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Britain and EMU

The case for joining

Graham Bishop, Chris Boyd, Alison Cottrell, Diane Coyle, Alan Donnelly, Niall FitzGerald, Pascal Lamy, Alman Metten, John Monks, Sir David Simon, Peter Sutherland and Martin Wolf

CENTRE FOR EUROPEAN REFORM

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Charles Grant

The focus of Britain's debate on economic and monetary union has shifted from the academic question of whether, in an ideal world, the euro should replace the pound. For there is no longer much doubt that a large part of continental Europe will push ahead with EMU. The possibility that there may be some delay to the project does not alter the essence of the choice facing Britain: to sign up for the euro, or to stand aside from an enterprise that is certain to make an impact on the British economy.

Until now the opponents of EMU have, with the help of their many friends in the media, dominated the British debate. Their sentimental and at times chauvinist stance has tended to obscure the serious economic arguments both for and against a single currency. The Centre for European Reform has already published work by writers who are sceptical of the merits of monetary union. It now believes that proponents of EMU should have a chance to state their case. The authors of this book—distinguished figures from business, the City, journalism, the trade unions and European institutions—focus less on economic theory than on the practical implications of Britain's choice.

Despite the authors' diverse perspectives, several common themes run through their essays. They believe that a single currency would make Europe's single market work better. Some of them fear that, if Britain stayed outside the euro zone, seeking to profit from competitive devaluations, its partners would retaliate with protection. That possibility is one reason why our contributors believe that, if Britain rejected EMU, it would gain less foreign direct investment. They also worry about the City's prospects: deprived of the chance to play a leading role in euro markets, it could lose ground to rival financial centres.

What of the erosion of national sovereignty that EMU must inevitably entail? The authors are sceptical that the government's loss of the right to run monetary policy would in practice make much difference. When the European Central Bank moved its interest rates up or down, a Britain outside EMU would find it very hard not to follow suit. Nor would the authors mourn the loss of the freedom to devalue: they do not believe that devaluation, with its tendency to boost inflation, is an effective weapon for combating the structural weaknesses of the British economy.

Our contributors do not believe that the economic and political consequences of EMU can be kept in separate compartments. A recurring theme of their essays is that, if Britain shuns the euro, it will become a semi-detached member of the European Union, with less influence not only on monetary policy but also on a wide range of EU business. Britain's sway on matters crucial to its economy, such as international trade talks and the value of the euro against other currencies, as well as on political questions such as the EU's institutions and enlargement, would diminish. If Britain wants to shape the European Union—and, through that club's influence, the world beyond—in ways that suit British interests, it should not shun the Union's most ambitious and challenging project.

That, in a nutshell, is the argument of **Sir David Simon**, whose essay opens this volume. He believes that the revival of parts of British industry has depended on companies comparing themselves and their performance to other world-class firms. A single currency would create greater transparency among European companies and reinforce this competitive pressure. He writes with some authority on the subject of Britain's industrial revival, having played a major role in the restoration of British Petroleum's fortunes. Britain's problem is that it has to cope with a conflict between its economic self-interest, which lies in further European economic integration, and widely-held political sentiments which yearn for the country's glorious, independent past. The critics of monetary union have succumbed to a pessimistic, nostalgic view of Britain's place in the world. Sir David makes the case for the euro being a route towards a more competitive, self-confident, optimistic Britain.

Alison Cottrell, one of the City's most original young economists, contradicts many pundits by predicting that the euro will, in the long run, prove a relatively soft currency. She thinks that arguments among EU governments on exchange rate policy will erode its initial strength. Yet she believes that Britain would gain more than it lost from joining EMU.

Britain would be unwise to join the first wave, however, since it lacks a political consensus in favour of the single currency. Britain should nevertheless join the new "mark II" Exchange Rate Mechanism (ERM), as a means of regaining its partners' goodwill. Cottrell discounts Euro-sceptic fears that joining EMU would be the first step on a slippery slope to federalism: the EU institutions are far too weak to create any sort of super-state.

