Business Europe

FORTNIGHTLY REPORT TO MANAGERS OF EUROPEAN OPERATIONS

E·I·U

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Will the euro work?

Ensuring that it does will require some hard policy choices

European economic and monetary union (EMU) is almost certain to be launched on time on January 1st 1999. This is an enormous venture that is not without risk. The challenge for all members of the EU is to make sure that the euro works well. A new EIU study* argues that this will entail some hard policy choices.

Whether EMU is a good idea or not is an increasingly academic issue. Only an extraordinary surprise will delay or derail its launch. Moreover, a large group of countries, most likely 11, will participate from the outset. Apart from Greece, it now appears that the only countries not in the first wave will be those that choose to stand aside: Denmark, Sweden and the UK.

Controversial reforms

To make EMU a success, it is not enough for countries simply to satisfy the Maastricht criteria for economic convergence. They also need to make sensible policy choices and tackle controversial reforms. In particular, they must ensure sound conduct of demand-side policies (monetary, fiscal and exchange-rate) under EMU; and they must create sufficient flexibility of labour and product markets in Europe to compensate for the lack of exchange-rate flexibility.

Stable demand policies require three things. First, the European Central Bank (ECB) needs to overcome the technical problems of setting a common, EU-wide interest rate during the transition to the euro, in the face of shifting patterns of money holdings. Otherwise the risk is that the macroeconomy within the EMU zone will be unduly volatile.

Second, the commitment to sound fiscal policies seen in the run-up to the launch of EMU should continue once it is operative. Participants should take seriously the aim of further reducing public deficits to a 0-1% average over the economic cycle, thereby allowing scope for automatic fiscal stabilisers to operate over the cycle.

Finally, there is a need to avoid possible conflict between national finance ministers and the ECB on the balance between monetary and fiscal policy, including the implications for exchange rate policy. Such conflicts are avoidable, but their avoidance will require responsibility on the part of politicians and skill on the part of the ECB. The outcome will affect not just the EMU area but the wider world, where the euro will in time start to match the dollar in importance.

Achieving greater flexibility of labour and product markets represents the greater challenge, especially in view of the relative inflexibility of most European markets compared with the United States, the UK and some emerging economies. With the loss of exchange-rate flexibility under EMU, the need for greater flexibility elsewhere becomes all the more pressing.

This is an issue that all national governments need to address, but they need not do so in the same way. There are different routes to greater flexibility and no need for a common approach: subsidiarity should prevail. But some countries show little inclination to change; a key challenge, for the UK presidency and beyond, is to spread agreement on the need for timely reforms.

The future of the EU

The success of EMU will depend on progress on these two dimensions of policy. The report sets out four plausible alternative futures (see box overleaf).

1) If both demand and supply policies go badly, EMU will impose severe costs on the European economies, affecting both the "ins" and the "outs", as well as having adverse effects on the rest of the world. The European economy

> ## New horizons
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> This week *BE* inaugurates a new regular section, **Greater Europe**. It will focus on the EU's evolving relationship with the countries of central and eastern Europe and how western companies are responding to the business opportunities and challenges of this region. See page 5.

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All four scenarios must be regarded as possible

Which one happens will depend on the policy choices

Four scenarios for EMU

UNSTABLE EURO / **STABLE EURO**

Labour & product markets inflexible

1) Europe in decline (Unstable euro)

- Instabilities in transition: ECB hits technical problems in running euro monetary policy, compounded by euro speculation.
- Conflicts between ECB and Ecofin lead to an overvalued euro, instability against $/yen.
- Macroeconomic instabilities compounded by continued rigidities in labour markets, leading to high and rising unemployment.
- Struggle to conform to stability pact, unpopular tax and spending decisions, growing disenchantment with euro.
- Indefinite postponement of EU enlargement, growing social and political instability in eastern Europe.
- Political pressures grow for abandonment of EMU, restoration of national currencies.
- Disenchantment with EMU leads to protectionist tendencies, undermining commitment to single market and European integration.

2) Europe slumbering (Stable euro)

- Smooth transition to euro, free from speculation. ECB establishes strong reputation. No conflict with Ecofin.
- Economies recover from recession, enjoy initial comfortable growth phase.
- But with this favourable background, pressure for market reforms is absent and governments duck issue of reform.
- Continued rigidities in labour markets lead to slowing of European expansion, persistent unemployment problems.
- Effective ECB monetary policy avoids inflation, but growth remains sluggish.
- Struggle to conform to stability pact leads to rising taxes, adding to sluggishness.
- Half-hearted EU expansion to the east, hedged by conditions and safeguards.
- Disappointing economic performance leads to protectionist tendencies, slackening commitment to single market and integration.

Labour & product markets flexible

3) Europe adjusting (Unstable euro)

- Unstable transition: ECB hits technical problems, euro speculation.
- Conflicts between ECB and Ecofin lead to an overvalued euro, instability against $/yen.
- Macroeconomic instabilities lead to volatile output and unemployment.
- Despite this, governments press ahead with labour market and welfare reforms.
- Resulting flexibility of labour markets ensures that trend of unemployment is downwards, despite short-run volatility.
- More open European market resulting from euro intensifies effect of single-market directives, which are enforced rigorously.
- Major moves to liberalise regulated markets—telecoms, energy and airlines.
- A confident Europe addresses the issue of enlargement to the east.

4) Europe resurgent (Stable euro)

- Transition to euro works smoothly, free from currency speculation.
- ECB establishes an early and strong reputation, no conflict with Ecofin.
- Recovery from recession, comfortable growth with falling unemployment.
- Reform of welfare systems and labour deregulation lead to more flexible labour markets, further fall in unemployment.
- More open European market resulting from euro intensifies effect of single-market directives, which are enforced rigorously.
- Major moves to liberalise regulated markets—telecoms, energy and airlines.
- A confident Europe addresses the issue of enlargement to the east.
- Dynamic and fast-growing economy creates more jobs and prosperity.

