

## The decline of the single market?

*"Europe is dead and we should now act accordingly".*

*- Italian Labour Minister Roberto Maroni, 28 February 2006*

### Are the EU's 'four freedoms' really under threat? Is Europe drifting towards protectionism?

After the French and Dutch overwhelmingly voted down the EU Constitution last year politicians in Paris and Brussels decided to interpret the votes not as a vote against further EU integration - but as a vote against enlargement or 'ultra-liberalism', or the perceived threats of globalisation. The French government has responded with a series of measures intended to counter perceived threats from the outside world: calling for Turkey to be barred from joining the EU and blocking any EU attempts to make cuts to the CAP to allow progress in world trade talks.

When stock-market rumours suggested last year that Pepsi might make a bid for the French 'national champion' Danone, Nicolas Sarkozy (often touted as an economic liberal) called on the authorities to "do everything" to "block this offensive".<sup>1</sup>

City traders joked that France now appeared to be pursuing not just a strategic industrial policy but a strategic yogurt policy. But the French government was serious: Prime Minister Dominique de Villepin subsequently drew up a list of 'strategic sectors' which his government would ring-fence off from foreign ownership. It was the beginning of a new wave of protectionist sentiment.

The embrace of anti-globalisation positions by some EU leaders has also led to a rash of attempts to protect national champions from competition not just from Asia or America, but also within Europe. A round of infighting between European governments has broken out over cross-border energy mergers, a development which, as a leader in the *Wall Street Journal* said, "calls into question the raison d'être behind the European Union far more than the constitutional crisis of last year did."<sup>2</sup>

### "Economic patriotism" versus the single market

The first row centred on a bid for Spain's largest energy company, Endesa, by the German utility E.ON. Jose Zapatero's government, following the French example, argued that the bid was unwelcome as it wanted to create a national energy champion

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<sup>1</sup> Le Monde, 22 June 2005

<sup>2</sup> 28 February 2006

of its own by getting Endesa to merge with another Spanish company, Gas Natural. It responded by pushing through a law which could allow the Spanish regulator to block the bid - a move the EU Commission suggested may be "illegal".<sup>3</sup>

But the real fireworks were reserved for a bust up between the French and Italian governments over the interests of their national energy champions. When the Italian company Enel declared an interest in the French utility Suez it triggered fear in Paris, which quickly dropped its long-term opposition to the merger of Suez with Gaz de France. The merger was announced by French ministers, alongside the chairmen of the two companies, ostensibly with the aim of creating a 'national champion' in utilities. French Prime Minister Dominique de Villepin defended the controversial move as an act of "economic patriotism".<sup>4</sup>

Silvio Berlusconi stated that "if they're going to protect their strategic sectors like that, we should do the same back to them". Italy hit back by threatening to create an even bigger Italian "national champion" in the sector, by merging the Italian companies Eni and Enel. The Labour Minister Roberto Maroni called for retaliatory action, declaring that "Europe is dead and we should now act accordingly". The Italian government even threatened to cut off energy supplies to the French island of Corsica.<sup>5</sup>

Elsewhere other European governments are taking a similar approach. Luxembourg is introducing new legislation to prevent the takeover of the Arcelor steel company by the global Mittal group. Poland is trying to block the takeover of the BPH bank by the Italian UniCredit, and the Commission has again threatened to take legal action.

Italian Finance Minister Giulio Tremonti compared the situation created by the French choice to that in autumn 1914: "At that time, no-one wanted the war, but the war happened. Today, no-one wants blockage in the European market, but, from ultimatum to ultimatum, we are risking a cascade effect."<sup>6</sup>

### **National champions, European champions - Where did it all go wrong?**

The French government defends its decision by arguing that the European economy as a whole will benefit from the emergence of strong national champions. In a statement reminiscent of Milo Minderbinder in *Catch-22*, the French Foreign Ministry argued that, "everything which strengthens French industry strengthens the whole of Europe".<sup>7</sup>

The European Commission's efforts to overcome this mindset are not helped by the Commission's use of the same kind of arguments on an EU wide basis: Neelie Kroes, the EU Commissioner for Competition, declared that the idea of national champions is outdated, but then immediately went on to argue that it is now "all about European champions."<sup>8</sup>

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<sup>3</sup> AFP, 24 February 2006

<sup>4</sup> Interview in Ouest France, 28 February 2006

<sup>5</sup> EU Observer, 28 February 2006

<sup>6</sup> Le Monde, 28 February 2006

<sup>7</sup> Statement, 28 February 2006

<sup>8</sup> Le Monde, 7 March 2006

Resistance in Europe to global trade is not new; indeed when the single market was first being created there were many in the Commission who saw it as a way to build up "Fortress Europe": a single internal market with relatively high barriers to external trade. The then Trade Commissioner, Willy de Clerq, was particularly in favour of this approach. He argued: "We are not building a single market in order to turn it over to hungry foreigners."<sup>9</sup> Jacques Delors' thinking ran along similar lines.