Chris Boyd, who has been closely involved in the European Commission's work on EMU, examines the likely impact of the euro on the world monetary system. He predicts that it will become a major world currency—whether for trade, central bank reserves or portfolio investment—rivalling the American dollar. Boyd acknowledges that a country in a grave economic crisis may occasionally gain from exercising the right to devalue. But he argues that the economic benefits of EMU would greatly outweigh the loss of that right. He does believe that the special features of Britain's economy—such as its tendency to high interest rates and a volatile exchange rate—plus the scepticism of many of its people argue for the country to shun the first wave of EMU. Britain should wait until a national referendum can be held and won.

Niall FitzGerald, chairman of the Anglo-Dutch conglomerate Unilever, predicts that EMU would deliver a virtuous circle of low inflation, more investment and greater competitivness. But such a momentous undertaking should be approached with caution and prudence. So the January 1st, 1999 deadline should not be treated as sacrosanct, and should, if necessary, be postponed. And only the small number of countries with a proven record of economic convergence should join the initial wave. But FitzGerald does not want such caveats to be taken as excuses for delaying the introduction of the euro. He argues that Britain's economy is similar enough to its partners' for it to thrive in the euro area, and that its low unemployment and flexible labour markets would even give it a competitive advantage. He wants Britain committed to the goal of monetary union, so that it can mould the project in ways that suit British interests and ensure that it is built on sound economics.

Diane Coyle challenges those who claim that the British economy could not cope with EMU because of its structural problems. Joining the single currency would, she maintains, help to resolve those problems—notably by overcoming the British propensity to relatively high inflation. In strong-currency countries such as Germany, France and Japan, companies have been forced to compete in export markets on the basis of quality and constant improvements to products. British firms, by contrast, have concentrated on price and sought to profit from sterling's habitual devaluations. Coyle, whose economic commentaries have won a growing following, believes that labour market rigidities, rather than strong currencies, have been the main cause of French and German unemployment. If Britain joined the euro and thus gave up the right to devalue it could at last defeat the demon of inflation.

For many years **Martin Wolf** has, from the vantage point of his *Financial Times* column, criticised the project of monetary union. He remains unconvinced that EMU would yield many economic dividends, other than lower interest rates. But he now argues that Britain should join a single European currency for political reasons. A Britain that remained outside would become more parochial and chauvinistic and would, as a semi-detached member of the European Union, lose the ability to influence its future direction. Inside EMU, he believes, Britain would be able to push the European Union towards free markets, deregulation and decentralisation.

Alman Metten, a Dutch socialist, has a blunt message for the British: if they reject EMU but seek to profit from competitive devaluations at their neighbours' expense, they will lose access to the single market. There is only one way for Britain to avoid both EMU and the erection of protectionist barriers within the EU: the pound would have to shadow the value of the euro. But Britain would need the support of the European Central Bank in order to fight off speculators—and it would not get that support unless it joined the new Exchange Rate Mechanism and accepted some EU economic surveillance. Thus the British would have to accept the very things they hoped to avoid by staying out of EMU, and they would still pay a premium on their interest rates.

Graham Bishop's shrewd analyses of international bond markets have for many years enhanced the reputation of Salomon Brothers. His essay examines how Britain's decision on the euro will affect the City. British banks would suffer from a decision to stay out—because they would lack direct access to the money market operations of the European Central Bank, and because continental banks could discriminate against them. He predicts that EMU would soon lead to a unified euro capital market, and that it would be large enough to rival US dollar markets for both bonds and equities. British participation in EMU would give the City the chance to dominate these new markets.

Pascal Lamy argues that Britain's traditions of free trade and fixed exchange rates should make it willing to embrace the euro. After all, the British helped to build the fixed-rate Bretton Woods system, while EMU would deepen the single market and thus boost trade. An anglophile Frenchman, Lamy laments the steady decline of British influence within the European Union. He believes that Britain's "opt-outs" from the Maastricht treaty have already caused great damage to its relationship with the EU, and that a definitive No to the euro would call into question its membership. A Yes, however, would give Britain a chance to regain a leading role in Europe.

Alan Donnelly looks ahead to many questions surrounding EMU—such as the relationship between the Union's monetary, exchange rate and fiscal policies—which have yet to be resolved. He worries that an informal group of member-states, based around France and Germany, could tackle these issues and then force the others to follow. Evidently, that kind of two-tier Union would be more likely if Britain stayed out of EMU. As one of Britain's most experienced members of the European Parliament, Donnelly is well-placed to judge the chances of such informal groups emerging. He calls for a strengthened council of finance ministers to act as an economic counterweight to the monetary power of the European Central Bank. The creation of such a body would help to ensure that all member-states, rather than just a caucus of them, steered the Union's economic policy.