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will combine volatility with stagnation, a recipe for decline and rising unemployment. If that persists, EMU will be judged a failure, and the result could be a divided EU.

2) Successful demand-side policies will mitigate the volatility, but without supply-side flexibility the European economies will lack dynamism and growth.

3) Supply-side reforms, with demand-side mistakes, will mean a dynamic but volatile EMU macroeconomy, an interesting state of volatile change.

4) The best outcome would be the combination of supply-side reforms to achieve flexibility with effective and stable demand-side policies. This offers the best chance of dynamism, low unemployment, innovation and growth.

The essential point is that all of these futures are possible. Which one actually happens depends on the policies that European leaders pursue over the next few years. If the will to reform is lacking, EMU may well work badly. With a commitment to the early adoption of the right policies, EMU can provide a real spur to the European economy.

The launch of EMU, warns the EIU report, is not the time for European leaders to sit back and admire their handiwork. It must be the spur for a determined drive to make the European economy more adaptable and dynamic, ready for the challenges of the new millennium.

The UK's position

The launch of EMU poses particular issues for the UK, which occupies the EU presidency at a critical juncture of preparation for EMU. This gives Britain a special responsibility for ensuring that the policies required for EMU to work well are at the forefront of the EU agenda. The danger is that European discussion will instead focus almost exclusively on the immediate issues that need to be resolved to get EMU up and running.

For the UK, undue delay in joining EMU could have a high cost

But the Labour government also faces difficult issues concerning the timing of the UK's own entry to EMU. Early entry has been ruled out for sound reasons, including the different state of the UK cycle and the sharp rise in sterling over the past year. But the risk of deferring a decision on entry until after the next election, as the government now plans, is that the UK may then be unable to enter until 2004 or 2005. Standing aside for so long could have a high political and economic cost.

* *Will the euro work?*, by David Currie. Available from EIU offices at £145.

Credit management

Underpinning the single market

The Commission wants to help creditors enforce court orders in other EU states

The single market rights created by the EU are fair-weather in character. Goods and services can be sold across the Union, and as long as the customer pays the invoice there is no problem. But once the payments stop, so does the protection of the single market. There is no common EU procedural law to force a debtor to pay.

Instead, the creditor firm finds itself back in the Europe of 17 closed borders (17 because the UK has three separate legal systems—for England and Wales, Scotland and Northern Ireland). Suing across a national frontier involves international law, several sets of lawyers, and the hope that the enforcement procedures which the creditor will eventually be permitted to use will be effective and quick enough to seize the debtor's assets before they disappear from that territory.

The Brussels convention

Back in 1968 the EU adopted the Brussels convention. This aimed to enable business to enforce judgments across national borders. The rules provided for a "recognition passport" for national judgments which permit them then to be enforced in other national courts.

However, as a recent report from the Commission (Com(97)609) reveals, the convention has severe limitations. Recognition of judgments from other member state courts is not automatic. There is evidence of far too many courts reopening the entire case on spurious grounds of public policy.

When it comes to debt collection, there is no single market

A further problem is that enforcement issues are left almost entirely to national procedural law. Such laws vary from the vigorous British and German rules to the arcane Greek and Italian procedures. The result is that, despite the Brussels convention, there is a complete lack of uniformity in enforcing judgments across the EU. Worse still, inadequate procedural laws encourage unscrupulous debtors to shift assets to a state where enforcement is costly, lengthy and ineffective. ➤

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Finally, notwithstanding the existence of a single market, the Brussels convention does not permit business to obtain EU-wide injunctions. The best it allows is for a single national judgment to be recognised and enforced in each and every member state. This can mean bringing proceedings in virtually every member state.

Reform proposals

The report makes two major proposals for reform of the Brussels convention.

- **Fast-track recognition.** The Commission proposes that recognition of a foreign judgment, instead of involving a court hearing, should be a "virtually automatic" administrative procedure. Only if the defendant challenges the recognition would court proceedings be held. To make such a challenge more difficult, it proposes to remove the right of courts to set aside a judgment on the grounds of public policy. This would significantly reduce the ability of defendants to persuade a court, and for the court to actually find grounds, to block enforcement.
- **Effective protective measures.** To prevent debtors from hiding assets, the revised convention would for the first time include protective measures. Every member state would be required to permit its courts to adopt such measures.

The new convention would stop debtors from hiding assets

Some states have already reformed their civil procedural law to empower their courts to adopt such measures. British courts, for example, can issue so-called *Mareva* injunctions prohibiting the movement of assets out of the UK until judgment. But others have no such procedure.

The 1968 convention does not deal directly with protective measures, leaving the issue entirely to national procedural law. The result is an uneven playing field which is exploited by unscrupulous debtors who use states without effective rules as a bolt-hole for assets from other member states. Because of the openness of the single market, those states are effectively undermining the protective systems of the others.

One idea is a fast-track procedure for simple money claims

Removing the legal borders

In its report, the Commission invites comments from business and the legal profession on how to improve crossborder legal protection. It makes three principal suggestions.

- **Fast-track money procedure.** For simple money claims, where there is no issue as to the debtor's liability, it proposes a fast-track procedure. This would require no special recognition and enforcement procedures in member state courts. A single certificate from the court where judgment was given would be sufficient to invoke the enforcement mechanisms of another state.
- **Bank account seizures.** Many but not all EU states permit the seizure and freezing of bank accounts. The Commission would like business views on the value of creating a common EU right to seize and attach bank accounts.
- **Declaration of assets.** One of the major difficulties for business creditors is to find a debtor's assets. In some, but again not all member states, it is possible to force the defendant to make a sworn public declaration of assets—which in itself is often enough to bring about payment. The Commission would again be interested in the views of business on creation of a common EU declaration procedure.

Business assessment

Executives should welcome these proposals, which will help underpin business transactions across the EU. Companies should take part in the debate initiated by the Commission on crossborder civil procedure, passing on their experience of trying to enforce judgment debts. In addition, industry should make two points to the Commission.

