

EUROPEAN BUSINESS LEADERS CONVENTION

2005 SUMMARY OF THE PROCEEDINGS

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FOREWORD

Getting Europe Moving Again!

One hundred executives and experts from twenty-six countries gathered in Helsinki from the 7th to the 9th of July 2005 to discuss European challenges and opportunities. This booklet provides a summary of the proceedings.

The theme of the conference was getting Europe moving again! Among the issues discussed were the twin economic challenge of Asia and America, reasons for Europe's slow growth and low rates of employment, Germany's progress with reforms, transatlantic relations, the impact of China and India on the world economy, the long term prospects for the euro and the dollar and the development of the Russian business environment.

The mood of the conference was concerned but hopeful. There was no doubt in anyone's mind that Europe was facing serious circumstances: deteriorating demographics, the lack of growth, the high unemployment rates especially among the young, the rejection of the constitution by the French and the Dutch voters and the inability of politicians to face the challenges. It was felt that these challenges were compounded by the fact that globalisation had become a negative buzzword in many quarters in Europe. As a result the goals of Lisbon seemed even more distant than before. The terror attacks in London were further proof of the fact that we live in an unstable world.

Yet, it was not all gloom and misery. Many hopeful signs were also recognised: successful firms, well-educated labour force, reform efforts in Germany, dynamism in new member states and the ambitious UK presidency of the EU.

Participants agreed that dynamic economy is necessary for Europe. As one participant put it, Europe can survive without a constitution but it cannot survive without a vibrant economy. Many participants made the point that the debate on the choice between liberalism and a social Europe is a false debate. Healthy markets are necessary for social Europe.

It was felt that it is time for the supporters of reform to become vocal. They must put forward the case for change without using scare tactics. Europe can succeed. It will succeed. But success will not come without commitment and passion for the future.

It was agreed that many scenarios were possible for the EU without a constitution. Variable geometry might be the way forward. Participants agreed that enlargement had become one of the main victims of the constitutional crisis. They also agreed that a European perspective was needed in Europe's neighbourhood. Therefore, Europe should continue to engage with countries that see themselves as candidates for accession.

It was strongly felt that the business community should get Europe moving again and show a way forward. It cannot watch idly as Europe plunges into a crisis. It should get involved. The business community should speak out for reforms in order to summon citizen support for them.

Risto E. J. Penttilä

Secretary General

European Business Leaders' Convention

THEME I: EUROPEAN COMPETITIVENESS GROWTH AND EMPLOYMENT: WHY IS EUROPE NOT DELIVERING?

- A** The employment problem in Europe can be fixed.
- B** The productivity problem may be more difficult to fix.
- C** The economic policy in the euro zone has not been clear.
- D** Changes will only be introduced in times of crisis.

There are three core problems in the European economy: productivity, employment, and the business cycle. Competitiveness is not a problem. A balance needs to be struck between structural and macro policies. The EU has a role to play in both.

The productivity growth in Europe has declined. This decline has continued into this millennium. The potential growth of the euro zone is less than one per cent. The EU has been on a slide for three to four decades whereas the US has recovered. Also the labour productivity growth has been slower in Europe. More new top companies have been created in the US.

The employment figures in Europe are converging but there are significant variations between the member states. The European inflation is sticky. The monetary policy could be labelled as overcautious. The nominal growth of GDP in Europe is below 3 per cent. In the UK and the US higher growth has been experienced. There is excess capacity in Europe. The core inflation is falling slowly.

The Lisbon strategy was built on three pillars: a strong economy, social inclusion, and environmental sustainability. All this is still possible. The social security is an economic asset but can the model of social inclusion be sustained? The results are mixed. Stronger focus on growth is indispensable.

Maybe the Lisbon strategy was too much about everything and it therefore amounts to nothing. In order to reform European economies there has to be own-

ership, visibility, and clarity on who has to do what. Political will is called for. Europe will not become the number one economy, but it can strengthen its position. In particular, Europe is not closing the economic gap with the US. Europe is facing a twin challenge: the US and Asia. Asia brings new competitors but also vast and growing markets. In the global economy Europe has a comparative advantage in the knowledge economy.

