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POLICY MEMO

WHY THE EURO CRISIS THREATENS THE EUROPEAN SINGLE MARKET

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SUMMARY

Twenty years after the Single European Act was signed, the European single market is under threat. Even if a break-up of the single currency is averted, the euro crisis has already subtly altered the single market and greatly changed the prospects for its future. In fact, no matter how the euro crisis plays out, the single market will never be the same as it was during the carefree years of the 2000s. Each of the three likely basic scenarios for how the euro crisis might develop would adversely affect the single market to a different extent and in different ways.

A full break-up of the eurozone has the potential to shatter the single market beyond recognition and threaten the Schengen agreement. A muddling-through scenario in which the current crisis is contained within the single currency's existing governance structures and with its existing instruments and only limited changes would reduce the depth of the single market. Even a positive scenario in which the eurozone solves the crisis by taking a great leap forward in terms of economic, fiscal and political integration would likely lead to the withdrawal of some countries such as the UK and thus shrink the single market.

Businesses leaders across Europe are anxiously – and rightly – following news of the euro crisis: a break-up of the single currency would lead to huge macroeconomic disruptions, with a large expected drop in economic activity, a strong increase in unemployment, and potentially widespread bank failures. The shock waves would definitely not remain limited to the European Monetary Union (EMU) itself, but would also spread to the rest of the European Union, to the United States and Canada, and to emerging markets from China to India to Brazil. Countries such as Spain or Italy are simply too big to fail. In fact, a full break-up of the euro might dwarf the failure of Lehman Brothers in 2009.

However, regardless of whether or not such a nightmare scenario becomes a reality, the euro crisis has already subtly altered the European single market and greatly changed the prospects for its future. In fact, no matter how the euro crisis plays out, the single market will never be the same as it was during the carefree years of the 2000s. In any of the plausible outcomes of the euro crisis, the single market will emerge in a different, diminished shape – completely shattered, reduced in depth or reduced in size. While it can be argued that the set-up of the single market in the 2000s and gaps in oversight and regulatory framework helped fuel the economic imbalances that now haunt Europe, it is also clear that the transformation of the single market will entail serious costs.

To understand this proposition, we need to look at the various possible scenarios in more detail. At the moment, there are three likely basic scenarios for how the euro crisis might develop: first, a full break-up of the eurozone; second, a scenario in which the current crisis is contained within the single currency's existing governance structures and with its existing instruments; and third, a scenario in which the eurozone solves the crisis by taking a great leap forward in terms of economic, fiscal and political integration.

We also need to remember that the single market is far more than just the legal provisions framing it. The single market has been shaped just as much by the actions of business leaders across the EU. It is their decisions to engage in cross-border activities, cross-border marketing and cross-border production sharing that have brought the single market to life. In the past two decades, the EU has become a single market not just on paper but also in the daily lives of citizens and managers. The most visible achievement of the single market is the ability to make quick, hassle-free trips for business or pleasure; within the Schengen area there are no longer even passport controls. In fact, however, the less visible cross-border production networks that now span across western and central Europe are much more important. A significant and growing share of trade in most EU member states over the past decade has been made up of trade in parts and components – a sign of growing cross-border production networks. These cross-border networks have been important not only to increase the efficiency and competitiveness of the European manufacturing sector, but also to spread technological progress and hence increase productivity in economies of Europe that are catching up with the most advanced member states.

Euro break-up: a shattered single market

The worst-case scenario, obviously, would be a break-up of the euro. Such a scenario could begin with the withdrawal from the single currency of one or more members. Discussion so far has focused on a possible isolated exit by Greece, but it is far from clear whether an exit by one country can be contained or, on the other hand, whether in the process other countries would also be forced out of the euro. In the course of these events, it is very likely that the eurozone would up either completely fragmented or much reduced in size – that is, without Greece, Italy, Spain, Portugal and Ireland.

