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GROWTH AND EURO AREA STABILITY: THE DOUBLE DIVIDEND OF A DEEPENED EUROPEAN SINGLE MARKET FOR SERVICES

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The European Commission's recent single market initiatives have a second important benefit beyond growth that is often overlooked: Deepening the Single Market for goods and services can also reduce imbalances in the euro area and limit its vulnerability to crises. A further integration of the Single Market thus provides a double dividend of growth and stability. This is the main issue addressed in this background note.

Many consider the creation of the Single Market the greatest success of the European project. It is based on the idea that the free movement of goods, services, capital, and labour across European internal boarders creates growth and prosperity for all. The Single Market is popular with most EU member states. Even the British, who will soon hold a referendum on remaining in the European Union, have generally been fond of it.

Yet the popularity of the Single Market and the freedom of movement suffered in the wake of the financial crisis.[1] Governments called for more discretion to shelter their markets and workers from the economic downturn. National subsidies, capital controls, and other protectionist measures were back on the political agenda of many member states. Euro area countries came under additional pressure, having to handle a deep recession and spiralling unemployment without the tool of individual monetary policy to facilitate short-term adjustment. Moreover, financial integration in the euro area – particularly in the interbank and bond markets – decreased considerably in the wake of the crisis. Capital flows retracted behind national borders. The financial fragmentation threatened the efficiency of monetary policy, forcing the European Central Bank to adopt unconventional measures.[2] The common currency, it seemed, was about to seriously hurt the single market rather than foster integration.

Moving out of the crisis, a further deepening of the European Single Market can have a substantial effect on European growth rates. The new European Commission of Jean-Claude Juncker is well aware of this untapped growth potential and actively promotes the benefits of a deepened Single Market for goods and services. To that effect, it will present a new set of legislative proposals later in the year. The digital market was identified as a discrete aspect of the Single Market and was presented in a separate digital policy initiative in early May 2015.[3]

Beyond their much-discussed growth potential, the Commission's initiatives have a second important benefit that is often overlooked: Deepening the Single European Market for goods and services is also one tool to reduce imbalances in the euro area and limit the currency union's vulnerability to crises. A further integration of the Single Market thus provides a double dividend of growth and stability.

This background note makes the case for investigating the stabilizing effects of further market integration more closely and links the recent Single Market initiatives to two important policy debates that are likely to shape European politics over the coming months. The general elections in the United Kingdom in early May 2015 paved the way for a referendum on British EU membership until the end of 2017. Prime Minister David Cameron seeks to renegotiate the British status and some principles of the EU before putting the

question on whether or not to remain in the EU in front of the British electorate. One of the main issues in the run-up to the referendum will be the Single Market. Despite early attempts of the British government at restricting the free movement of workers into the United Kingdom, Juncker's Single Market initiatives overlap with some of Cameron's most prominent reform demands: to cut red tape, to open the EU to more competition, and to pursue further economic integration in the Single Market.

Moreover, completing the Single Market is an integral part of Europe's efforts to strengthen the Economic and Monetary Union (EMU). The importance of a strong Single Market for the common currency is stressed by a recent Franco-German position paper as well as by the "Five Presidents Report" that was published on 22 June 2015.[4] On a substantive level, the Single Market is one of the main tools to ensure sustained convergence for members sharing the common currency and the European Union as a whole. What is more, the Single Market is one of the very few areas where euro area member states and the European Commission are in broad agreement, making it also a politically important area to drive forward further reforms.

1. How does a deepened Single Market stabilize the euro area?

In a smoothly functioning currency union that fulfils the so-called OCA-criteria (OCA stands for "optimal currency area"), a strong "real exchange rate effect" acts as an important stabilizer and counterweight to internal imbalances.[5] Put simply: When inflation remains persistently above average in one member state of the currency union, that country's products become relatively more expensive – in other words, its real exchange rate deteriorates. As a result, its economy becomes less competitive vis-à-vis low-inflation countries. As domestic firms find it harder to sell their products at home and abroad, economic activity and inflation slow down. After a while, it arrives at an equilibrium. The opposite effect applies to countries experiencing below-average inflation. Their real exchange rate appreciates, and goods and services become relatively cheaper. This in turn raises price competitiveness, which boosts economic activity and inflation. If such effects are at work in all member states of the currency union, they synchronise their business cycles and prevent imbalances from building up.