First, national civil procedural rules need to be reformed. The enforcement of crossborder actions is made much more difficult by national rules which vary widely in both content and effectiveness. It is often the national procedure, not the Brussels convention, which obstructs the enforcement of judgment debts in another state.

There is a clear precedent for EU action in the field of national procedural law. In sex discrimination cases, a newly adopted directive (*BE* Jan 28th) will shift the burden of proof and introduce discovery procedures in all national procedural laws. Business can reasonably argue that if gender equality can be effectively protected by EU law, then so can commercial contracts.

Second, national courts need the power to adopt EU-wide injunctions. It is not enough to permit a plaintiff to go from one national court to another seeking recognition and enforcement of its original judgment. In a single market it is possible to be faced, for example, with multistate copyright infringement, with illegal products being sold across the Union. To terminate such infringements a firm needs to be able to go, say, to the high court in London, and obtain an EU-wide injunction that will be enforced without question by other EU states.

While the Commission's proposal is to be welcomed, much more remains to be done if European business is to have the same legal security when undertaking crossborder transactions that it enjoys at home, or equivalent to that it enjoys in the US market.

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EU-Russian relations

Bear necessities

A framework for better ties with Russia is in place—but there's a limit to what the EU can do

Eastern Europe is looming ever larger in EU thinking, and not just because of enlargement. The likes of Hungary, the Czech Republic and Poland are safer places to do business, but no market has greater potential than Russia. The region's sleeping giant is already the EU's sixth-largest trading partner; when the Russian economy takes off, the volume of trade and investment will rocket. The Commission may describe Russia as "not yet a safe place to invest in", but it is doing what it can to ensure that European companies have a front-row seat when the show begins.

Bilateral relations have been governed since December 1st by an EU-Russian partnership and cooperation agreement (PCA), which covers all aspects of trade and economic ties and which brought together ministers from both sides for the first meeting of the cooperation council last month. The council had a crowded agenda—trade tiffs abound in industries as diverse as textiles and aviation. And while the individual disputes largely remain unresolved, the PCA does offer hope of progress.

The agreement will lead to the creation of a series of working committees to address the EU's major gripes, ranging from food safety controls on eggs, import restrictions on carpets and discriminatory distribution licensing costs for EU-produced alcohol to fees levied on EU aircraft overflying Russian airspace and lax intellectual property protection. The committees should help address the Commission's prime problem—identifying the best bureaucratic point of contact. "We simply don't know who to talk to at the technical level, and we can't keep going to the highest political level to settle problems", laments one official.

Erratic customs controls and border procedures are another bone of contention. So too are laborious product certification regimes. Here the EU is adopting a nuts-and-bolts approach, by helping to finance improvements to Russia's creaking customs infrastructure. At the notorious Russo-Finnish border, for instance, the EU is paying for the building of a weighing station and the training of sniffer dogs.

Whether the EU can bring about real policy change in Russia is an open question, however. The Commission can make useful gestures—for example, it has proposed to the Council of Ministers that Russia no longer be designated a non-market economy, thereby making it more difficult to prove that Russian exporters are dumping. But to a great extent, the ball is in other courts.

On trade issues, Russia's pursuit of World Trade Organisation (WTO) membership is the most likely way that EU concerns will be allayed. Russia is scheduled to submit its formal offer for membership this year. The offer should contain a plan for dismantling existing trade barriers; introducing the principles of national treatment and non-discrimination; and subjecting trade conflicts to the WTO's dispute panel procedures. If it does, the EU and Russia are due under the PCA to move ahead with exploratory talks on the long-term possibility of a free trade zone.

Working committees should help iron out the EU's trade gripes

In their hands

As for improvements in the investment climate, which is dogged by legal uncertainty and procedural murk, internal Russian politics and market forces are the crucial variables. Imminent tests of Russian reform include the following.

- Upcoming debates in the Duma, the recalcitrant lower house of parliament, on key issues such as the ratification of the European energy charter treaty and tax reform measures.
- The stability of the rouble in the face of continued market turmoil. If the currency begins to fall, inflation will quickly rear its head again.
- The forthcoming privatisation of Rosneft, the best oil company still in state hands. Western majors such as **British Petroleum** and **Shell** have declared a keen interest in the sale, but a murky carve-up between Russian bidders is in the air.

Internal politics will determine the success of Russian reform

If miracles aren't likely on the trade and investment front, things are brighter in the field of science and technology, where the PCA commits the EU and Russia to enhanced cooperation. In particular, Russia has become central to the EU's ambitions to establish a new global navigation system, as a means of severing its dependence on the GPS and GLONASS systems operated by the United States and Russia respectively. The Commission wants to launch negotiations with both the US and Russia jointly to develop a new system, and has especially high hopes of snagging Russia's interest. ■

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EU/country briefing

SINGLE MARKET

■ UK sets priorities

Lord Simon, the UK minister for trade and competition and chairman of the EU's internal market council during the UK's six-month presidency, intends to speed up the simplification of single market legislation, while raising the pressure on member states to enact approved directives into national law.

Speaking to the European Parliament, the former chairman of British Petroleum outlined other issues he plans to broach when ministers get together for an informal meeting in Cambridge on February 13th-15th:

- mutual recognition of qualifications and vocational training;
- standardisation, particularly in respect of regulatory transparency; and
- public procurement rules, with a view to following up the Commission's end-1996 green paper.

In addition, the UK wants to push forward on two intellectual property measures: the draft directive on biotechnology inventions and the proposal on industrial designs and models.

Lord Simon also said he would do what was necessary to smooth the path of the European company statute, an issue on which there has been little progress over the past few years.

Lastly, he would ask ministers, during their meetings of March 30th and May 18th, to discuss reform of the EU's transit system and the recent green papers on patents, Internet copyright and encrypted services.

