

## VIEWPOINT

# Pulling over for a two-speed Europe

**Dr Gerard Lyons**, chief economist of DKB International, London-based subsidiary of the Dai-ichi Kangyo Bank, says some countries may be forced into the slow lane of monetary union

**E**UROPEAN financial markets could be in for a long and turbulent summer. Tensions in the exchange rate mechanism are mounting and the situation will deteriorate over the coming months. As the Bundesbank persists with an excessively tight monetary policy and further doubts surface over monetary union (Emu), the D-Mark will benefit while the main casualties are likely to be sterling and the lira. A devaluation of both cannot be ruled out. Since the Danish vote, political and economic uncertainty about monetary union has arisen. And tensions could mount in the run-up to the French referendum of 20 September. Although latest opinion polls suggest the French will vote Yes, opposition to the Maastricht Treaty has increased recently. A No vote by the French could halt the movement to monetary union, but even a Yes vote will not undo the uncertainties over Emu that have surfaced recently. The Danish vote showed that financial markets had become too optimistic about the prospects for Emu. This optimism was based on the timetable set out in the Treaty, which spoke of Emu before the end of this decade. To achieve union, all 12 EC countries need to achieve economic convergence targets for inflation, budget deficits and long-term bond yields and currency stability within the ERM. The markets had underestimated the political costs involved in Emu. But they still remain too optimistic about the prospects for economic convergence as not all the EC countries will be able to satisfy the tough criteria. Political opposition to Emu could grow once people realise the high cost of achieving convergence. This is currently being seen



Dr Gerard Lyons

in Britain. All the gains, in terms of low inflation and low interest rates, come at the end of the process, but all the costs come up front. To achieve convergence, most countries need very tight policies: a tight monetary policy for currency stability and low inflation; a tight fiscal policy for budgetary

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convergence. The combination of tight monetary and fiscal policies will lead to below trend growth, low output and high and rising unemployment in most countries. The consequent social unrest could boost the political opposition to Emu. An ERM realignment now could ease some of the tensions. A revaluation of the D-Mark would allow a lowering of interest rates elsewhere in Europe. But as this is not politically acceptable in many EC countries, it is unlikely to happen.

There are three ways in which events could turn. The first, and least-likely, is that the whole process towards monetary union collapses. Clearly there would need to be a bombshell for such an eventuality to occur. A No vote by the French? This would severely weaken the ERM and prompt currency instability on a far greater scale than was seen after the Danish vote.

The second possibility is a return to the optimistic days before the Danish referendum. For this to happen, the markets would have to take the view that the present political momentum in favour of Emu would overcome any obstacles. Either the Danes change their minds in favour of Emu, which seems unlikely, or the other 11 proceed towards a single currency. But attempts to act as if nothing has happened in the last few months would lack credibility.

The third possibility seems the most likely. In view of the economic difficulty and political problems some countries face, the markets are likely to think in terms of a two-speed Europe. Countries that can satisfy the convergence criteria are viewed as most likely to form a union and enter the fast lane. The rest stay in the slow lane.

The Bundesbank will continue to insist that only those countries that can achieve economic convergence enter the monetary union. It is difficult to see how countries such as Spain, Italy, Portugal and Greece will be among these. The harder currencies will remain stable within the ERM but the currencies of countries that may not satisfy convergence are likely to be subject to bouts of speculative attack. The lira and sterling are already both vulnerable and there could be worse to come.