The enlargement has not made the implementation of the Lisbon agenda easier despite the more rapid growth in the new member states. Their low taxes and wages can cause social fractions. The enlargement has also created fears in the old member states. Free labour movement can create growth and employment in the old member states. European potential should be released via employment and productivity growth. The Central European states are in a special situation. They are addressing globalisation with very proactive strategies. Passion and commitment are important

The ageing population is a problem for Europe. The birth rate is low and there are more and more aged people. Large part of the population is outside the workforce. The European labour force should become more efficient. It should work longer on a flexible basis. It should have up-to-date skills. Lifelong learning should be implemented on a large scale.

The priority areas are the knowledge economy, the business climate, the quality of legislation, the availability of risk capital, the labour markets, lifelong learning, long-term sustained productivity, environmental synergies, and the macroeconomic framework.

The visibility of the national governments should be increased in this process. They bear the main responsibility for implementing the right reforms and involving the parliaments, the interest groups and the citizens.

Better use should be made of the single market – also in services. More R&D spending is needed in order to boost the knowledge economy. The EU budget should reflect a drive for competitiveness and a focus on the future. 10 years ago Europe was leading in pharmaceuticals. Now European companies are moving to the US. We need the right incentives to invest in the right jobs.

The urgency of Europe's challenges needs to be better explained to the public. There needs to be clear and vigorous debate and dialogue. The status quo is not an option. A balanced reform package is needed. Confidence and mutual trust

should be built in societies. New leadership and moral authority is called for after the rejection of the European constitution.

The growth rates are low in Europe. There is a difference between long-lasting and more recent problems. Before 1996 Europe was not falling behind the US. It was actually growing faster than the US. The development of the GDP was still good in Europe between 1996 and 2001. During that time Europe was better at job creation but its productivity growth was not good. Europe has a deep-rooted problem of productivity. There are external and internal challenges. Europe should act now. There is no time to lose. Something happened in the US productivity in the mid-1990s. The key difference with Europe was that the pace of productivity in industries using information and communication technology – in particular retailing and wholesaling – increased much faster.

Another key difference exists between the unemployment rates of Europe and the US. In Europe unemployment is increasing and in the US it is decreasing. In Europe specific economies have an unemployment problem. Labour market efficiency matters. It is important that benefits are conditional. Trade unions are not an impediment to employment as long as there is coordination in wage bargaining. A key question is whether the higher marginal taxes are distorting the choices of the Europeans. People want growth without sacrifices. Reforms should be introduced in the good years.

The difference in competitiveness is much less pronounced. In export performance the US has in fact lost and Germany for example has gained.

Bad policies have led to bad performance and good policies have led to good performance. It is not a question of a European problem. It is a problem of national governments that should face it.

Low consumption is a problem in the euro zone. The ECB should have been more aggressive. But the key difference is in the fiscal policy. There has been a massive stimulus in the US and the UK. In Finland and Sweden also, there has been a bigger fiscal stimulus than elsewhere in Europe.

In 2000 there were deficits in the euro area as a whole whereas in the UK, the US, Finland and Sweden there were surpluses. Automatic fiscal stabilizers could therefore be allowed to work. The surpluses should be used to deal with the stock of debt.

There is rough agreement on the diagnosis. There are three key problems in Europe's economic performance: structural problems, a productivity shortfall, and macro demand deficiency. The Lisbon agenda sounds good but it is not addressing the most serious problems, i.e. the demand deficiency, the problems in the labour market, the productivity problems, especially in distribution and retail. It is shying away from the really difficult areas.

How to address the demand deficiency? It will take time. The gravity of the problem varies in the member states. The aims are contradictory. Short-term flexibility and discipline should be pursued in parallel. It is not clear what drives behaviour in savings. Lack of clarity in policy is a disadvantage. It creates confusion and uncertainty. Clarity on reforms is needed.

The periods of growth should be used for consolidation. There is no magic solution. The ECB should express its objectives as positive inflation targets, which would reflect what it is de facto doing. Expectations drive behaviour.

HOW TO FIX THE EUROPEAN MODEL?

- A Europe is stagnating and facing tougher competition.**
- B The business community is getting vocal. The message to the political leadership is clear: get action going.**
- C The Lisbon agenda is a vision and a political scenario. Europe could be a tremendous place.**

The situation in Europe is worrying. There is stagnation while the US, China and India are rushing ahead. 400 000 European jobs have been moved to the US. In Europe there are fewer jobs and bleak prospects for the young. The Lisbon agenda is not being delivered. We have a sick European economic patient.

