Financial markets raise the monetary union temperature

Monetary Union fever has gripped European financial markets, sending temperatures soaring, particularly in Italy and Spain. The fever has spread even to UK markets, despite the caution of both main political parties towards European Monetary Union (EMU). Sterling and the gilt market have soared.

Political enthusiasm on the Continent towards EMU has always been high, keeping open the possibility that the convergence criteria would be relaxed sufficiently to allow the process to proceed on time.

The argument has been that it would be far better to proceed with a few countries in 1999, otherwise a delay could risk the whole process falling apart. What then has changed recently to boost confidence about EMU?

First, there has been increased optimism across Europe about achieving the Maastricht convergence criteria, particularly low budget deficits. This stems from optimism about growth prospects and also reflects the tough budgets that have been unveiled across Europe in recent weeks

Spain, for instance, announced its smallest planned increased in public spending since it became democratic. The Italians surpassed this, announcing total savings in their budget of 62.5 trillion lira.

This is a huge £26.8 billion to be achieved through a combination of spending cuts, tax increases and unspecified operations. Such tough fiscal stances have allowed the Spanish to cut interest rates during the last week and the Italians are likely to ease next month, after October's inflation data. There may be additional political pressure to cut rates in order to boost growth prospects.

One has to be sceptical about such budget savings being achieved, and not just in Italy, but in other countries who have announced tough budgets, including France and Germany.

The second key factor was the recent European Union meeting in Dublin, where countries agreed to the principle of a fiscal stability pact. Originally proposed by German Finance Minister Theo Waebel, this pact is aimed at preventing any country from relaxing fiscal policy too much once EMU begins. The idea is that any country could be fined for allowing its budget deficit to exceed 3% of GDP. The exact details have yet to be decided, but there is little doubt it will be economically damaging.

Automatic fiscal stabilisers such as unemployment benefits are essential for helping those hit by economic downswings. Now, the proposal is to have automatic fiscal sanctions, which will prevent increased government spending during times of economic weakness. Rather than being counter-cyclical this is pro-cyclical and will exacerbate the economic cycle. It highlights the deflationary mentality that has dominated European policy making. There is no sign that this is about to change in Monetary Union.

A single currency will mean a loss of monetary sovereignty, with interest rates being set on a European-wide basis by an independent European central bank. This pact is the first step towards a loss of fiscal flexibility as well. There is clearly a need for medium-term fiscal consolidation but this should not be at the expense of the essential need to use fiscal policy for short-term demand management.

Where does this leave the UK? The pace of change in the financial markets has created the impression that the UK must rush quickly into a decision. We needn't, even though there will be further enthusiasm about EMU ahead of the Dublin Summit in mid-December. The process is likely to proceed on time but the risk of a last-minute delay or a still small number of starters is higher than the financial markets are currently assuming.

There could still be a delay as so few countries will be able to achieve the convergence criteria. Despite the enthusiasm about reducing budget deficits, the European economy may not be as strong over the next year as many governments hope. Disappointing growth will limit the hoped for improvements in budget deficits. More likely, the criteria will be interpreted flexibly. It is in this scenario that the likely opposition of the German general public becomes important.

The Germans remain sceptical about a single currency and will only accept it if it is seen as being as hard as the DM, thereby safeguarding their savings. The last thing they will agree to is a single currency involving Spain and Italy. Thus the choice of qualifiers will be very political and may appear to be arbitrary. Belgium, with its high level of debt, will be in, Italy not. The trouble is that if political enthusiasts like Italy are excluded they need to be offered an eventual route into EMU. Thus the ERM will be resurrected as a stepping stone for Italy and Spain to reach EMU.

The markets are not only too optimistic about the EMU prospects for Spain and Italy, but are assuming that a Labour Government would take sterling in as well. This is premature. Even though Labour has adopted a pro-European line they have stopped some way short of endorsing EMU. If Labour was to enter EMU they would surely have to fight the election on a pro-EMU ticket.

This was to create an unnecessary electoral risk. Furthermore, EMU-related legislation could absorb so much time of the new government's first few years it would divert it from any of its other objectives, to say nothing of the constraints it will impose on fiscal policy. Other countries may, of course, put pressure on sterling to re-enter the ERM but that too is unlikely. There is still much that could happen on the way to EMU. Temperatures in financial markets could soon cool to reflect this.

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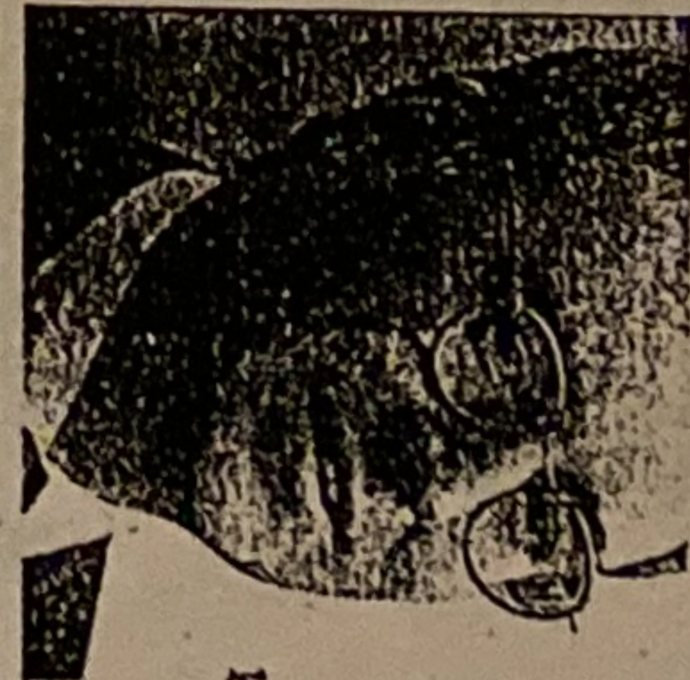

ECONOMICS WEEK

The UK does not want to catch the Monetary Union fever that is gripping financial markets, says Gerard Lyons