In such a scenario, Greece would at some point fail to service its debts – either because it cannot fulfill the conditions of its bailouts and the troika stops loan disbursement, or because new financing needs arise and the troika is unwilling to top up existing credit lines – and would default again. This would cut off Greek banks (which hold a large amount of their assets in Greek government bonds) from refinancing at the European Central Bank (ECB). The Greek government would then be faced with a choice: either reintroduce a national currency and recapitalise its banks through the printing press or accept a complete collapse of its banking system and a much deeper recession than it has so far experienced. The odds are that any sensible government faced with these options would choose to leave the eurozone.

However, since a reintroduction of the drachma would mean a redenomination of deposits in Greek banks into the new currency and thus a significant loss in the value of these deposits, a Greek euro exit could send shock waves through the eurozone. As soon as Italian or Spanish households learn that a euro in the bank can be quickly retransformed into a devalued national currency, a large capital flight towards Germany can be expected to set in. This would further increase liquidity pressure on banks in Spain and Italy. If the ECB is not willing to accept liquidity support of several trillion euros (or if the Bundesbank is not willing to accept a further increase in the TARGET2 balances of this magnitude), other governments might be faced with a similar choice as the Greek government and might ultimately decide to leave the euro as well.

The disintegration in the monetary arena would quickly lead to disintegration in other areas: the first obvious result of a break-up would be the reemergence of strong exchange rate fluctuations. As one of the reasons for introducing a new currency would be to be able to gain competitiveness by devaluation and the countries leaving the eurozone would almost certainly use their regained national power over their own central bank to stabilise their banking sectors and finance their budget deficits with the printing press, there could be initial devaluations of up to 50 percent or even more. Thus, such a development would thrust Europe back in time to the period of violent monetary and exchange rate instability of the 1970s – that is, before any of the arrangements that created at least partial exchange rate stability, such as the European Exchange Rate mechanism, in the 1980s and early 1990s. Moreover, cross-border finance would likely come to an almost complete standstill and costs for insuring against exchange rate risks would surge. Add to this the expected wave of bank failures and one would have to predict a sharp drop in private investment.

Such a development would disrupt the single market on two levels: the business level and the policy level. At the business level, the increased risks and costs of cross-border trade would lead to a reorientation in both production and sales activities towards domestic markets. Exchange rate stability is crucial, especially for cross-border investment and cross-border production networks, as hedging through financial markets usually is not feasible beyond a horizon of two years or so. Such a renationalisation of business activities would lead to less competitive pressure in all countries and in a number of markets for different goods and services with negative effects for innovation and productivity.

At the policy level, a sudden burst of competitiveness in countries that devalued their currencies and an increase of unemployment in the other countries would quickly cause accusations of unfair competition along the lines of the claims made by the US against China when it had fixed its exchange rate at a low value in the late 2000s. Calls for new non-tariffbarriers for trade, capital controls or new subsidies for ailing industries could be expected to follow soon. As the break-up of the eurozone would almost certainly entail balance-of-payments difficulties for at least some member states, a least some of these actions would even be legal under Article 144 of the Treaty on the Functioning of the European Union, which stipulates that EU member states may take unilateral action to protect their balance of payments even if these restrictions damage the single market.

Normally, one might hope that, together with the European Court of Justice (ECJ), the European Commission could protect the single market against these threats. However, in the break-up scenario, this hope will most likely be in vain. Under current EU law, it is not possible to leave the euro. Thus in order to leave, a country would have to either leave the EU altogether, violate EU law and hope that no one will take action, or seek a change to the European Treaties to accommodate economic realities. But each of these options would diminish the power of the Commission and the ECJ: the EU would no longer have jurisdiction over a country that left the EU altogether; an open and tolerated violation of EU law would undermine the legitimacy of the EU institutions; and a treaty change would create the impression that EU rules were open to alteration whenever opportune.