At the same time Europe has many things that are right: the long holidays, the social system and so on. But these luxuries are proving very expensive. People are getting older. There is a serious problem of youth unemployment. Europeans should work harder and they should be better in the high value added sector.

The Lisbon agenda was brilliant. It offered a vision. It was a challenge and useful in benchmarking. But in reality there is no productivity growth and an ageing population. The European population is not working. In acting towards the Lisbon agenda the focus should not be on low cost jobs. Europeans should build on the European advantages.

In India there is a growth rate of 8-9 %. But the base is lower. India was stagnating before the 80's and suffered from protectionism. Its growth was driven by technology and innovation and low cost healthcare. Europe has incredible opportunity in India. It is a vast market with a lot of potential partners.

China can be seen both as a threat and an opportunity. There has been a huge transformation. Millions of people are in manufacturing in the high technology sectors. China is therefore a threat that can only get larger. European investments are diverted to China. But China is also facing problems. The profitability of many Chinese industries is starting to decline. Input prices are going up. Companies are competing against each other. There are big infrastructure problems and air pollution. There is a lot of room for European companies. Asia is a big market. There is complacency in Europe. In Asia, young engineers are volunteering for training, even for the weekends. Europeans are less willing to do so. Europe

should make the incentives work. They should not hamper free choice. Keeping people at work is key.

Global companies need to be present in different markets in order to be close to the customers and to work profitably. Costs need to be matched with business opportunity. Manufacturing can still be competitive in Europe, especially when an innovation element is involved. There are big opportunities in Europe. But Europe will have to change. It needs the right attitude, the right incentives, and innovation.

The problem is political. Governments are to be blamed. The internal market has not been realized. The debate on the services directive debate was telling. The European labour markets are rigid. The right incentives are needed to get the best of both worlds.

The European economies are different. Not all problems are structural. There is insufficient consumption and demand. The housing market is not operating optimally. The economic realities should be explained to the public.

A culture revolution is needed. Europeans need passion, immigration, and higher birth rates. The key question is who is going to lead. The US had similar concerns in the 80's but it re-vitalised itself.

Comebacks are possible. Europe has a chance. But the internal market is necessary. Education should also be made to work in enhancing productivity. There have been some good cases in Europe. The telecom services have been virtually liberalised. The same mindset is needed in all services. Markets should be opened.

The vicious circle of non-confidence should be broken by inspiring leadership at national level. Europe should be made more exciting. People should be mobilized for the Lisbon strategy. The labour markets should be opened. The mindset should be changed. Risk-taking should be encouraged. A crisis might be needed to initiate change. Good communication is needed. People need to be confronted with the realities.

Monetary policy matters as well. It should boost demand. Macroeconomic policies should be relaxed. Demand matters. Europe is already competitive but some of its economies are not. Labour market regulation is to be fixed at national level. Europe should not be blamed for it.

RESTARTING THE GERMAN ENGINE

A The key problem is the lack of confidence in the future.

B Reform is the answer.

Germany is at the heart of the European problem. It has had a one per cent growth for a decade, which is the lowest in the euro area. This contributes to the European weakness. There are spill over effects: the stability and growth pact is difficult to apply, it is difficult to agree on the financial perspectives, and the Lisbon process is not backed up. The citizens are afraid of change but the challenges are the same everywhere. The good news is that competitiveness has improved more in Germany than in any other member state.

Germany has had a pension reform and tax reforms. But consumption has not increased and the savings are high. The households are afraid, which produces a vicious circle. No classical recovery is taking place. A lot of input to the German economy is produced in the neighbouring countries. The housing market is not booming either.

Germany has many strengths: high exports, highly educated workforce, and good infrastructure. But it is not enough. It is not showing up as performance. Germany's economic performance has deteriorated vis-à-vis its European partners. At the same time unemployment has increased. The share of total debt of the GDP is also considerable.

German profit performance is good. But corporate performance does not help Germany. It is mostly the old industries that are present in Germany with the notable exception of the chemical industry. Germany is weak in high-tech, high-service industries.

Reforms are needed. A key problem is the high labour cost. The net income of Germans is in fact low: 44 % of income goes to the welfare state. Reforms are also needed in education and in R&D.