One of the main reasons why governments are still able to block mergers is the half-baked compromise over the European takeover directive which was passed in 2004 in a very watered down form. The law requires ratification by individual nations, allows governments to opt out of key clauses if they wish. The most important of these provisions, (centring on the obligation to seek shareholder approval in order to adopt a 'poison pill' defence and concerning voting rights in companies subject to hostile bids) are being shelved by the majority of member states, including France and Germany.

### Four freedoms - or not

What about the rest of the EU's so-called four freedoms? As well as a single market in goods the EU was supposed to allow free movement of capital, services and people.

While formal capital controls are a thing of the past in the developed world, anti-takeover measures are a clear restriction on the free movement of capital, and destroy what economists call the "market for corporate control" - arguably one of the most important sources of competition and productivity improvement.

On services things look fairly dire too. The services directive passed by the European Parliament last month was not only watered down to the point of uselessness, but now also includes provisions to allow the Commission to start passing regulatory harmonisation measures in five years' time ([see separate report](#)). Instead of reducing red tape (by getting member states to recognise each others' standards), this harmonisation process will almost inevitably lead to an increase in regulation, making the directive worse than useless.

In financial services the outlook is no better. The EU's Financial Services Action Plan, currently entering into force, has done little to accelerate market integration, and has come at the price of a hugely costly new tier of regulation. For example just one of the 42 directives in the Plan (known as MiFID) will cost up to £6 billion to implement.<sup>10</sup> According to the Financial Services Authority some of the legislation will have costs but no benefits - like the replacement of the UK's existing anti-market abuse legislation with the EU Market Abuse Directive, at a cost of £50 million.<sup>11</sup>

The related issue of free movement of labour is also still extremely contentious. Since the accession of the 10 new EU members, 12 of the 15 original states have taken advantage of legislation allowing them to block entry to eastern European migrant workers for a 7 year interim period. Only Sweden, Britain and Ireland have opened their doors fully to these workers and while economic studies show the effects have

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<sup>9</sup> What Happened to Fortress Europe? External Trade Policy Liberalization in the European Union Brian T. Hanson (1998)

<sup>10</sup> Euromoney, 28 December 2005

<sup>11</sup> Sunday Telegraph, 2 May 2005

been benign, opposition is growing. Sweden has been rocked by the Vaxholm case, a lawsuit brought by the Swedish Builders Union against a Latvian company for refusing to pay its Latvian workers according to Swedish collective bargaining rules. The case created great opposition in Sweden to the free movement of workers and services and is likely to colour the debate there for years to come.

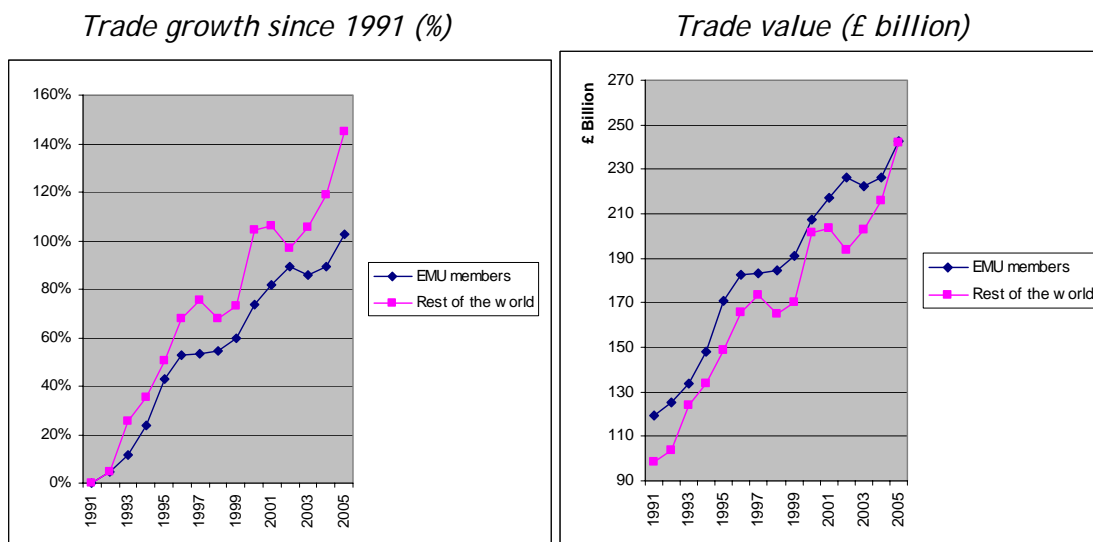
Meanwhile a January poll in the Irish Times suggested that 78% of Irish voters now favour the reintroduction of a permit system for workers from the accession states. The move is led by trade unions who argue that the influx of workers is depressing wages and depriving Irish citizens of jobs. For this reason Britain may end up being the only member state which allows free movement of workers from Romania and Bulgaria after they accede in 2007/8.