Moreover, the legitimacy and power of the European Commission stems to a large extent from the acceptance of its rulings at the national level. If, in a situation of large-scale exchange rate fluctuations, deep recessions, record unemployment and a general feeling that member states were unfairly taking advantage of each other, national governments might be inclined to openly revolt against European Commission proposals and regulations and ECJ rulings. This would not only tie up resources that could otherwise have been used to push forward the single market, but might in the end also force the EU institutions to take a more cautious approach in enforcing the single market.

The Schengen agreement could also quickly come under pressure if the euro disintegrates. The deep recession following the disintegration of EMU would cause new flows of migrants from crisis countries to the rest of the EU. As unemployment would rise all over Europe, these migrants would not always be welcome in the countries to which they moved and might trigger a new wave of xenophobia. As we have seen in the past, this might be used by nationalist forces as an occasion to reinterpret, counteract or even pull out of the Schengen agreement and erect new barriers to the free movement of labour within the EU.

In short, a full-blown break-up of the euro has the potential to shatter the single market beyond recognition. Fortunately, such a full-blown break-up is not yet the most likely scenario – even though one should now attribute a non-trivial probability to such a catastrophic chain of events.

Muddling through: a shallower single market

The second-worst outcome of the euro crisis from the perspective of the future of the single market is a muddling-through scenario. In this scenario, there would be no strong move towards a fiscal union, but rather only partial fixes. Incremental steps towards greater integration and the existing rescue mechanisms would be able to stabilise interest rates on government bonds in the crisis countries at an elevated but not excessively high level. In such a scenario, economic growth would remain subdued in the eurozone over years and the euro periphery would experience only a very slow and sluggish recovery from its recession. This scenario could also include a sub-scenario in which a small country such as Greece leaves the euro but the fallout is contained and the other euro members remain in the monetary union.

In such a scenario, brutal exchange rate movements and outright attempts at beggar-thy-neighbour policies through nominal devaluations would be prevented. But there would still be dangers for the single market. In particular, the de facto disintegration in the markets for banking and other financial services that we have seen in recent months could be expected to continue. Already, banks across the eurozone have renationalised their business and cut back cross-border lending significantly. Over the medium term, this development will lead to a new fragmentation of financing conditions and financing costs along national borders.

This would have two effects. First, diminished competitive pressure would lead to less innovation in the quality and price of financial and payment services for companies and EU citizens. Second, it would drive a permanent wedge between financing costs in Germany, the Netherlands and Finland on the one hand and Spain, Italy and Greece on the other. As the journalist Paul Taylor puts it, "the best-managed Spanish or Italian banks or companies have to pay far more for loans, if they can get them, than their worst-managed German or Dutch peers."[1] For example, Spanish global firms like Santander whose operations are largely conducted outside Spain (only 13 percent of Santander's profits are earned in Spain) have to face higher borrowing costs than their European counterparts, thus negatively affecting their market position. Such a fragmentation of markets for banking services is not fair because it punishes companies for their location and not efficient because it cancels the benefits of free markets, which are supposed to reward the best companies and punish poorly managed ones. In addition, such a situation could lead to calls for government subsidies in countries with high financing costs to prevent de-industrialisation and potentially also

1 Paul Taylor, "Signs are growing that Europe's economic and monetary union may be fragmenting faster than policymakers can repair it", Reuters, 9 July 2012, available at http://www.reuters.com/article/2012/07/09/us-eurozone-banking-policy-idUSBRE86805N20120709

for protectionist measures by their peers in the north as all member states compete for market shares in a stagnating or even shrinking market.

Again, the European Commission and the ECJ are usually supposed to prevent such policies by member states, but they would face a number of dilemmas in this scenario. Prohibiting subsidies that clearly distort the single market is one thing, but prohibiting subsidies that are introduced to correct a market failure in other markets (in this case the market for banking and financing services) is another issue and would cause conflicts with member states governments.

The renationalisation of banking would also have another, more subtle consequence: as financing would become scarcer and more expensive in some countries, cross-border production sharing or outsourcing might become riskier and more expensive. Again, business could to a certain extent be expected to focus more on production in their home markets. As in the break-up scenario, though to a lesser extent, this would lower competitive pressure and reduce innovation in the single market.