Tax reform is pressing. Significant decreases are needed in the overall tax rate. Corporate taxes are still high. Tax laws need to be simplified and the non-wage labour cost needs to be reduced. The health care system has to be opened to competition. Labour cost should be decoupled from health contributions.

In the same vein, the rise of pensions needs to be adjusted to demographics and the retirement age should rise. The capital funding of pensions should be increased.

The German economic engine is running smoothly in some areas: the foreign direct investment, exports, and infrastructure. But the growth performance is lagging behind.

It is also a problem of perception. There is gloominess and insecurity. Private consumption is low and savings are high and most of them are liquid short-term savings. There is a fear for the future. A stronger political consensus is needed as well as better communication. There needs to be a determination to execute reforms. The federal system is a hindrance to reform.

The priorities are the following: the public sector has to be downsized, less bureaucracy, less subsidies, better federalism, more interaction, investments in education, reform of social security, and labour market reforms.

More flexibility is needed in the labour market. Agreements should be struck between employees and companies. The labour market parties should come together to build consensus. The context is globalisation, which entails a shift of power. Reforms need to be introduced quickly. They should not be constant.

The unification meant an enormous shift of wealth to the East. It showed the strength of German capitalism. But it also left a hefty price tag: less money to spend, higher taxes and labour costs, scepticism - and a demographic time bomb.

The reform discussion started in Germany in the 80's. The Kohl government introduced reforms. The single market, the euro and the EU enlargement necessitated reforms.

In the 1998 elections more reforms were expected. The Schröder government introduced corporate tax reforms that decreased the burden on large companies but not the SMEs. There was also liberalisation of the retail industry and the unemployment benefits were reduced. But more is needed.

Macroeconomic policies are not the key to German problems although the entry rate of the D-mark to the ERM was too high. The problems are mainly structural.

The capital markets are weak in Germany. A small share of businesses is in the stock exchange (40 %). Investments are increasing in Germany but not enough. German companies are investing abroad.

More capital funding is needed. Germans are a risk-averse population. Confidence needs to be built up in a consistent manner.

There is reason for optimism. A lot has been achieved. A lot depends on politics and psychology.

DOING BUSINESS IN RUSSIA

- A** Russia is a paradox. It is going through a complicated transition.
- B** Putin and oil are sources of stability.
- C** Russia has many business-friendly traits.

Russia has induced many mood swings in the west. Putin was first seen as welcome change but later attitudes towards him turned more reserved.

There are tensions in Russia's basic project that reflect fundamental conflicts. The key question is whether political control and market-based economic growth can be introduced in parallel. State control is a key priority for Putin. It sometimes leads to arbitrary use of law, sanctions, authoritarian control and uncertainty.

The boundary between business and politics is fuzzy. The state wants to maintain control over the strategic sectors. There is declining confidence and an outflow of capital. Reassurances are needed to restore credibility and a good business climate.

Russia is experiencing fast growth but there is a lack of basic reform. There is corruption, which increasingly means steeling by the state. The lack of social reform is a policy weakness. There is also a deficit on information. At times the rules seem to be changed arbitrarily. Property rights need to be strengthened. The business side is experiencing a failure of leading key groups to organise themselves for trust. Lobbying is needed.

Russia is going through a transition in all ways, economic, political, budgetary, and mental. The transition is ongoing. The difference between good and bad is not always clear. There is a grey zone between business and authority. The huge stock of Russian natural reserves is slowing down the speed of reform.

Russians aspire to European values and humanism. Russians want to follow the European model and the European debate is important for Russia. Russians should not however be importing models but adapting them.

There are reasons for seasoned optimism. There is strong economic growth, a strong currency, a trade surplus, political stability, and a strong centralised state. Russia has a liberal economy and tax regime. It is more liberal than the average European economies. Taxes are flat. Russia offers a good ground for entrepreneurship.

The microeconomic environment in Russia is improving but volatility remains. On the other hand, Russia remains bureaucratic, there is corruption, the tax administration is getting tougher, the protection of property rights is weak, and there is growing inflation.

In the long term the Russian strengths should become evident. It has an educated people, a business-friendly culture, an advanced scientific and industrial base, huge territory, overwhelming natural resources, high social mobility, and no permanent stratification. The downside is that there are no permanent social networks, the logistics are deficient, the living standards are low, the climate is tough, and the infrastructure is obsolete.

