Forget France, imagine Britain holding key to Emu

IMAGINE Britain holding the key to European monetary union. Impossible some may say. But it is possible, particularly if Labour wins the next general election and in view of France's economic problems. Thus Deutschmark/sterling could replace the mark/franc as the vital exchange rate to watch

ECONOMIC VIEWPOINT

Dr Gerard Lyons argues that a Labour government could enter sterling into a single European currency

Britain, not France, will be able to achieve the fiscal convergence needed to join a single currency.

With Labour favourite to win the election and adopt a pro-European stance, Britain could join Germany and a small number of European countries in forming an early monetary union.

If Germany formed a single currency with only a number of small countries it would not be credible — it would be merely a Deutschmark bloc. It requires a larger country alongside Germany for monetary union to proceed. Britain, not France, could be that country.

This distinct possibility will make European policy the key election issue in Britain. The party conferences showed that as Labour is becoming pro-European the Conservatives are becoming more Euro-sceptic. This difference could widen before the next election.

Before the 1992 election the Conservatives and Labour were in favour of sterling's exchange rate mechanism membership.

Then I was one of the few economists convinced that devaluation would happen whoever won the election. Sterling was devalued, on Black Wednesday. That not only allowed the economy to recover but partly explains Tory caution on Europe.

I am still against a single currency and monetary union. Already it has led to inappropriate policies throughout Europe, as we saw in Britain prior to Black Wednesday and as we see in France now.

The French economy is weak and needs lower interest rates. Instead the Bank of France is keeping rates high to protect the franc and there is talk of spending cuts to control the budget deficit.

This policy will only weaken the economy further and lessen France's chances of meeting the convergence criteria.

In fact monetary union continues to point to deflationary policies, even though unemployment has replaced inflation as Europe's main problem.

Despite this, it is important not to underestimate the political enthusiasm on the Continent for a single currency. This will intensify ahead of next year's inter-governmental conference, which will rubber-stamp 1999 as the date for a single currency.

One hurdle is that the German government's desire for a single currency is not shared by the public or German investors.

The last thing they want is their Deutschemark to be watered down as it is replaced by a weak Euro currency.

The way to alleviate these concerns has been for the German authorities to insist recently that only strong economies can enter a monetary union.

THE MAASTRICHT convergence criteria must be met in full by any country wishing to enter a union. This is the only way of ensuring the Euro currency will be as strong as the mark.

The Maastricht criteria point to the need for low inflation, low bond yields, stable currencies and healthy fiscal positions, including low budget deficits and low debt levels.

Fiscal policy is the most complicated area. In recent years it appeared the fiscal criteria could be interpreted flexibly — as long as things were moving in the right direction, with budget deficits falling and fiscal policy tight, the criteria would not need to be met. But not now.

Flexibility attached to the fiscal criteria has been replaced by an agreement that the budget criteria must be achieved in full by 1997, based on the actual outcome for that year and not projections. This is where the fun begins.

Only a small number of countries may be able to achieve the budgetary criteria and go on to form a monetary union. France will not be one of these countries, but Britain will.

Other possible qualifiers could be Austria, Denmark, Germany, Luxembourg and the Netherlands.

Surely the rest of Europe will wait for France?

Not necessarily. Already the date for a single currency has been put back to 1999. Further delay risks the whole thing falling apart so there is pressure to proceed as soon as possible.

There are two routes to a single currency. The most likely is a fast monetary union, with those countries achieving economic convergence forming a single currency.

This points to a multi-speed Europe, allowing those countries who do not qualify the scope to join at a later date.

The alternative is to resurrect the narrow bands of the ERM, using that as a stepping stone to a single currency. But this would be doomed to failure. The only time the ERM worked properly was during 1979-87 when it was a flexible system with frequent realignments.

The original intention was that currencies should be tied against each other in the ERM's narrow bands for two years prior to a single currency.

This becomes redundant if fast monetary union occurs.

The idea that currencies prove their stability is valid but misleading. Far better for the economic fundamentals to be sound, with the convergence criteria being met.

Thus it may not be essential for sterling to return to the ERM's narrow bands.

SHOULD Labour win the election, what could be better for Blair than to show his European credentials by taking advantage of France's economic misfortunes and push sterling into a single currency.

Such a prospect may alarm the Eurosceptics, particularly as Labour is so far ahead in the opinion polls, and an anti-European mandate, as well as income tax cuts, will dominate the Tories' election strategy.