Economic health warning for Monetary Union

European Monetary Union (EMU) is once again the hot topic, following the mid-week parliamentary debate and the Dublin summit.

During the year there has been a dramatic shift in thinking about EMU. Back in February, financial markets and most commentators assumed it would not begin on time, if at all. Then, in March, following local elections in Germany, sentiment changed. The victory of Chancellor Kohl's coalition government effectively removed any political opposition until key elections in 1998. This encouraged him to press on with his desire for EMU and allowed us all to witness how much enthusiasm for EMU there is among the political and bureaucratic elite of Europe.

Political enthusiasm has resulted in tough fiscal policy across many countries in an attempt to achieve low deficits.

By next year those countries who want to enter EMU have to achieve economic convergence, even if helped by fudges. Who has achieved the qualifying standard will be decided by the summer of 1998. The euro will then be introduced in 1999 and trade alongside existing currencies. This transition phase will last three years, until in the first half of 2002 when existing currencies of those who are in EMU will be phased out and the euro becomes sole legal tender.

There is still a long way to go but the tempo is picking up and it is now possible that EMU will begin on time in 1999. Consequently the City and UK financial authorities are preparing for the euro, whether the UK is in or not.

Yet there are still big hurdles to EMU beginning on time. First, Europe's economic prospects are poor. Growth next year will not be as strong as most European governments hope. This will make it difficult to achieve economic convergence. Second is the attitude of the German public, who do not want the entry conditions into EMU relaxed.

This highlights a dilemma. There is a clash between the political will to have as many countries as possible within EMU at the start, including Spain and Italy, and the economic wish of the German authorities and European central banks to ensure that the euro will be a hard currency, as good as the mark. The ideal solution is to allow only those countries that achieve convergence into EMU at the start. The trouble is that only a few countries will make it.

Hence an attempt to have it both ways, pleasing the politicians and the central bankers. The aim is to interpret the criteria flexibly, even letting in countries that fudge the figures. This will permit a large number of entrants. But then, once in EMU, impose tough conditions on all participating countries, to ensure the euro is hard.

Not everyone is convinced, not least the German public who appear alarmed and fear that once in, previously high-spending governments will return to their old ways, with the result a soft euro, as higher inflation undermines their savings.

This explained the tough German negotiating stance over the so-called fiscal stability pact. The Germans are not content that countries will have to achieve low budget deficits to qualify for EMU. They want a permanent constraint on fiscal policy. Even if countries qualify for EMU they will then have to maintain low budget deficits, else they will be fined.

Even though the Germans compromised in reaching agreement on the stability pact at the Dublin summit, there will now be tough outside control of budget deficits. This control is not being exercised by the financial markets in the usual way of higher bond yields for those countries with high deficits. Instead governments will be fined for excess budget deficits unless their economy is in deep recession.

While the German compromise on the stability pact was welcomed, such a constraint on fiscal policy is asymmetric and deflationary. It will not allow a government to respond to a weak economy by boosting spending and increasing its budget deficit.

It highlights the economic problems in the present politically driven desire for EMU. First, the whole economic thinking behind EMU is deflationary, pointing to weak, below-trend growth and high European unemployment. Already this is evident on the Continent and there is no reason to think it will change if EMU proceeds.

Second, there are no economic stabilisers. Sensible economic policy needs to respond to shocks. A rigid, inflexible policy means economic growth and employment will suffer. Already we know if we enter EMU we give up our monetary sovereignty. Interest rates will be set in the interests of the European 'state'. Also the stability pact aims to limit fiscal flexibility as the Germans will continue to aim for tough policies because they fear the likes of Italy will destabilise the whole system through high budget deficits. So neither monetary policy nor fiscal policy will be flexible and stabilising in EMU. And, as we already see from the Continent, labour markets in most European countries are not flexible.

Even if EMU proceeds on time the British Government should not be enthusiastic. Already there are far too many economic health warnings attached to EMU. Monetary Union could seriously damage the nation's health.

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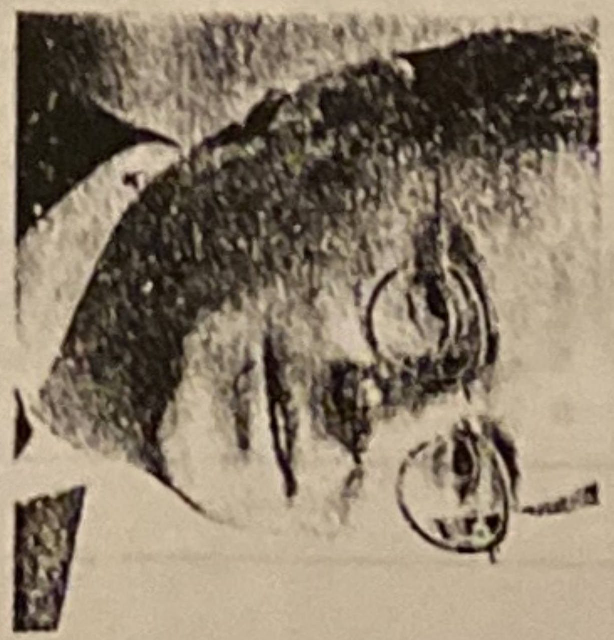

ECONOMICS WEEK

The aim is to let many countries into EMU and then control them tightly says **Gerard Lyons**