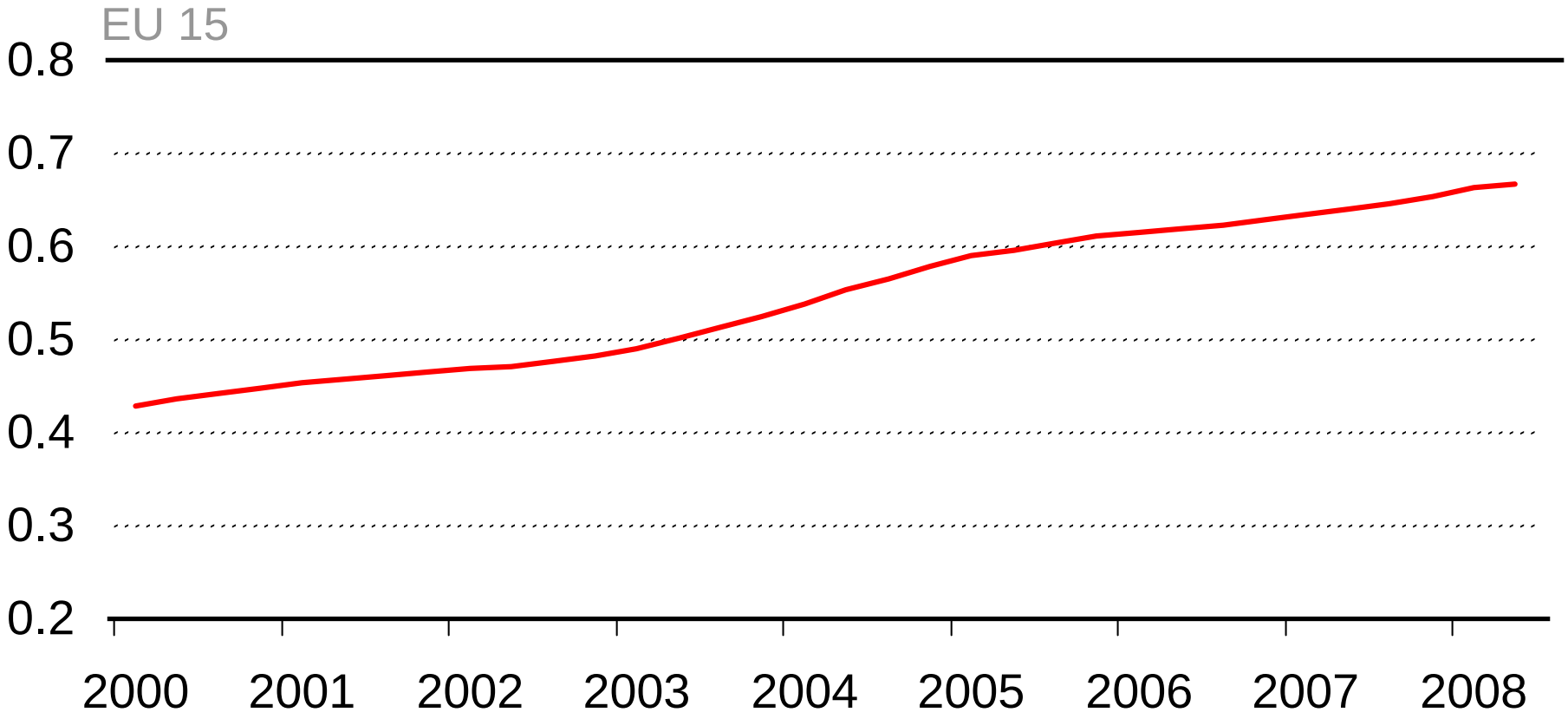

Chart 23

European Growth and Jobs Monitor investment activity (equipment) component

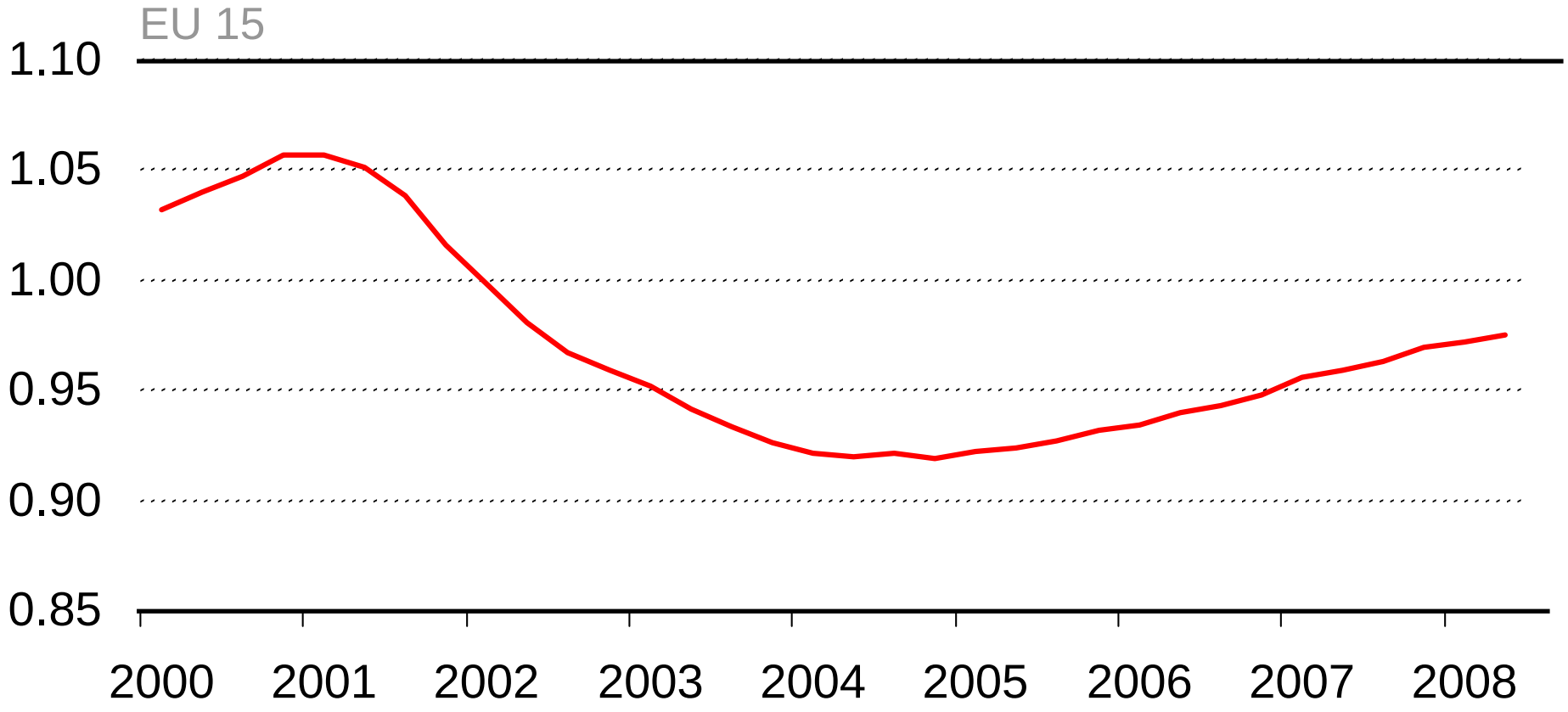

Chart 24

European Growth and Jobs Monitor public finance component