However, EMU in its current form is incomplete. The real exchange rate channel in the euro area has so far been weak, which means that countries' relatively high (low) inflation rates are not immediately reflected in lower (higher) demand.[6] In the absence of an alternative stabilising force, such as a fiscal balancing mechanism at the European level, a shock-absorption capacity, or high labour mobility, EMU is thus prone to internal economic imbalances.[7] This became apparent in the run-up to the euro crisis. Differences in inflation between euro countries remained very persistent over time.[8] As a result, levels of competitiveness diverged widely at the eve of the crisis. Over the years, the countries today known as "deficit economies" such as Greece, Spain, and Portugal piled up an unsustainable amount of foreign liabilities (mainly in the private sector), while other euro area member states persistently ran large current account surpluses. Germany is the prime example, but other countries like the Netherlands showed a similar trend.[9] Following the financial crisis of 2007/8, the accumulated imbalances led to a sudden stop in private financing in some countries, leading to the severe recession that Europe is still struggling to escape today.[10]

The underlying dynamics persist and pose a constant threat to EMU's medium-term stability. The Macroeconomic Imbalance Procedure (MIP) that the euro area has introduced seems to be better at detecting than at reducing divergence. Ultimately, the most effective way to limit the size of new imbalances is to expose larger parts of the economies to competition, thus allowing the real exchange rate mechanism to work fully. The architects of the euro expected the Single Market in goods and services to do precisely that. But while the goods market is largely complete on paper, many products are in fact not tradable, and services are poorly integrated. In consequence, Europe's economies still have large sheltered sectors where wages and prices can still be persistently at odds with levels of productivity and can deviate significantly from the EMU average. For example, in many "crisis countries", exports suffered in the run-up to the crash, but the domestically-oriented part of the economy continued to grow, financed by capital imports.

In sum, a well-functioning Single Market provides an automatic corrective to divergent cost competitiveness and inflation rates in member states. It promotes gradual adjustment between euro countries as opposed to the sudden, costly and painful adjustment experienced in the course of the crisis after 2008. Deepening the

Single Market thus has a double dividend: In addition to fostering growth in Europe, it mitigates the build-up of large imbalances and thus helps stabilizing the euro area.

2. Why services? Why now?

On which area should efforts to deepen economic integration focus? In 2010, the "Monti Report" for the European Commission already delivered a detailed analysis of the obstacles to complete the Single Market, and set out a strategy to overcome them.[11] Little political action has followed since then. Services are rightly placed at the heart of the new Commission's upcoming Single Market strategy. From an economic point of view, the sector is a good candidate for three main reasons.

First, services are less well integrated than goods. The European Commission estimates that trade integration – measured by the average of imports and exports divided by GDP – in the Single Market for goods stands at approximately 22%, with that for services at around 5%.[12] This lack of integration is also reflected in member states' price levels. Prices for services vary much more than those for goods across the euro area. Instead of narrowing, the gap is widening. A successful Single Market in services should lead to a gradual convergence of prices across the European Union, and even more so among the countries sharing a currency ("law of one price").

Second, the service sector makes the largest contribution to economic output in the European Union. In 2014, this came to a total of 75% of GDP. The services sector also accounts for 70% of employment in the European Union. According to the European Commission, 9 out of every 10 new jobs created in Europe is in the services sector, making it the key sector for job creation and economic growth.[13]

Third, consider the alternatives: Bluntly speaking, integrating the European market for services is definitely a bigger fish to fry than further deepening of the goods markets. The heavy political contestation and long implementation phases of the 2006 Services Directive are a good example. Yet when it comes to avoiding internal imbalances, deepening the Single Market for services might be more feasible the short run than achieving large increases in labour mobility or setting up transfer payments between euro area countries. This is not to say that the other options should be discarded. On the contrary, they may well be needed in addition. However, from a pragmatic perspective, integrating services might be the best first step for now.

3. What next?

There are three main avenues that are currently pursued to integrate services further: First, the European Commission wants to ensure full implementation and enforcement of existing services provisions. This concerns closing the still-existing implementation gaps of the Services Directive, the far-reaching legislation package that was adopted in 2006 after heavy political contestation.[14] Here the Commission wants to focus on those sectors with the largest economic potential, particularly business services, retail, construction, and tourism.

Second, and in addition to clamping down on member states that have not fully transposed and implemented the already-agreed rules, the Commission also plans to make new proposals to remove further barriers to cross-country exchange. This relates to sectors that have remained outside the scope of the Services Directive, such as transport, utility and network industries, public procurement, or professional services.[15] Another means to enlarge the scope of the Single Market is to integrate services along the entire value chain, including marketing, maintenance and after-sales services.[16]

Entry barriers to foreign markets often take the form of domestic regulation. Many service providers with the intention to access or establish themselves in another member state face lengthy authorisation procedures even if they already obtained similar licences or permits in their home country. For instance, professional qualifications are not recognized or service providers are obliged to have a certain legal form or capital requirements when trading across borders. National rules relating to labour, taxation, health and safety, consumer protection, and company insurance also contribute to a fragmentation of the single market. These administrative and regulatory barriers "behind the border" are a third area where the Commission intends to make proposals.

