Politics not economics mean EMU is a done deal

European Monetary Union just won't go away. As the rest of the Union prepares for a single currency in 1999, John Major is now focusing on Europe as a centrepiece of the campaign. As welcome as this is, it seems too late in the day.

In the Seventies Liverpool football club would often bring on a "super sub" called David Fairclough with only a few minutes to go in important games. He always seemed to score a crucial winning goal. Because he was so effective it always seemed strange that he was not on the field from the start. Major hopes Europe will be his "super sub", but the trouble is there is not long left in the game and the opposition are so far ahead that it would be a miracle if it made any difference.

Instead, the Conservative party is positioning itself for a post-election anti-EMU strategy. Labour, meanwhile, is keen not to upset anyone. Like Janus, they are looking both ways, making positive signals to our European partners whilst telling the electorate they will be tough and defend British interests. A Labour Government may find it difficult to keep everyone happy.

In recent weeks the momentum towards EMU has gathered pace. At the meeting of finance ministers in Holland two weeks ago it was agreed the European Commission and the European Monetary Institute (EMI) will publish reports on countries' convergence, outlining who has achieved the criteria, by the end of next March. Although the Maastricht criteria state 1997 as the year when the targets have to be met, their reports will be based not only on actual data for 1997 but also on forecasts for 1998. How convenient. There is little doubt most countries will expect to achieve the convergence criteria next year, just as they did this.

These reports, with recommendations from the Commission, will be presented a few weeks later to the European Council of Ministers of Economics and Finance (ECOFIN), which will use majority voting to decide who should enter a single currency. Their decision will be passed to the European Council (Heads of State) who make the final decision the same weekend. The European parliament will also submit its opinion to the council.

This complicated process raises many possibilities. The most important is that even if countries do not achieve the convergence criteria, EMU can proceed on time.

Economic prospects on the Continent are not good and the financial markets are too optimistic about Germany. Next month the combination of weak growth and high unemployment should force the German government to admit it cannot meet the 3% of GDP budget target this year. Meanwhile, the French budget deficit is heading for 3.8% of GDP. This economic hurdle will not stop the process. It makes no sense to judge fiscal positions on what happens in any one year. Sustainability is important.

The trouble is once the criteria are interpreted flexibly then hard economic numbers will be replaced by politics and behind the scenes bargaining in deciding who will be in EMU. Anything is possible, as politicians are keen for EMU to begin on time with as many starters as possible.

This makes the financial markets nervous. During September 1992 the markets blew the ERM apart but such an assault on EMU is unlikely. Yet, President Lamfalusy, head of the EMI, which is the precursor of the European Central Bank, predicts two difficult periods: between now and the reports on convergence at the end of March; from those reports to the weekend of the ECOFIN/Council meetings, when the chosen few will be announced. But the six months between the ins being unveiled and EMU beginning in 1999 will also be a troubling time. It has been called the end-game.

Last week's annual report from the EMI cast doubts on how credible and sustainable some of the attempts to reduce budget deficits are. Although it didn't single anyone out, Italy is a case in point. The European Commission is expected to lower its deficit forecast for Italy to 3.2%, but to achieve this the government has announced total savings, including last week's mini budget, of 78 trillion lira. This is about £28 billion. Little wonder their economy is on the verge of recession; their government looks wobbly and the Germans still need to be convinced that the Italian budget improvement is sustainable.

During the end-game the currencies of countries which make it into EMU but whose credentials are not sound and those left out will suffer. Club Med countries like Italy and Spain will be excluded, to be allowed in at a later date, if their fiscal behaviour is good.

There will also be uncertainty about the rates currencies are to be fixed at in EMU. As our ERM experience showed, entering a currency union at the wrong time and wrong rate brings problems. Clearly if countries are to tie their currencies for ever the starting rates should be close to equilibrium. Yet each country will want a competitive exchange rate. The Germans realise this and are not worried by the current creeping devaluation of the mark.

There is likely to be an initial group of eight countries: Belgium, Austria, France, Finland, Luxembourg, Ireland, Netherlands and Germany. Taking the first letter of each country spells BAFFLING. An appropriate word to explain the political enthusiasm for an economically damaging process.

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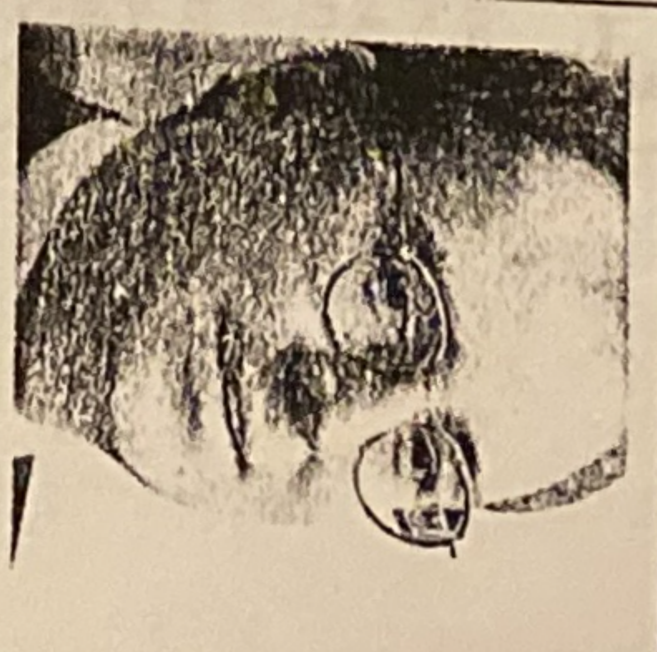

ECONOMICS WEEK

John Major hopes Europe will be his super-sub, but the game is almost over, says **Gerard Lyons**