CENTRE FOR EUROPEAN REFORM

How serious is the threat to the single market?

by Simon Tilford, 19 March 2009

There has been a lot of anguished talk about how the EU's single market is under threat. Much of this alarm has focused on government support for struggling car firms and public bail-outs of crisis-ridden banks. An erosion of the EU's competition rules would be every bit as debilitating as the impact of the financial crisis and the resulting recession. But how serious is the risk to the single market?

On the face of it, there is plenty to worry those who see the single market as key to Europe's future prosperity. First, any hope that the impact of the financial crisis on the 'real economy' would be limited has ended. In the face of huge falls in industrial output this year and the prospect of several years of very weak economic growth, many European industrial firms will go bankrupt. Wage subsidies and short-time working, and all the other strategies currently being employed to cope with the collapse of demand, can only be sustained for so long. Many of the firms that go bust will be fundamentally competitive, or at least appear so. EU governments will be under huge pressure to intervene to protect such companies. The way in which they intervene will be crucial. The Commission will have a real fight on its hands to ensure that competition is not distorted. It should be strong enough to enforce the rules. But much will depend on whether member-state governments support the Commission and on who is appointed to be the next EU commissioners for competition and the internal market.

Second, the landscape of European banking has changed fundamentally over the past year and competition policy in this sector has effectively been suspended. A number of the biggest EU banks have been nationalised in all but name and governments have moved to provide public guarantees for bank loans. The shot gun marriage of Britain's Lloyds TSB with another high street British bank, Halifax Bank of Scotland (HBOS), has left the combined group controlling around a third of the entire UK market for consumer banking services. The German, Dutch and Belgian governments have bailed out financial institutions, while governments across the EU have recapitalised banks.

The dramatic increase in government influence over the lending process will need to be reversed if potentially serious distortions are to be avoided. There is a risk that pressure will be put on banks to maintain funding for national champions and to avoid lending to companies based in other EU states. Such politicised lending would undermine the efficient allocation of capital throughout the EU by protecting inefficient companies and reducing available funds for more competitive firms. Once the financial sector has stabilised and normal levels of financial intermediation have been restored, the Commission will have to get serious about ensuring that the EU does not retreat into such 'capital protectionism'.

Third, a further deepening of the single market can be ruled out. Crucially, faster action to liberalise and integrate service sectors across the EU now looks out of the question. It was hard enough to gain consensus in favour of radical moves to dismantle obstacles to the integration of service sectors before the crisis, but it will be impossible in the face of the backlash against liberalisation. This is bad news. Service sectors account for around two-thirds of economic activity across the EU. Service sector productivity has been extremely weak for a number of years now, holding back economic growth. More competition at both national and European level would do much to change this, and boost economic growth.

The lack of service sector integration will be particularly damaging for the eurozone. Countries that decide to forego exchange rate flexibility as a tool of economic adjustment need to ensure that their economies can be flexible in other ways. If countries such as Spain and Italy are to recover their competitiveness within the currency union, they will have to boost their productivity. This, in turn, requires more competition in service industries. The alternative route to greater competitiveness – wage cuts – would condemn their economies to stagnation. And such wage deflation might not be possible in any case, as Germany is heading for deflation. It will be extremely difficult to cut costs relative to Germany, if German costs are falling.

The legal underpinnings of the single market appear robust. But there are real reasons for concern. The steady progress in reducing state-aid has been halted and is likely to be put into reverse. The partial renationalisation of bank lending is inimical to the emergence of a single capital market. And progress towards deepening the single market in services has ground to a halt. All this bodes ill for Europe's growth prospects and the stability of the eurozone. All EU governments profess to be committed to upholding the single market. The next couple of years will determine the strength of that commitment. If member-states do not respect the Commission's right to enforce those rules, the single market could indeed come under threat.

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