COMPETITION RULES

■ Huge fine for Volkswagen

The European Commission has imposed a fine of Ecu102m ($112m) on **Volkswagen**—the largest ever on a single company—for pressuring its Italian dealers not to sell cars to German and Austrian nationals in search of cheaper prices than those available at home.

Explaining the reasons for this draconian sanction, EU competition commissioner Karel Van Miert said: "It was a very elaborate system, under control of the management, and Volkswagen was fully aware that it was committing a large number of infringements."

Following an "avalanche" of complaints by consumers, the Commission carried out dawn raids on various VW premises in October 1995, and discovered evidence that the company had threatened to terminate contracts with 50 dealers who were selling to non-Italian residents, and had actually done so in 12 cases. The company had used the chassis numbers from German vehicle registrations to trace back vehicles to the dealer who sold them. The size of the fine was intended to reflect the gravity and duration of the offence, which began in 1987 and escalated in 1993 despite repeated warnings.

Volkswagen said it would appeal the Commission's decision to the Court of First Instance, describing the penalty as "completely disproportionate". The company declared "there could be no question of systematic infringement" of the competition rules.

TRANSPORT

■ EU-Swiss transport deal

Brussels and Bern have reached an agreement to phase out by 2005 the 28-tonne weight limit currently placed on lorries passing through Switzerland, offering potential savings of around 20% on the cost of trans-Alpine transport.

Under the deal, which needs majority approval by EU transport ministers to go into effect, the weight ban would be replaced by a transit charge of around Ecu200 on average, depending on the vehicle's pollution level. From 1999 through 2004, Switzerland would allow gradually increasing quotas for the 40-tonne lorries used by most EU hauliers.

Neil Kinnock, the EU's transport commissioner, who negotiated the deal together with UK transport minister Gavin Strang (representing the EU presidency) and his Swiss counterpart Moritz Leuenberger, said he would firmly recommend the agreement to the EU transport council. "We have obtained what the member states asked us to negotiate—an agreement that is beneficial to the economies of both Switzerland and the European Union while guaranteeing environmental protection for the Alps," he said.

Until now, the ban has meant that 40-tonne lorry traffic passing between the north and south of Europe has had to circumvent Switzerland. This has seriously congested highways in France and Austria, extending travel distances and forcing EU shippers to bear extra costs estimated at Ecu160m per year.

Mr Kinnock said he hoped that the transport deal would smooth the way towards conclusion of a broad cooperation agreement between the EU and Switzerland which has been under negotiation for the past five years. In addition to road and air transport, the accord covers free movement of people between Switzerland and the EU, research cooperation, trade rules, agricultural market access and technical trade barriers.

TELECOMMUNICATIONS

■ Italian mobile phone fracas

The EU's competition commissioner, Karel Van Miert, has written to Italian communications minister Antonio Maccanico to ask what response he will make to the decision by Telecom Italia Mobile (TIM) to stop compensation payments to its rival Omnitel.

TIM announced last month that it was halting further payments under a compensation package agreed with Omnitel-Pronto Italia to make up for an Ecu370m licence fee exacted from Omnitel but not from TIM. The move was a protest against Brussels' postponing permission for trials of TIM's new DCS 1800 cellular telephones, which should have begun January 1st.

The Commission has ruled that three GSM mobile operators must be working in Italy before the incumbent players can move on to more advanced services such as the DCS 1800. Hence, the absence of a third mobile operator is hampering the business development plans of existing operators TIM and Omnitel.

Delays over payment of the compensation package, agreed in late 1996, have been a constant source of friction between Brussels and Rome. Mr Van Miert's letter reminds Mr Maccanico of his government's obligation to ensure proper implementation of the TIM-Omnitel compensation deal. He also asks why Italy has announced a further delay (until early April) in allocating a third mobile licence. ➤

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INFORMATION SOCIETY

■ Internet charter

The Commission has put forward plans to negotiate an international charter to improve regulatory coordination with regard to advanced communications and Internet services. Without better coordination, Brussels fears there is a risk of over-regulation as individual countries legislate on their own with conflicting rules.

The Commission will formally present the idea to telecoms ministers on February 26th. Once it has their firm backing, it will propose an international ministerial conference before year-end to launch the drafting of a charter, with a view to completing it during 1999. A meeting with interested businessmen will also be scheduled for this spring.

The planned charter can best be described as a road map. It will set out the gaps in the current regulatory environment that require priority treatment at international level, and introduce tight deadlines for filling these in. Equally important, it will identify the international institutions that will negotiate the solutions, such as the World Trade Organisation, the World Intellectual Property Organisation and the Organisation for Economic Cooperation and Development. Indeed, the Commission has identified 50-odd organisations that are involved in some way with Internet policy, without counting national regulatory authorities.

The Commission does not want to create a new organisation to settle the problems, but it does want to provide guidance for these existing bodies, all of which are presently reviewing their policies to adapt to the changing business environment.

Regulatory gaps at international level include lack of a consensus over data privacy rights, recognition of digital signatures or ensuring the confidentiality of information sent over the Internet. Continuing disagreement over copyright protection and fiscal treatment of transactions on the Net must be resolved as soon as possible, the Commission says. Added to these is the whole question of governance, which also requires an international solution.

Industry commissioner Martin Bangemann launched the idea of a charter last year in recognition that, while bilateral talks could resolve certain issues, most require an international response if the new services are to benefit from a global market. Both Mr Bangemann and trade commissioner Sir Leon Brittan, who are co-sponsoring the initiative, believe better coordination at international level could contribute to more harmonious development. "The explosion of the Internet is unstoppable," said Sir Leon. "The only question is whether this will be accompanied by over-regulation or confusion." An example is the current discord over data privacy, where the EU has introduced binding legislation while the US favours voluntary codes.

TRADE POLICY

■ Lomé to be renegotiated

The Commission has announced that it intends to change the way the EU trades with the world's poorer regions, replacing preferential trade agreements with a series of free-trade pacts.