John Monks, who has done much to convince British trade unions of the merits of EMU, argues that the euro would bring lower interest rates and thus more employment. But the single currency needs to be balanced by a greater emphasis on EU social policy and employment policy. He believes that the stability and growth pact, agreed at the December 1996 Dublin summit, opens the door to a flexible interpretation of the Maastricht treaty's convergence criteria. Thus the euro should not, as some fear, be deflationary. But Monks wants Britain to be actively involved in EMU so that it can tilt the Union towards pro-growth policies.

Peter Sutherland argues that EMU is already bringing widespread benefits to the European economy. Remove the goal of a single currency and you remove the pressure on France and Germany to modernise their economies and welfare states. Sutherland—who steered the Uruguay round of world trade talks to a successful conclusion—favours a flexible interpretation of the Maastricht treaty's convergence criteria. It would be more useful to focus on which countries had succeeded in conquering inflation than on the rule that budget deficits must be no greater than 3 per cent of a country's GDP. However, he sees EMU as essentially a political undertaking, part of a broader process of European integration. He admits that it involves the loss of some sovereignty but denies that the euro would erode anyone's national identity.

EMU, the route to a confident, competitive Britain.

Sir David Simon

Britain is more reliant on overseas trade than any other country in the developed world, relative to the size of its economy. Thus the case for membership of the EU, our largest market, is—for the overwhelming majority of British businessmen engaged in international trade—clear and straightforward.

To this same majority a single currency is a logical extension of the single market to which Britain has been committed since the Single European Act was agreed in 1985. That market of 370 million people accounts for almost 60 per cent our trade and capital flows. Our participation in the single market, directly and indirectly, gives work to well over a million people. The single market is far from complete and any steps which improve its operation will help to generate more trade and more jobs—not least among the small and medium sized enterprises whose development and expansion is currently hindered by national barriers.

A single currency, introduced at the appropriate time, will reduce costs for businesses that trade or invest across Europe, as well as giving Britain a better chance of sustaining a sound monetary policy and low inflation—the two crucial ingredients for a stable investment climate. More investment in growing businesses means more employment. A single currency would help to bring about economic convergence and a more integrated management of our economies, thus diminishing the uncertainties that businessmen dislike.

The stability stemming from membership of a single currency should reduce British interest rates and thus cut the direct costs of every company which borrows. For the last 20 years those rates have averaged 3.5 per cent more than those in Germany—putting British firms which borrow in sterling at an immediate competitive disadvantage, compared with their German counterparts.

This view of the economic benefits of membership of a single currency is not just a personal opinion. In November 1996 MORI conducted a meticulous poll for the CBI and the British Chambers of Commerce. Half the 1600 companies that answered the questionnaire favoured British membership, either immediately or in the near future. Overall, 91 per cent believed that we should keep open our options for membership in 1999 or soon afterwards. Only 7 per cent declared themselves against membership in principle.

Farewell the trumpets

Economics and the views of business, though, are clearly only one part of the story. The prospect of EMU has opened up a debate running well beyond economic technicalities and convergence criteria, into constitutional issues that touch on Britain's standing and future as a nation state. Our future is indeed bound up with an integrating European economy, but that fundamental interest clashes with political sentiments that hanker after the idea of Britain's unique position and unconquered independence. EMU's critics concentrate on the need to ensure that we "control" our own monetary and fiscal policy, through the government's accountability to Parliament. But the fact is that this "control" has long been shared with the international financial markets.

We already share sovereignty and accountability willingly, in such matters as vital as defence and trade negotiations. So this debate should focus less on absolute principles and more on a clear-headed examination of our interests. I am confident that, in the end, interests will prevail over sentiment. It is very hard to imagine that the British people will put such a high value on the retention of one particular set of notes and coins over another; or that they will be ready to pay more for their mortgages; or that they will wish to see jobs lost as a result of the country becoming more distant from its main trading partners.