The muddling-through scenario also poses threats to the Schengen agreement, albeit not as acute as the euro break-up scenario. Weak economic growth in Europe would mean an increase in unemployment and the long recession in the south would create new flows of migrants to the northern countries. Again, the danger is that this will be exploited by nationalist politicians to push for a rollback of the free movement of people within the EU.

Thus while the muddling-through scenario looks better than the full-blown break-up, it still entails significant damage to the single market. While the single market might (almost) retain its size and geographical coverage, it would be significantly shallower. This is especially tragic because, with politicians unwilling or unable to push strongly for a great leap forward in integration, this muddling-through scenario has long looked to be the most likely one.

Fiscal union: a smaller single market

The third scenario is economically the most promising for Europe. In this scenario, the leaders of the euro area actually take a great leap forward in terms of fiscal and economic policy integration. This would entail a full-fledged banking union with a restructuring/recapitalisation mechanism at the European level, centralised banking and financial supervision and oversight, at least some partial mutualisation of debt, a significant increase in the rescue capacities, for example by the ECB stepping up to its promises to intervene on a large scale in secondary bonds markets or granting a banking licence to the ESM, some transfer of revenue sources to the European level and the introduction of some inter-regional transfers to the European level to counter macroeconomic imbalances. To fulfill demands of the German constitution and the German constitutional court, such a leap of integration would have to come with stronger democratic legitimisation at the European level, either through a strengthened European Parliament or through the introduction of a new chamber made up from deputies from the national parliaments of eurozone countries.

In economic terms, such a move towards true federalism has the potential to end the euro crisis. Financing costs among countries would converge again once the risk of spillover from national banking crises to national budgets has been mitigated. Once it is clear that market sentiment alone cannot push interest rates to unsustainable levels and hence cannot lead to self-fulfilling speculation on a country's default any more, risk premiums on government bonds would fall. Lower interest rate payments would allow for a slower fiscal adjustment path and hence a quicker recovery from the current recession in the periphery. Returning business confidence would add to this trend. With the risk of a euro break-up off the table, cross-border financial flows would grow again. Overall, economic growth in the eurozone would be much stronger in the coming years, improving debt sustainability across Europe.

However, even this positive scenario entails risks for the single market and European integration. In principle, one could imagine taking many of the integration steps described above through enhanced cooperation among the eurozone countries – and therefore within the framework of a two-speed Europe. In practice, however, it is unlikely that such a two-speed Europe with a stronger integration of the banking and financial sector in the core will be viable without at least some of the other member states leaving the EU altogether.

The drive towards more coherent financial sector supervision in Europe after the fallout of the US sub-prime crisis 2008/9 has already created conflicts between a number of continental European governments and the British government, which has traditionally had a strong national interest in protecting its financial industry. The compromises made in the legislative process up to the end of 2011 meant that national supervisory authorities kept significant discretion in the regulation and oversight of their national financial institutions and the European authorities had limited power when it came to ordering national supervisors what to do.

The real banking union that eurozone leaders are now discussing would mean a much stronger centralisation of oversight – at least within the eurozone itself. However, a bank's risk can only be fully controlled if either of the counterparties' risk is also controlled or if exposure to a counterparty is limited. Thus, over time, there would be pressure by eurozone authorities to impose similar standards for non-euro EU banks as they do for eurozone banks. In fact, the recent proposals by the European Commission on the single supervisory mechanism (SSM) for financial institutions implicitly assume that EU member states outside the eurozone will follow the rules set by the ECB. If member states such as the UK do not accept this, eurozone legislators might try to limit business with counterparties outside the eurozone. Unless the UK accepts the eurozone regulator's decisions, the markets for financial services would break up along currency lines. Both options would seriously alter the British cost-benefit calculation of its EU membership: accepting eurozone regulators' rulings would mean a loss of sovereignty in an important policy area; a fragmentation of the financial market at the eurozone's border would be against the British financial sector's business interests and make EU membership less attractive.