Current arrangements between the EU and 71 African, Caribbean and Pacific (ACP) countries are organised under the Lomé convention, which expires in early 2000. The Commission believes that Lomé's successor regime, on which negotiations are due to begin this autumn, should move away from the old-style donor-recipient relationship. Instead, it wants to refocus on helping ACP countries adjust to globalisation and free trade, enabling them to attract greater private investment.

Lomé, which dates from the mid-1970s, has been criticised as being counter to the aims and principles upheld by the World Trade Organisation, since it effectively discriminates between developing states. But some ACP countries have expressed fears at being exposed to a more competitive marketplace, for which they will be ill-equipped.

The Commission remains adamant, however. "It is absolutely necessary to change if we want to end the marginalisation of the ACP countries," said the EU's development commissioner, João de Deus Pinheiro.

Following the completion of a new ACP agreement, the Commission proposes that regional "economic partnership" pacts be negotiated, whose aim will be to establish trading zones corresponding to the level of development in each region, allowing them a "phased in" exposure to free trade.

For the time being, the Commission would like to see preferential access to the EU market maintained for sugar, bananas and beef, to be integrated into the regional deals later on.

Such deals will not be on the agenda until well after 2000, and the poorest nations will still hold on to preferential trading rights. But the Commission intends to inject a measure of political conditionality into the talks: respect for democracy and human rights will be taken into account, as will the quality of public administration.

■ German export guarantees

Bonn will not place any restriction on government-backed Hermes export credit insurance to south-east Asia because of the current economic and financial crises, the economics minister, Günter Rexrodt, has announced. This is part of an initiative by export credit insurance authorities in the G7 leading industrial countries to support international efforts to stabilise the region.

But new risks arising in the region will be carefully examined, Mr Rexrodt said. He added that the inter-ministerial committee that approves individual Hermes coverage applications will increase its scrutiny and give preference to export-oriented customers in the region since local-currency declines have made them more competitive. So far, the minister said, Bonn has seen no change in bad-debt levels or the payment process on the part of Asian customers and has not had to make good on any outstanding Hermes credit guarantees to Thailand, the Philippines, Malaysia or South Korea.

LABOUR RELATIONS

■ Employee consultation

Pádraig Flynn, the EU's social affairs commissioner, has warned European employers—represented by UNICE and CEEP for the private and public sectors

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respectively—that they must improve dialogue with workers on big issues such as factory closures or face the possibility of having legislation imposed on them.

The Commission has drafted plans for legislation to establish a "fundamental right" for workers to be consulted on strategic and economic decisions likely to affect them (*BE* Nov 19th). Directive 94/45 already obliges companies with at least 1,000 employees in two or more EU countries to hold regular talks through European works councils. But the Commission now wants to extend these rules, albeit in a more diluted form, to smaller companies, including those based in one country only.

Many employers oppose the plans, and the UK government, currently holding the EU presidency, is on their side. London sees the Commission's proposals as unnecessary and believes they would be detrimental to business throughout the EU.

However, the Commission believes EU-wide rules are needed because national laws have often proven to be inadequate in anticipating the social problems that are the by-products of corporate decisions. The issue was highlighted last year when Renault announced a plant closure in Belgium without having consulted either its European or national works councils.

Mr Flynn would prefer a deal to be reached between employers and unions, independent of the Commission, and to this end has extended the six-week consultation period to give the employers' organisations more time to consult their membership.

UNICE has said it would be in its members' interest to negotiate a deal. But its secretary-general, Zygmunt Tyskiewicz, points out that many of its members felt the Commission had ignored their views in a consultation held last summer.

Mr Flynn is seeking a meeting with the employers' federations later this month to discuss their final positions on establishing worker dialogue.

■ France's 35-hour week

The French government's bill to introduce a 35-hour workweek has survived a stormy parliamentary debate almost intact. But employers remain hostile, fearing it will damage their competitiveness just as Europe is introducing a single currency.

The bill, which has still to be approved by the senate, provides for a cut in the statutory working week from 39 to 35 hours from the start of 2000. Companies with less than 20 employees will have an extra two years. Financial incentives are available to employers who agree with unions to move to a 35-hour week before 2000, while creating or preserving jobs.

Parliamentary amendments include extra subsidies for companies that move towards a 32-hour week by 2003. Companies that do not respect their commitments on hours cuts and job creation will have to repay the subsidies.

Another important amendment allows for the cut in working hours to take the form of time off, provided this is agreed with labour unions. Such time off must be taken within two months.

This bill is a key plank of the left-wing coalition's bid to reduce France's 12% unemployment level. Employers' organisation CNPF argues that compulsory hours cuts will raise business costs, damaging industry's competitiveness and thus endangering jobs. However, government and unions seem to accept, albeit tacitly, that jobs will only be created if costs are kept down. Unions appear more ready to accept that hours cuts be accompanied by a pay cut, or at least a freeze.

The government has proposed the introduction of a monthly minimum wage, to protect minimum wage earners against income losses resulting from the drop in the workweek. But it is not yet clear exactly how this issue will be tackled. Neither has the government spelled out whether it plans to adjust overtime rules. These thorny issues should be resolved by further legislation, due by 1999. The government says this second law will lay down concrete details for implementing the 35-hour week.

■ German smoking ban defeated

A bipartisan bill to protect Germany's non-smokers (*BE* Mar 12th) was overwhelmingly defeated last week after a long and emotional Bundestag debate. The requirement to separate smokers and non-smokers in the workplace would have cost firms a onetime outlay of nearly $9bn, according to the industry-financed Institute of the German Economy. The bill's supporters claimed that the healthcare costs due to smoking are up to ten times as high. But the vote against the bill—336 to 256, with 34 abstentions—was so strong that a new attempt to enact a smoking ban is not expected in the foreseeable future.