Russia's bureaucracy is insufficient and its institutions are underdeveloped. There is uncertainty while the rules are changing. But Russia is on a long-term growth path, and it is an attractive destination for investment. The basic values are right in Russia. No authoritarian tendencies persist. But property rights need to be improved.

Russia's direction is mixed. Patience is needed. Russia will be a different country soon. There is a lot of ambiguity. Russia is the source of both success and concern. The post-soviet systems have not proven very sustainable. There is a lot of state intervention, which has led into a system that can be labelled as bureaucratic oligarchy. Corruption is estimated at 34 billion USD. Russia is a commodity state with superpower ambitions. The security services are politicised.

Russia is a conservative bureaucracy but it has no permanent rules. The strategic assets are not to be trusted to foreigners. The case-by-case approach to this entails unpredictability. Putin values foreign investors. He is even decentralizing some powers to the regions. But the element of trust is missing. Ordinary Russians support Putin but are not happy with his performance.

The situation still has a lot of shades. No new nationalization is probable. Russians hate oligarchs. The Russian business matures via dialogue and partnership with the west.

The role model for the politicians is the US, for ordinary Russians it is Germany. Russians generally appreciate liberalism and are not nostalgic. The politicians are more conservative. The Russian business community is largely non-political.

Russia does not look messy from the inside. There is a growing role of the state, and the Russian people like it. Russians trust the visible hand. The state has no clear list of priorities.

There are a lot of activities where the state welcomes investors: foodstuffs, cars, services, banking. There are also many success stories. The price of oil and Putin are sources of stability. Small variations in oil price would not be critical for Russia.

THEME II: EUROPE BETWEEN ASIA AND AMERICA TOWARDS A NEW TRANSATLANTIC RELATIONSHIP?

- A Europe is no longer a problem for the US.**
- B The new Bush administration wants a stronger Europe.**
- C North America and Europe need each other.**

Europe and America have experienced difficult years. The new Bush administration is making a new effort to re-establish a strong transatlantic relationship. Its strategy is already being implemented. There have been three presidential trips to Europe, American senior officials spend more time in Europe, and there is more dialogue in general.

The Bush administration is also adopting a new approach to the European Union. It wants a stronger Europe. The Americans are asking themselves whether the EU is falling apart when they really need help. They are wondering what the no's to the constitution mean.

Both the US and Europe are facing the deadly threat of terrorism. The key transatlantic contacts are now in the area of homeland security. This dialogue takes place outside NATO.

There is no institutional relationship to replace NATO. The EU-US strategic dialogue is in its infancy. Some Americans distrust integration and fear it is polluting the relationship. NATO remains the organisation for training, logistics and force planning but it is not the forum for strategic discussion. The transatlantic economic ties are getting stronger and they are a source of strength.

The Americans and the Europeans are facing the same issues. The key question is whether those issues are bringing them together. The old transatlantic agenda needs to be transformed. Europe and America are partners but not in the cold war sense.

The transatlantic relations got so bad during the disputes over Iraq that the sheer lack of disputes now feels good. But many current leaders on both sides of the Atlantic are on their way out. There is a need to get back to the fundamentals.

The US is the sole superpower. The traditional rationale for transatlantic relations has disappeared. The basis needs to be reinvented. The US foreign and security policy is increasingly the result of internal, not external, processes. Europe is strategically marginalized. It no longer poses a problem. NATO has been marginalised strategically. The transatlantic relations are determined by non-transatlantic issues, i.e. the outside factors. The rise of domestic distractions in the US might lead to intensified naval-gazing on that side of the Atlantic as well. The Balkans is a European problem. For the Americans the mission determines the coalition, and there are no set piece alliances.

What are the consequences? In the middle east there seems to be no common strategy, with the exception of Iran. In China the transatlantic cooperation is not encouraging either. In energy issues the Americans and the Chinese seem to work together, on the opposite side to the Europeans.

The current situation should not lead to setting the wrong targets. Multilateralism in the framework of NATO is dead. The partnership will have to be built on a new basis. The EU is an option in strategic dialogue. The American reaction to the referendums was a positive sign. If no common framework can be established for the dialogue it might proceed on the basis of à la carte or lead to division.