Another possible point of conflict is the plan by continental Europe to impose a financial transaction tax (FTT) and other bank levies to pay for the bank rescues now underway in the eurozone. If countries such as the UK did not participate, it would lead to losses in revenue, which could create political pressure for either compensatory payments or capital controls to prevent tax evasion. All this has the potential to turn public opinion in some non-euro countries even further against the EU and increase the risk of an exit from the EU. But even if such Euroscepticism can be contained, measures by eurozone countries would lead to a further fragmentation of financial markets between euro-ins and euro-outs.

Thus even in the best-case scenario the single market would suffer. Although it would not be shattered or become shallower, the likelihood of a withdrawal of one or several countries from the EU would increase and there will almost certainly a certain degree of disintegration in the financial and banking market along currency lines. In other words, deeper integration in the core would come with disintegration in the EU's periphery and shrink the single market. In other words, it might be the least bad – rather than best – scenario. The UK might try to negotiate a relationship to the EU similar to that of Norway or Switzerland in order to remain part of the single market for goods. Moreover, one might even argue that the benefits of a more deeply integrated core single market compensate to a large degree for the costs of a geographically downsized single market. But this least bad scenario is not the most probable of the three.

The impact on the EU's standing in the world

Thus, 20 years after its inception, the outlook for the single market is not bright. This may have consequences for Europe's standing in the world. For years, people all around the world have admired the peaceful integration of Europe. In fact, a host of regional groups of countries from Asia over Africa to South America have actually tried to copy European integration when drawing up their own regional institutions and rules. Even if the latest step in European integration, the single currency, is now viewed with more scepticism around the world than it was before the crisis began, the single market is still envied. But with cracks in the single market appearing, it too could lose some of its shine.

This will have important consequences for the EU's influence in global trade negotiations and international economic policy coordination. First, emerging markets will be less willing to accept advice from Europe if the general perception is that the old continent is unable to solve its own economic problems sufficiently. This will make it harder for Europe to pursue its interests in international institutions like the G20 or the International Monetary Fund (IMF). Second, it will be harder for the EU to negotiate preferential trade agreements and free trade agreements. If the single market is diminished in any of the three ways described above, getting access to it will become less attractive. Other countries around the world could therefore be less willing to make concessions in return for a trade agreement with the EU.

It is above all policymakers who can limit this fallout. A leap towards more integration at the core seems to be the least bad option for the single market, even if it risks being reduced in size and there is some disintegration at the fringe. Of course, safeguarding the single market is not the only objective for policymakers. They have to weigh the cost and benefits of different policy paths. But it is important that they do not deceive themselves and believe that the single market can be separated from the current euro issues. The euro has been a catalyst for many elements of the deep de facto economic integration of Europe that now exists. But conversely, the euro crisis has also hit the single market.

The potential cost of a shattered single market needs to be taken into account when deciding what to give up to save the euro – not only in terms of monetary costs but also in terms of national sovereignty. But this lesson is also important for the non-euro EU member states such as the UK: beyond the adverse short-term impact of the recession in the eurozone on the rest of the EU, there are potential long term costs of the current euro crisis for them. When deciding whether and how much they will contribute to eurozone bailouts, and how much of a two-speed Europe they are prepared to accept, they should take these costs into account.

Business leaders also have a role to play. They need to become more aware of the benefits the single market has brought them and of the risk the euro crisis entails for them. They need to clearly define their interests and then lobby vigorously for a solution to the crisis that will be conducive for their business activities. At times, they will need to step up and publicly support potentially unpopular steps towards closer integration. The single market has been a great project that has brought a large number of benefits to Europe, from better consumer choices to easier production sharing to a vast market for European firms to develop and test their products. Twenty years after the Single European Act that established this single market was signed, it now needs all the support Europe can collectively muster.

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