DISTRIBUTION

■ Swedish pharmacy deregulation

Some of Sweden's largest retail chains, including Ahlens, Statoil of Norway, ICA and Hennes & Mauritz (H&M), have signalled their intention to apply for licences to operate in-store pharmacy outlets, in what amounts to the first significant development in the run-up to liberalisation of the Swedish pharmacy market.

Statoil is hoping to locate a pharmacy outlet at around one-third of the 650 filling station mini-malls the company plans to develop in Sweden by 2001. ICA and Ahlens have been lobbying since the mid-1980s for deregulation of the pharmacy trade.

The heightened interest has emerged as the government moves to end the monopoly of the state pharmacy group, Apoteksbolaget. Sweden's current system of state-owned drugstores was living on borrowed time once it joined the EU in 1996. A government-commissioned report, submitted at end-January, recommends that private pharmacies be allowed to compete with state-owned ones.

Moreover, there is to be a gradual removal of government control over prescription drug prices. These are expected to drop by 10-20% in the face of competition and the possible arrival of foreign pharmacy chains. At present, drug prices are established by the national social insurance board. The report proposes that this process be decentralised, allowing county authorities to negotiate prices directly with pharmaceuticals firms, a system already in operation in hospital pharmacies. ■

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Taxation

Tug-of-war over transfer pricing

New UK rules have focused fresh attention on an old problem

Globalisation is providing a platform for risk management and cost reduction in a number of new ways, but at the same time is raising some major tax questions.

In their quest for regional and global efficiencies, multinational firms are setting up distribution centres, call-service facilities and leasing services, as well as opting for contract manufacturing in some countries, to service all of their subsidiaries in Europe or even worldwide. And for years they have centralised finance operations, R&D and regional administrative management, charging subsidiaries for the costs of such centres plus a mark-up for profit.

At the same time, tax officials have been searching for ways to increase revenue without the political pain of raising tax rates. More and more, they are scrutinising transfer pricing between affiliated companies to make sure that they are getting a fair share of MNCs' tax payments. For example, the UK recently completed a consultation period on newly issued draft transfer pricing regulations. The government will soon place the final version before parliament, with the aim of implementing the new rules in 1999 when corporate tax self-assessment begins.

Multinationals under scrutiny

Ernst & Young (E&Y), the Big Six accounting firm soon to merge with KPMG, contacted some 400 international companies for its 1997 global survey on transfer pricing. More than three-quarters of the respondents view transfer pricing as an important international tax issue, and a similar number expect to face a transfer pricing examination within the next two years. Inter-company services are seen as the transactions most likely to be challenged. And respondents consider that there is only a 50:50 chance that a company can avoid paying higher taxes after a transfer pricing enquiry.

How are companies preparing to fight such battles? The firms in the E&Y survey are not certain as to what kind of transfer pricing documentation will be required. Where there are no clear national guidelines, many MNCs are documenting such transactions according to strict US rules. (For an alternative approach see the proposed UK rules in the accompanying box.)

A number of companies have made use of advanced pricing agreements (APAs), a mechanism whereby the setting of transfer prices for specified controlled transactions may be agreed with tax administrations in advance of the transaction being undertaken and reported. Some companies are pleased with their APAs, which provide certainty of tax treatment, avoidance of double taxation and freedom from costly examinations. But others complain about their inadequacy, saying the process is too slow, bureaucratic and not user-friendly. Moreover, some report that tax officials apparently changed direction during the negotiations.

Most companies will face a transfer pricing audit in the next two years

There are a couple of new alternative approaches to APAs that a good number of firms would consider, namely the alternative dispute resolution used in the US or the EU arbitration convention. As yet, however, both these systems are untested.

More official tax action

The E&Y surveyors also talked to tax officials in major countries and discovered that many authorities are paying more attention to transfer pricing compliance.

- **France** has recently formed a new group of transfer pricing specialists and is looking at the question of whether or not to set up an APA programme.
- **Germany** is planning to update its administrative principles for transfer pricing, following the recent publication of guidelines for the taxation of permanent establishments.
- **Italy** tends to concentrate audits on central management services and other cost-sharing arrangements, paying particular attention to transactions with known tax havens. There are no statutory provisions regarding documentation, but authorities expect comprehensive documentation to be available on site.
- **The Netherlands** has no specific law on transfer pricing, but tax authorities rely heavily on the OECD guidelines when reviewing MNCs' transfer pricing practices. The finance ministry has begun training sessions in transfer pricing for its field inspectors, and a greater number of audits could be performed in future.
- **Sweden** has set up a parliamentary working group to review current legislation on transfer pricing. Officials are considering the use of APAs, not currently included in current laws.
- **Switzerland** also uses the OECD guidelines and admits usage of APAs.

National tax authorities are sharpening their approach

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The new UK law will introduce severe penalties on errant firms

Corporate responses indicated that UK firms often face audits in France, and Dutch companies in Germany. Three-quarters of the German firms had undergone audits abroad, averaging three each.

What the UK plans to do

In July last year the UK issued draft provisions for modernising its transfer pricing legislation. Its draft law provides a good indication as to what companies in Europe can expect in future.

The new rules will require taxpayers to apply the arm's length basis for transfer prices in calculating taxable profits in their tax returns. Once corporate tax self-assessment begins (probably in early 1999), companies will have to take the new transfer pricing rules into account.

The draft has a documentation requirement to help companies substantiate transfer pricing practices (see box). The Inland Revenue feels that such documentation is the type companies need for evaluating decisions using "prudent business management principles", and therefore should not impose an undue burden on firms.

There is also a section relating to APAs that could provide a legal framework for such agreements. At present, the Inland Revenue uses the mutual agreement procedure (MAP) of the relevant double taxation agreement through bilateral negotiations with the other tax administration involved. This has worked in the past, but it does result in the APA being geared towards the formal procedures established by the other country's tax system.