The transatlantic relationship is sound. It has survived the trauma of Iraq. The economic relationship is the largest. There is an increasing convergence in the defining values. The major differences relate to the Kyoto protocol, the International Criminal Court, the Test Ban Treaty, the death penalty, and Guantanamo.

On the other hand there has been close cooperation in Kuwait, in the NATO expansion, in Bosnia, and in Kosovo. There was agreement on Afghanistan and cooperation in Iran and North Korea. Iraq stands out as a singular failure. It reflects discomfort with the US superpower status and its preventive engagement. These are healthy differences.

There is also a divergence in transatlantic economic performance. Prosperous Europe is supported by the US. The US favours deeper integration and has understood that the forces behind the no's in the referenda are no friends of the business community.

North America and Europe need each other. The global economy needs fixing. There is weak demand, and an absence of structural reforms. Close coordination is needed. The global trading system also needs fixing but the Doha prospects are grim. Best practices are needed in regulation, the capital markets, and counterfeiting. Cooperation is needed in defusing Muslim extremism and in dealing with non-democratic regimes pursuing nuclear weapons, e.g. Iran. Transatlantic cooperation is indispensable in the war against terror.

What is driving the realism of the new Bush administration? It has its hands full at home, which fuels pragmatism and partnership. The administration is also acutely aware of the costs of friction experienced in the past. It needs the Europeans to share the costs, and it needs their cooperation in China.

Europe is not at the heart of American policymaking though. Its key issues are the rise of China, North Korea, South Asia, and Iran. Europe is seen as a partner in dealing with these. There is also a difference in the ways in which terrorism is viewed and different lessons have been drawn from it in Europe and in the US. Extreme Islam is seen as an external enemy in the US and it is being fought outside its borders, Iraq being the frontline. Europeans see terrorism as an internal problem and as a problem of legitimacy. Europe does not want to attract terrorism.

The Europeans and the Americans have no option to working together. They need a transparent market. Dialogue à la carte might become necessary. Joint actions are necessary in order to face the challenges posed by the rise of China, Asian security, Iran, Ukraine, the Middle East, and terrorism.

In the transatlantic business agenda the US signals are encouraging. It must be remembered that transatlantic trade represents two thirds of world trade. An overwhelming part of it is intra-firm trade, which means that volatility is not great.

Protectionism is rising in the US. Also the Americans are blaming globalisation. In many industries there are subsidies on both sides of the Atlantic.

THE EURO AND THE DOLLAR: A LONG TERM PERSPECTIVE

- A** There is no need for a depreciation of the dollar in the short term.
- B** Europe can play an active part by creating assets and by carrying out reforms.

In the long-term perspective the euro is stronger than the long-term average. We are not in an exceptional situation. But there is volatility which is a source of concern. It is driven by three factors: the external (im)balance of the US, the growth prospects, and the exchange rate policies. There are two major trends: the widening imbalances and the rising dollar reserves.

There are two theories. The first states that the current account deficits are a serious problem. The debt is rising, there are large deficits in the US and a shift to protectionism. In the rest of the world there is export-led growth, which stimulates investment and more saving in the US.

The second theory posits that the deficits are not a serious problem. The external liabilities are stabilised, depression is avoided by export-led growth, and the deficits are not a problem as long as there is growth.

What should be the policy response? Since there is instability, real adjustment is needed. At the same time the economic fundamentals should be taken into account and a long-term perspective should be adopted.

There are three forces shaping the interest rates. The changing demographics lead to an increase in the savings rate and, initially, to an appreciation of the dollar. The relative productivity trends are strengthening the dollar. So are the reserves management strategies in Asia. The question is when.

The labour force is declining in Europe. The number of retirees is rising. The savings are rising with them but most people are investing in other regions. There is a looming conflict between the active workers and the retirees. The situation is less dramatic in the US.

Where are the savings placed? They could be placed in the emerging economies but that would lead to uncertainty. There are also capital flows to the US. Is the fiscal deficit in the US sustainable? What should the fiscal policy be?

Europe is moving in the right direction. There is a momentum for the reformers. But there is slow productivity growth in Europe. There is little progress in the Lisbon agenda. There is potential for a real appreciation of the dollar.

The Asian central banks are funding the US deficit. The switch to the euro depends on export-led growth. The US is willing to tolerate large trade deficits. The reserves show that the indicators have improved. We simply do not know when the dollar will appreciate.