### Stalling or falling?

Some have argued that the current atmosphere of protectionism is just a blip in a longer term shift towards greater openness. But in some ways the EU is going backwards: particularly its accelerating use of anti-dumping duties and non-conventional trade barriers to block imports. The EU is pursuing trade wars with China and Asian states over everything from clothes to shoes to bicycles, furniture and plastic bags. The EU now launches a new so-called anti-dumping investigation every twelve days.

The internal market is also moving backwards in relative terms, with intra EU trade growing more slowly than world trade. From a UK point of view, Britain's goods trade with rest of the world has grown nearly 50% faster than its trade with the euro member countries since 1991. Interestingly, in the closing months of 2005, the UK's goods trade with EMU countries was overtaken by trade with the rest of the world for the first time. For the EU as a whole, intra-EU trade is falling as a share of members' trade - while within Free Trade Areas like ASEAN and NAFTA the share is growing.

Trade with the rest of the world is growing faster and has overtaken the EMU area

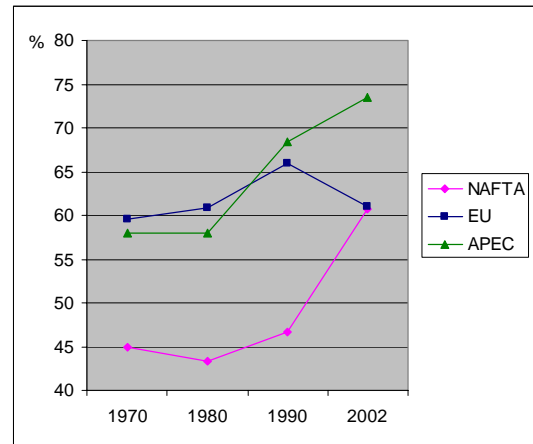


Source: National Statistics, Quarterly Balance of Payments

## Trade within the EU is shrinking- but is growing in other blocs

*Share of members' trade within area*

In 2004 the EU Commission's *Kok Report* noted that "intra-EU trade in manufactured goods has been shrinking since 2001, and it is the same story in services". It goes on to explain that "free movement continues to be hindered by a range of local rules, often applied arbitrarily and in clear contradiction to the mutual recognition principle that is the cornerstone of the internal market."



*Source: UNCTAD Global Statistics Database*

### The future - backwards not forwards?

The real test of whether protectionism in Europe is a temporary throwback or the start of an alarming trend will come over the next few years. Two of the most important question marks hang over how Europe's politicians will behave in a future recession, and whether the current Doha round of world trade talks will succeed. It is not too late to change direction - but supporters of an open Europe face a number of worrying developments:

- The current round of protectionist behaviour comes at a time when international economic conditions are relatively benign. How much further will Europe's politicians be prepared to go, for example, if there is an international recession of the kind that marked the start of the 80s and 90s? The current level of competition from China, India etc are going to radically intensify. Will EU leaders shape the public's reaction to this in a positive way or pander to it in a destructive way?
- The Current Doha round of trade talks is now closer to an outright failure than any previous round (mainly due to the EU's refusal to move on agriculture). Several of the leading trade players are now talking about putting the round into "cold storage". If there is no deal before the April 30 deadline (or even if there is a resort to a minimal face-saving deal), will the WTO effectively be put permanently on ice?
- Just as importantly, Peter Mandelson is actively making the case *against* trade liberalisation, claiming this month that there would be "free market mayhem" if global agriculture trade was liberalised, and also attacking the World Bank. Will Mandelson be allowed to carry on parroting anti-globalisation slogans?

- Will the EU's behaviour spark retaliation from elsewhere in the world? China has already threatened to start legal action at the WTO. During the last election in the US John Edwards and John Kerry advocated a number of protectionist measures, including a return to disastrous "Article 301" measures which stoked the US - Japan trade rows of the 1980s. An acrimonious end to the Doha round could produce a global climate giving protectionists their chance.
- Finally, to what extent will Europe's internal problems spark problems for the internal market? German Finance Minister Peer Steinbrück has called on new EU member states to raise their low corporation taxes or face the loss of EU funds. In a protectionist climate this could easily slide into a row affecting the internal market. Likewise, Italy is heading for tensions surrounding its euro membership. The current Italian government has become increasingly sceptical about the euro (which Berlusconi always calls "Prodi's euro"). Alternatively, if Prodi wins the Italian elections in April, he is likely to try and comply with the rules of the euro (with a deflationary programme of spending cuts and tax rises). This could also put the already weakened Italian economy under severe strain. One way or another, a future Italian Government may in future put pressure on the ECB to cut rates and/or devalue. This could be the catalyst for a row, not just about the single market, but of historic proportions.