The regrettable thing is that the discovery of such realities could take time. In the meantime our economy would suffer damage, it would be harder for us to converge with the rest of Europe and we would be denied the chance to sit at the tables where the shape and character of Europe's

integrated market will be defined. The even greater longer term risk would be of Britain being dragged backwards into membership, eventually acquiescing in a mood of reluctant defensiveness, only to find that the prize for latecomers would be smaller. And "Europe" would undoubtedly be condemned as the cause of all our difficulties when it should be seen as one of the crucial elements in their resolution.

That is why I hope that the decision on membership, when it comes, will be conscious and positive rather than regretful and half-hearted. To reach that point, those of us who support membership of EMU and the EU on economic grounds have to understand peoples' political and constitutional concerns. And we have to demonstrate clearly and convincingly that EMU, and the process of European integration of which it is part, can offer Britain more than mere commercial benefits.

I believe the full-hearted support we are seeking will emerge, when people realise that monetary union is perhaps the simplest way to restore the sense of natural, national confidence which comes from competitive success. That confidence cannot come from searching to revive the past, by pretending that Britain is still a major world power and that the map is still coloured red. These days it is the quality of our products, services and governance which matters. Confidence in their delivery will certainly not come through the downward slide of devaluation—in which each step represents a recognition that we cannot compete or earn our living in the world without clipping the coinage.

The mixture of wistful nostalgia and acceptance of second best which lies at the heart of the argument against full participation in the Union is an interesting commentary on the current level of national confidence. This sometimes gloomy mood is an expression of a self-absorption which not only exaggerates the problems but also makes it harder to overcome them.

A hundred years ago we were a major imperial power. In 1900 our per capita income exceeded that of every other nation in the world. The fact that this past has vanished does not mean that our decline is inevitable, or that we are condemned to watch one country after another exceed our living standards or our influence in the world. For those willing to seize the opportunities there is a world to win.

The secret of corporate success

Within Britain there are encouraging signs that change is possible. The great achievement of the last two decades has been the revival, in one sector of the economy after another, of true competitive strength. In telecommunications, in parts of the car industry, in the energy sector, in high-tech engineering, in key elements of financial services, and in the rapidly growing sectors associated with the media and culture, British firms are now the equal of any in the world.

This achievement has depended not on subsidy or protection but on the willingness of individual companies to recognise the realities of the world in which they must compete. These are, of course, the need to control costs and to raise productivity, and to apply technology and skills to production. But it is also necessary to excel in marketing, responding to the demands of customers who have new powers of choice in a world of open markets. In many sectors that means establishing highly flexible working patterns and adjusting to the fact that change is the one enduring certainty. For some firms it has meant building alliances and partnerships with other European and international companies, sharing strengths and using combined resources to improve the performance of all concerned.

While some firms have gone through the rigours of adaptation and improvement, the process is far from complete. There is a long tail of underperforming companies, struggling to survive in this highly competitive world; and there is a shortage of the entrepreneurial energy that is required to create the new businesses which can generate future employment.

In almost all instances it is competition which has spurred British companies to success. Those which can now legitimately be described as world leaders have succeeded because of their ability to compare themselves and their performance with that of other world class companies. This simple process of "benchmarking"—identifying strengths and weaknesses, and setting the standards to be matched or surpassed—is a powerful tool for transforming corporate cultures and removing complacency.

As the world economy develops, opening up markets and the protected niches which have sheltered some companies, benchmarking will become even more important. EMU will allow a more transparent comparison,

undistorted by fluctuating currency values, and thus can only improve the quality and effectiveness of such benchmarking.

Monetary union could be a tremendous boon to Britain's small and medium sized businesses, of which only 10 per cent currently trade overseas. Many are discouraged by the complexity of nationally based regulation, the diversity of legal structures from one country to another and the sheer burden of transaction costs. Large companies operating in several countries can absorb many of those costs and hedge currency risks. For small companies the hurdles are higher and the deterrent to expansion outside one's national borders is powerful.

Another advantage of EMU is that it would impose a discipline absent from an environment in which underperformance—whether at the level of the country or individual firms—can always be concealed, at least temporarily, by devaluation or inflation. This is perhaps the single most powerful argument in favour of a single currency.

If devaluation were the key to successful economic management, as some opponents of monetary union suggest, then Britain would be the wealthiest country in Europe bar none! If British companies are well-managed and able to work within a fully complete, euro-based single market, I see no reason why the British economy could not perform as well as Germany's has done since the second world war.