Removing barriers to intra-EU services exchange goes hand in hand with a change in the domestic regulatory environment, including (foreign) market access and the right of establishment.[17] This can unlock sectors

currently sheltered from competition that impede real adjustment in an incomplete monetary union, making the euro area more stable in the long run.

To conclude: Growth and euro area stability are two good reasons to bring the Single Market integration back on the political agenda. A joint effort to complete the Single Market for Services offers the chance to make EMU more resilient in a way that is acceptable to all its members. Euro area members should take a double interest in seeing this initiative through. Expanding the Single Market to additional areas such as capital markets[18] is likely to further enhance euro area stability through better private risk-sharing across the European Union, an aspect that has been explored in detail elsewhere.

1. European Commission, Internal Market: Awareness, Perceptions and Impacts, Special Eurobarometer No. 363, Brussels, September 2011.
2. See e.g., European Central Bank, Financial Integration in Europe, Report, Frankfurt, April 2015.
3. European Commission, A Digital Single Market Strategy for Europe, COM (2015) 192 final, Brussels, 6 May 2015.
4. Deutsch-französischer Beitrag zur Wirtschafts- und Währungsunion, June 2015; Jean-Claude Juncker et al., Completing Europe's Economic and Monetary Union, Brussels, June 2015.
5. For a detailed description of the real exchange rate effect in the context of EMU see Enderlein et al., Completing the Euro: A road map towards fiscal union in Europe (Report of the "Tommaso Padoa-Schioppa Group"), Paris, June 2012.
6. E.g., Sebastian Dullien et al., Adjustment in EMU: Is Convergence Assured? DEP Discussion Papers, Macroeconomics and Finance Series 7/2009, University of Hamburg.
7. See Henrik Enderlein et al., Blueprint for a Cyclical Shock Insurance in the Euro Area, Studies & Reports No. 100, Notre Europe – Jacques Delors Institute, Paris, September 2013.
8. E.g., Philip R. Lane, The Real Effects of European Monetary Union, The Journal of Economic Perspectives 20 (4), 47–66, 2006; Juan I. Aldaroso and Vaclav Zdarek, Inflation Differentials in the Euro Area and Their Determinants – an Empirical View, William Davison Institute Working Paper No. 958, 2009; Malin Andersson et al., Determinants of Inflation and Price Level Differentials across the Euro Area, ECB Working Paper Series No. 1129, Frankfurt, 2009.
9. E.g., Alan Ahearne and Jean Pisani-Ferry, The Euro: Only for the Agile, Bruegel Policy Brief 2006/1, Brussels; Olivier Blanchard, Adjustment within the Euro. The Difficult Case of Portugal, Portuguese Economic Journal 6 (1): 1–21, 2007; Céline Allard et al., Toward a Fiscal Union for the Euro Area, IMF Staff Discussion Note, SDN/13/09, Washington, DC, September 2013.
10. E.g., Jay C. Shambaugh, The Euro's Three Crises, Brookings Papers on Economic Activity, Spring 2012.
11. Mario Monti, A New Strategy for the Single Market, Report to the President of the European Commission, Milan, May 2010.
12. European Commission, A Single Market for Growth and Jobs: An Analysis of Progress Made and Remaining Obstacles in the Member States - Contribution to the Annual Growth Survey 2014, COM (2013) 785 final, Brussels, November 2013.
13. European Commission, Buy and sell services in Europe, Brussels, March 2015.
14. The Service Directive of 2006 that was transposed by all EU member states in 2009 has been in force since 2011 and covers sectors that account for around 46% of EU GDP. EU countries have had to modify national laws that restricted the freedom of establishment, or the freedom to provide cross-border services.
15. The current Services Directive does not apply to the following sectors: Financial services, electronic communications services, transport services, healthcare services, temporary work agencies' services, private security services, audio-visual services, gambling, certain social services, and services provided by notaries and bailiffs.
16. European Council of Ministers, Preparation for the Council meeting "Competitiveness" on 2 and 3 March 2015, 6117/1/15 REV 1, Brussels, February 2015.
17. The link between EU-services exchange and domestic regulation "beyond the border" is also made in Federica Mustilli and Jacques Pelkmans, Access Barriers to Services Markets: Mapping, tracing, understanding and measuring, Special Report No.77, Centre for European Policy Studies, Brussels, June 2013.
18. See European Commission, Building a Capital Markets Union, Green Paper, Brussels, February 2015.

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