Under the self-assessment law, companies will be subject to penalties if they do not take transfer pricing rules into account when making their returns. The maximum penalty would be equal to the amount of the tax lost as a result of negligent or fraudulent conduct—ie, doubling the offending company's bill. (Under present law, negligent taxpayers face only an additional liability to tax if detected, and are not exposed to penalties.) ■

UK documentation rules

The UK proposals for documentation of transfer pricing can help provide guidelines for companies operating in other European countries as well as in the UK. While not as strict as US rules, they are more detailed than the provisions of the OECD guidelines, which most companies and tax experts characterise as not detailed enough.

Under the proposed rules, such documentation should normally include, for each tax period, a record of:

- all relevant transactions and the extent of any other commercial or financial relations with associated companies;
- the nature and the terms of any transaction with associated companies (where the terms of a transaction change during the period, a record of the renegotiation of the terms and the circumstances leading to the change);
- all commercial agreements entered into with associated companies or with independent third parties, including distribution agreements, manufacture or supply agreements, service contracts, agreements relating to R&D, loan or other financial agreements, licence agreements and cost-sharing agreements, as well as any documents relating to their negotiation;
- all investment appraisals for investments in or involving associated companies;
- the information used in evaluating transfer pricing arrangements under the arm's length principle, including the factors taken into account and the decision-making process;
- the transfer pricing method selected, and why it should produce arm's length pricing (where the application of the selected transfer pricing method relies on comparability data such as prices, margins, etc, any such data used should be retained);
- any price negotiations with associated enterprises;
- any offsetting transaction taken into account in determining the pricing for any transactions involving associates;
- the nature, terms and pricing relating to any uncontrolled transaction relevant for determining the arm's length price for any comparable transactions involving the taxpayer and associates;
- any business or management or pricing strategy adopted by the taxpayer and the reasons for adopting that strategy;
- any budgets or forecasts prepared (if these are set up for separate businesses or products, such detailed data should also be retained by the taxpayer); and
- any financial information including profit and loss data (again, figures referring to separate businesses and products should also be retained).

Some companies undertake in-depth analysis in developing and implementing an overall group-wide transfer pricing policy. Such records might include a formal written statement of the firm's transfer pricing policy; a pricing appraisal or other report showing the basis on which transfer prices should be set and the factors taken into account; a comparability analysis referring either to individual transactions or a series of transactions; and a functional analysis. If analysis of this kind is undertaken by companies, any documents that result should be retained by the taxpayer.

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ACQUISITIONS

■ **The Big One.** The marriage of two UK-based multinational drug firms, **Glaxo Wellcome** and **SmithKline Beecham**, will be the largest corporate union in history, giving birth to a colossus with market value of nearly $190bn, second only to US General Electric. With 7.5% of the global drugs market, the new Glaxo SmithKline will also be streets ahead of its nearest rivals, Merck and Novartis, each with around 4.5%.

Stitched together in just ten days of secret negotiations, the match would appear to be made in heaven. Both firms are financially fit and strong in complementary medical fields and research techniques. As with Novartis, which brought together Basel-based Sandoz and Ciba in 1996, they are close neighbours in west London, and should therefore be resistant to the kind of culture clashes that have wracked US-Swedish hybrid Pharmacia & Upjohn or German-US-French Hoechst Marion Roussel. Their bosses are old friends, with recent experience in implementing megamergers. Together they will deploy formidable scientific resources and marketing muscle, with a $3bn R&D budget and a salesforce of 36,000.

And yet, research by A.T. Kearney shows that companies that took part in the last big round of pharmaceuticals mergers have generally performed less well than those that held aloof. However, the markets showed no trace of scepticism; on the day the deal was announced, Glaxo's share price jumped 21% and SmithKline's 11%.

■ **One more time.** Peter Braybeck, the new CEO of Swiss food giant **Nestlé**, told the *Wall Street Journal* just two months ago that "mega acquisitions are basically behind us"; from now on the company would concentrate on internal growth. But he added that Nestlé, a voracious acquirer under his predecessor Helmut Maucher, could still make purchases that assured its position as number one or two in a particular market or segment.

This could explain last week's acquisition of **Spillers Petfoods** from the UK's **Dalgety** for an eyebrow-raising $1.2bn. The move will boost Nestlé's share of the fast-growing European petfood market from 8% to 20%, placing it second behind Mars' 40%. Spillers is strong in the UK and northern Europe, balancing Nestlé's strength in the south. And besides, Nestlé had long coveted the business, having lost out to Dalgety in the auction of Quaker Oats' European petfood division some two years ago.

Dalgety, which a week earlier sold its food-ingredients business to the Irish **Kerry Group** for $560m and an R&D operation to US **DuPont** for $40m, plans to return as much as $1bn in cash to its shareholders. Having failed to make a go of petfoods, and suffered badly from the impact of the 1996 mad-cow crisis, the company has effectively broken itself up.

■ **Triple play.** Another major divestor was the UK's **BOC**, which has jettisoned its ailing healthcare arm, **Ohmeda**, in order to concentrate on its core industrial gases business. Unable to find a single buyer for the whole of Ohmeda, BOC finally parcelled it out among three buyers. **Instrumentarium** of Finland is buying the medical systems division (which makes anaesthetic machinery) for $494m. **Becton Dickinson** of the US is paying $452m for the hospital products division (catheters). And US-based **Baxter International** is taking the pharmaceuticals division (anaesthetic gases) for $104m. BOC plans to use the proceeds to buy back some of its shares.

For Instrumentarium, a listed Finnish medical technology company, this is the biggest crossborder deal in its 25-year history. Ohmeda will now be integrated with the group's Datex-Engstrom subsidiary, a world leader in monitors and computer systems for anaesthesia and intensive healthcare.

■ **The Thyssen/Krupp saga (the end is near).** As expected, Krupp's supervisory board has followed its Thyssen counterpart in approving the merger of the two German industrial giants, and the pair have revealed their major plans for the new entity. In the latest calculation, Thyssen Krupp will have some $40bn in annual sales, soon increasing to $55bn, 186,000 employees (2,000 less than at present) and over 15% return on investment. Still unsettled are the value of each partner and the sensitive co-determination issue.