At the same time there are global imbalances. The US, Australia, and the UK have deficits. In the rest of the world there are surpluses. There is a decline in the long-run interest rate since 1983 and a decline in the current account of the US. We live in an unbalanced world

There is income growth in many countries but it is difficult to produce attractive assets for savings. On the supply side the US has better growth prospects. There is demand for global assets.

Where do we go from here? A slowdown in the emerging markets is unlikely. Rapid financial development in them is not likely either. There will not be significant growth acceleration in continental Europe nor a US slowdown.

The most likely scenario is that nothing changes and the current account deficits will remain large in the US. At the same time there will be more pressure on the US, and the exchange rate may suffer a bit. There will be financial bubbles, investment in the emerging markets, and decolonisation.

What are the implications? There is no need for a depreciation of the US dollar in the short term. In the long-run the prospects are difficult to foresee. Europe can play part of this game. It should be creating assets.

The current imbalance is not a crisis. Long run interests are rising. But global imbalances are no good. There are risks in the deficits. The current situation is an "equilibrium". There is no need to plan too much. The exchange rates will remain volatile. European reforms are possible and they would have an impact.

THE IMPACT OF CHINA AND INDIA ON WORLD ECONOMY

- A** China will continue to grow fast. India will catch up.
- B** India has bottlenecks that are being addressed.
- C** India and China will remain different.

The rise of China and India is a mega subject that impacts everyone. China and India are the most populated and fastest growing economies. The key question is whether the growth will continue. China and India have an appetite for raw materials but the structure of their economies is different. The global economy is changing because of Brazil, Russia, India and China.

It is not easy to extrapolate based on past facts. The development of the GDP is a function of labour force, the capital stock, and productivity. The real growth rates are actually declining in China and India. By 2050 they are likely to experience a growth rate of about 3 %. India continues to grow very strongly. Its demographics are positive but it has further to catch up. The currencies of India and China could appreciate by close to 300 % in purchasing power parities.

The age share of the active population peaks later than it does in the developed world. In China there is actually a slide in the working age population. In India its share grows. India will overtake China in about 2030.

Economic Gravity shifts to Asia. China will represent 10 % of the world economy by 2020. China is the biggest singular source of fundamental economic growth. The GDP per capita is rising in China. But the US is growing as well. China's wealth will remain at about a third of the US level.

The largest economies will not be the richest. The demand for durables will remain volatile. China is in the hub of the middle class growth. India is not. The Chinese middle class is growing faster than the GDP.

Outsourcing is an irreversible trend. Globalisation is here to stay. The benefits of outsourcing are manifold. They are not limited to cost savings. They relate to new markets, better utilization of the workforce people, reduced lead times, and customer satisfaction.

In India there is a learning curve effect. The productivity is consistently growing because of learning. There is a large pool of hungry talent and many high level IT companies.

The population development of India is transforming itself into a blessing. There are millions of English-speaking graduates, high quality education, a strong market, strong growth, and a consumer revolution. The per capita income is growing.

The rise of India is related to the capitalist reforms carried out since 1991. The capital markets were reformed, the poverty went down, the savings went up, the pattern of society changed, the manufacturing went up, agriculture down. In the ICT sector there was significant growth. The service sector employment went up and shows up in the exports.

India is a huge economy, it has skilled manpower, the largest democracy in the world, free press, a good judicial system. The IT sector growth has been advancing unhindered by the government. There is a high return on investment. India is a leader in R&D. It is good at applying research. There are a lot of PhDs employed in India.

China and India are different. Western companies should work in both. India started reforms later after it ran out of foreign currency reserves 1991-92.

India is a democracy. China is a one-party state. India will remain a "noisy democracy". China will not turn into a multiparty democracy. Saving rates are higher in China. There is massive infrastructure spending. The infrastructure is good in China and bad in India. Chinese exports are much higher than the Indian ones. India is getting started. It has little manufacturing export. The foreign direct investment is also much higher in China. India is lagging behind in agriculture and manufacturing. China is lagging in the services and financial sector.

India has high indirect taxes. The tax system is confusing; there are differences between the states. The common VAT rate has only been introduced recently. China has a unified VAT rate, which has facilitated its transformation into a large market for consumer goods.

