Monetary union: the nightmare returns

European Monetary Union should not go ahead. If it does, it will be economically disastrous for the countries involved. It will instill a deflationary mentality into policy making, resulting in low growth, high unemployment and increasing social divisions.

Despite the strong economic arguments against monetary union there is an increasing possibility it will proceed on time. At the recent Inter-governmental Conference in Turin, most European countries reiterated their commitment to a single currency. Last weekend in Verona this was taken a step forward. With the exception of the UK, the European Union agreed a strategy based on a two-speed Europe. Those countries who do not make the grade for a single currency will enter ERM 2. The nightmare returns!

At the end of last year the situation was different. EMU by 1999 seemed unlikely. Economic weakness throughout Europe was casting doubt on the ability of most countries to achieve low budget deficits in time. The French government faced widespread social unrest; the franc faced devaluation.

That hurdle to EMU was overcome. Lower interest rates in Germany and throughout Europe eased the burden on the franc and other weak currencies. Further monetary easing is likely, as growth on the Continent is weak, inflation low and fiscal policies tight.

Although there is much opposition to EMU, this has failed to stop the politicians. Even in Germany, where opinion polls suggest opposition to union is highest, this has not been reflected in elections. The socialists, who campaigned on an anti-EMU platform, did poorly in three regional elections in March while Chancellor Kohl's coalition did well. This puts Kohl in a strong position until he faces re-election in 1998. By then his desire for EMU may have pushed the process so far that it is unstoppable.

There will, of course, be further hurdles. The biggest problem will be the economic outlook in Europe. This is still poor, despite falling interest rates. Germany is unable to act as the locomotive for European growth.

Towards the end of the year most governments will unveil economic forecasts for 1997, suggesting they will achieve the criteria. The markets will not believe them. That will not stop the political enthusiasm, but it will again cast doubts on the outcome.

There are two main possibilities for EMU. First, it could be delayed at the last minute when it is clear that few countries have achieved the convergence criteria and weak economic performance will intensify public opposition, particularly in Germany. Second, the Maastricht convergence criteria could be interpreted flexibly. The criteria already allow a degree of latitude. This would allow EMU to proceed on time, with around seven countries, even though not all of them will have budget deficits under 3% of GDP or debt levels of less than 60% of GDP. France and Germany would qualify.

It is with this latter scenario in mind that the Verona meeting outlined plans for ERM 2. The argument is that monetary stability is necessary throughout Europe, for the benefit of all. In reality most countries are looking after their own interests.

The countries who think they will definitely be in the monetary union at the start don't want the "outsiders" to enjoy possible competitive advantage by being able to depreciate their currencies. This is ironic, as the core countries have continued to argue that devaluation does not work. So surely it should not matter if the non-qualifiers do not tie their currencies to the euro. The reality, of course, is different. The euro does not contain all the advantages countries like Germany and France suggest.

An ERM 2 is doomed to failure. The original ERM only worked during its first phase, between 1979 and 1987. It benefited from exchange controls, but its real success was due to its flexibility. When currencies were weak and in trouble they devalued. Realignments were frequent – 11 during that period.

During its second phase, between 1987 and 1992, the ERM became rigid. There was only one realignment, when the lira moved to a narrow band. The markets believed EMU was inevitable, but problems built up beneath the surface as "real" exchange rates moved hopelessly out of line. The problem came to the surface after the Danes said no in June 1992. As doubts about monetary union grew the markets could not ignore the damage being caused by the ERM. The result was Black Wednesday. Sterling and the lira left the system, and what was left of the ERM became a sham, with wide 15% bands.

Most countries who do not qualify for the euro will be keen to enter ERM 2, hoping it will provide the stepping stone by which they can reach the euro. The reality is likely to be different.

ERM 2 must be flexible to survive, with wide 15% bands and scope for realignments. This will not provide a stepping stone to the euro. For that, it will have to be a rigid system, with narrow bands. Such a rigid system will be blown apart by the markets as it could trigger a conflict between the needs of domestic economies and the requirements of keeping currencies at artificial levels.

These strains will inevitably appear, particularly as those countries in ERM 2 will also be required to adopt tight, deflationary, fiscal policies in order to 'qualify' for the euro. ERM 2 will prevent interest rates from falling to offset this. The currencies in ERM 2 will be weaker than those entering the euro. Once strains appear these weak currencies will be defenceless. They will need help from countries in the euro. By that stage those core countries will have enough economic problems of their own. Britain is right to stay out of ERM 2 and must say "No" to the euro.

Dr Gerard Lyons is chief economist of Dai-Ichi Kangyo Bank (DKB) International.

Sunday 21st April 1996
Sunday Business

ECONOMICS WEEK

The introduction of a slower track will not stop the latest version of EMU from being as disastrous as its unlamented predecessor, says **Gerard Lyons**