The already named new board favours the slightly more moderate co-determination law of 1976, but negotiations are still going on with works councils and the IG Metall labour union. Employee representatives on both supervisory boards voted almost unanimously against the merger. These issues, plus EU approval, will have to be settled before the merger is voted on at a special shareholders' meeting expected in the autumn.

There is a risk that shareholders will not accept the co-determination plans. Unlike the current system at Thyssen and Krupp, the 1976 law does not give workers' representatives and unions a veto over the appointment and dismissal of the board member in charge of personnel and welfare issues. A compromise on this law was made for the Krupp-Hoesch merger in 1992.

A strong argument for the merger is the fact that 75% of the combined sales are in six core areas (auto supplies, mechanical engineering, plant construction, lifts, materials trading and steel), in each of which the new firm will rank among the top three worldwide, which is seen as the only guarantee of long-term profits.

ALLIANCES

■ **Siemens and Microsoft get closer.** Germany's leading electronics hardware producer and the US software giant have announced plans to expand their cooperation considerably. In a letter of intent, whose importance was highlighted by the presence in Munich of Microsoft founder Bill Gates, Siemens said it will use the Windows CE and NT systems in its products worldwide, from consumer white goods to sophisticated telecoms and IT gear. Both firms will also cooperate in product development. The agreement is non-exclusive, allowing Microsoft to continue working with other electronics firms. Until now, cooperation with Microsoft has been confined to the German group's Siemens Nixdorf computer systems subsidiary. ■

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Business outlook: Germany

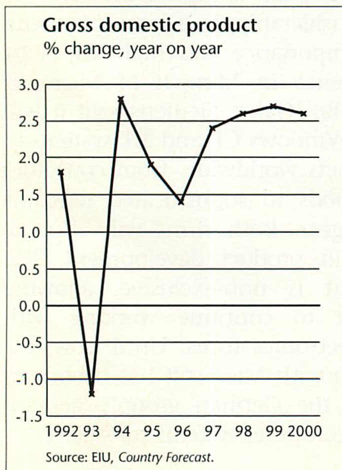
Election watch

Less than eight months ahead of elections on September 27th, opinion polls show the ruling CDU-led coalition trailing well behind the opposition SPD and Greens. With economic recovery failing to make any impact on the high unemployment figures, and the popularity of Helmut Kohl waning, a fifth victory for the long-serving chancellor looks increasingly uncertain.

But it would be premature to write off Mr Kohl's chances of victory. Much will depend on the SPD's choice of a candidate for his job, and on whether the coalition's junior partner, the liberal FDP, will clear the 5% threshold for parliamentary representation.

Although an SPD-Green victory would produce a government that controls both the lower and upper houses, it is difficult to see how such a disparate coalition would manage to agree on coherent reform of taxes, pensions, labour markets and business regulation. A grand coalition between the CDU and SPD cannot be ruled out, but both parties see this as a last resort.

As a result, the paralysis of decision-making that has lately characterised German politics may not be cured by the coming election.



Source: EIU, *Country Forecast*.

Forecasts for Germany, 1997-2000

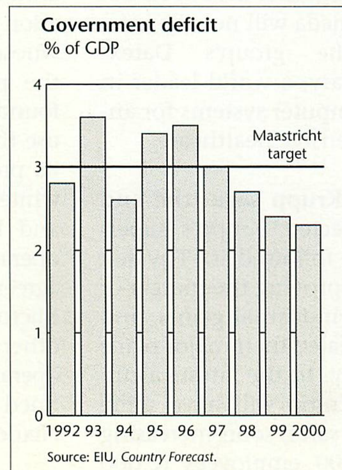
	1997	1998	1999	2000
Real GDP (% change)	2.4	2.6	2.7	2.6
Consumer prices (% change)	1.8	2.3	2.0	2.0
Average wages (% change)	2.2	2.7	2.8	3.0
Unemployment rate (%)	11.5	11.7	11.5	10.4
DM:$	1.74	1.75	1.74	1.71
DM:¥	70	80	78	75
3-month interbank rate (%)	3.3	3.7	4.3	4.6

Source: EIU, *Country Forecast*, 1st quarter 1998.

Economic clouds

Prospects for a further economic acceleration in 1998-99 have been clouded by events in Asia. The strong export-led recovery in 1997 was expected to feed through into investment and private consumption this year. But thus far domestic demand has failed to ignite, so growth remains dependent on the export sector. Rising outlays on machinery and equipment will be offset by further decline in construction activity. And any strengthening of consumer demand will be modest, given the lack of progress in cutting unemployment, limited rises in real wages, and the slow pace of fiscal consolidation (which will make significant cuts in the tax burden difficult to realise).

Slower growth in Asian markets and stiffer competition from Asian exporters in third markets will dampen foreign demand for German goods.



Source: EIU, *Country Forecast*.

But a weaker D-mark, continued wage restraint and impressive gains in productivity will ensure that German exporters maintain their competitive edge.

The good news is on inflation and interest rates. Although inflation will pick up slightly in 1998, this reflects a 1% VAT rise to be implemented on April 1st, rather than a rise in underlying inflationary pressures. And weaker growth and the deflationary impact of the Asian currency crisis will reduce the pressure on the new European Central Bank to establish its anti-inflation credentials by tightening euro monetary policy when EMU starts in 1999.

Business environment

The low level of inward investment is a cause of much concern. The almost hysterical tone of debate over the competitiveness of *Standort Deutschland* (Germany as an industrial location) has damaged the country's image among foreign investors.

Much attention is given to the need to simplify and reduce the tax burden, reduce labour costs and simplify the business environment in order to improve Germany's attractions as an investment location. Tax and regulatory systems will indeed be simplified over the next few years, but the burden of taxes and non-wage labour costs will remain a deterrent.

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