The GDP per capita in terms of purchasing power parity of China and India used to converge. There has been a difference since 1990 that is due to the Chinese reforms in 1978. The gap is growing. The critical reforms in China were the following: the creation of legislation that allowed the special economic zones to attract

foreign direct investment, the labour market reforms, the reduced indirect taxes and the lower interest rates.

In India manufacturing is not an important sector driving growth. The services exports are growing rapidly. India is not yet an industrialised nation. As the agricultural jobs are being reduced it is necessary to create new jobs. Otherwise there will be social discontent. India's work force is growing. The peak will be around 2020.

The foreign direct investments are driving exports in China. China is entering the world trading system. India is not, except in the services. There are infrastructure bottlenecks in India.

What would it take to produce growth in India? India needs a clearer tax and trade policy, less regulation, fewer land market product market barriers, and labour market reforms. The Chinese growth rate is steadier.

India offers huge opportunity. Outsourcing is a real issue, it offers real business advantages. Cultural differences are strength and so is Indian tolerance. There are no serious regional concerns but there are huge political problems.

EAST ASIAN UNCERTAINTIES

- A East Asia has many sources of serious concern.**
- B Economic growth is not accompanied by political stability.**

The political rationality is different from business rationality. This is demonstrated by relations between China and Japan and China and Taiwan, the situation in North Korea. The future will not be linear. Political risks may upset economic patterns.

The real annual growth in Asia is high. National income doubles every eight years. But there is a stop-and-go pattern and a lack of real business cycles.

China's impact in the Asian region is impressive. It represents 83 per cent of world trade in manufactured goods. China's market share increase has been huge in 1990-2000 vis-à-vis the new tigers. In the low technology goods China's share is growing. It could soon be around 50 per cent in textiles. In the medium and high-technology goods its growth is the fastest. After the WTO accession the growth will be even more impressive.

At the same time there is a rise of China's neighbours with the exception of Hong Kong. Standard comparative advantage theory does not explain it. There are no perfectly competitive markets. Intra-industry trade is about 25 per cent of world trade.

China is experiencing partial marketisation. It has its limits. China's slowdown factors are the banking sector, unemployment, and the legal system. China's influence is generalized. Its slowdown has an impact on the global economy, especially in the commodities sector.

China is implementing a partial reform strategy; otherwise market forces would take control. There are social frictions and divisions. There is a lack of social security. China has a growing middle class but a lagging political system. Its income inequality is getting worse.

In the 1960s Europe was doing well. In the 80's the Japanese economy was booming. The new millennium has brought new uncertainties. China's economic challenges are significant. It has to implement international economic law. There are geopolitical risks and trade tensions. The outlook is bright as long as the reforms are maintained.

The nation state is not withering at all. It is alive and kicking in China, Korea, and Japan. A booming Asia is likely. At same time war is possible. There is a strong sense of nationalism in Asia. India and China cannot become very close.

In China scale is a possibility and a problem. The driving forces are demographics, economics, and social and political factors. There are many possible scenarios for China: peaceful rise, chaotic rise and fall, chauvinism and imperialism, and implosion. Something can be done about the risks. In China the probable scenarios involve authoritarian political regimes, economic growth, ballistic missiles, rapid military build-up and modernisation. Taiwan is still deeply divided.

In North Korea the likely scenarios involve economic strangulation, leadership change, regime change, the Israeli scenario and chain reactions in its neighbourhood.

The EU has become China's new source of science and high technology. It has silently accepted Taiwan's annexation. It acts as a counterbalance against the US. China poses a real military threat to Taiwan. It is favouring offensive action. It will unify Taiwan by force in 10-15 years regardless of Taiwanese policies.

There is a hegemony shift which leads to a high risk of conflicts. China-Japan confrontation is due to an attempt to divert domestic anger and frustration. The US-Japan alliance has been strengthened. There is a decay of US military presence in East Asia. The confrontation is between China and the US-Japan axe. A China-Russia-India triangle is emerging. It is a strategic partnership for "multilateralism" driving Russian arms exports.

The EU arms embargo has been handled badly by the EU, the US and China. It has nothing to do with selling arms to China. China is not Zimbabwe or Burma. Dialogue should be continued. The EU should engage China.

There are areas of common concern for China and the EU: the UN reform, the WTO, peacekeeping, emissions, and regional integration, oil, and arms proliferation. The Europeans should talk to the Chinese in a friendly way.

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