Competitiveness, of course, is not an end in itself. It is the route to higher employment, to stable public finances and to the wealth creation required for both rising personal living standards and a modern welfare state. Uncompetitiveness, by contrast, is the route to declining employment, the imposition of an ever greater fiscal burden on the successful minority and falling living standards.

That is true for Britain, but it is also true for Europe as a whole. Far from making Europe a closed entity, as some fear, the establishment of monetary union would allow the best companies to operate to their full potential and thus to succeed on the world market.

This international context has received scant attention in Britain's public debate. The establishment of the euro will mark the beginning of a new phase in international economic history. The eight members chosen by commentators as likely to form the initial EMU core in 1999 will hold a share of 18 per cent in the International Monetary Fund. Those eight states now account for 25 per cent of world exports and for 31 per cent of the world's total financial flows. The collective power represented by the euro will be a pole of attraction for the countries around the EU, including those seeking membership. Trading partners from further afield may also choose to link their currencies to the euro, to reduce the risk of exchange rate volatility damaging their own commercial interests.

The euro states, speaking with a single voice, will have a powerful voice within the World Trade Organisation. They will be able to use their leverage to open the markets of third countries to trade and investment, and to bring new areas of business activity—including services and intellectual property—within the scope of multilateral agreement.

The ability to influence and shape the trading environment, using the collective authority embodied in the euro, is a priceless commodity. Britain's history, skills and strengths would give it a major part in shaping the role of EMU in the world economy—just as it helped to shape the development of the Bretton Woods settlement fifty years ago. British companies have much to gain from participation in the process—but equally much to lose if, in our absence, the environment is shaped in ways that do not suit us.

The illusion of national sovereignty

Unfortunately, the fact that British interests and jobs are at stake has not discouraged serious commentators from arguing that our goal, and our route to prosperity, should be—whatever happens in continental Europe—the preservation of independence and sovereignty. But I regard this romantic view of the world as misguided and dangerous.

Of course there is an alternative to EMU. Britain can choose to stand aloof, and to allow those who do join to integrate at their own pace. The end result, however, is unlikely to be anything which could truly be described as an independent Britain. A country which accounts for just 5 per cent of world trade cannot remain immune from the dynamics of the surrounding markets. Sovereignty is not a concept familiar to the modern international financial markets.

The logic of Britain's trade patterns would suggest that sterling should stick closely to a particular value of the euro, adjusting its interest rates as and when necessary. But the British might find it unacceptable to pay the full cost of shadowing the euro, which would probably involve higher interest rates, when it was denied the benefits of participation, such as, in crises, the support of the European Central Bank.

So a British government might, as an alternative, try to link sterling to the currency of our other major trading partner, America. Sterling would become a quasi member of the dollar zone, on a par with those of Argentina, Chile or the Philippines.

But this too could become uncomfortable. British trade with the United States is valuable and deserves to be developed. But the bulk of Britain's commerce and investment lie elsewhere and, since the value of the dollar is often affected by America's short-term domestic policy needs, a dollar link could disrupt our own trade. As the "Argentina" of the Eastern Atlantic our influence on American policies would be minimal, whatever the strength of the special relationship.

Just as sovereignty is unattainable in the world financial system, so it is undesirable in the global economy that is emerging. Having lost the economic power which went with imperial authority, we have learnt, gradually and painfully over the last 50 years, that our trading position in the world depends on the willingness of others to do business with us. The central fact of the modern economy is choice—with few markets remaining closed or protected. Trade is no longer about selling the goods and services which we want to produce. It is much more about supplying what others want to buy in conditions of intensive competition.

I believe that Britain can compete in this environment, but not if we cut ourselves off or seek success in isolation. We need to work with others—adapting to changing markets, influencing trading patterns and positioning ourselves to meet the needs of customers and partners.

Europe is the ideal base from which British firms can develop this combination of competitiveness and co-operation. Europe offers us a vastly expanded home market and the discipline of sound financial management. And as partners, European firms offer skills and a wide diversity of experience.

The argument for membership of EMU is therefore positive rather than negative. It is not just a matter of there being no alternative and of Britain backing in against its will. As members we would be active participants in a currency grouping which will have great influence in the world. Much trade, including that with non-EU countries, may eventually be denominated in euros. Britain has the experience and skills to be at the heart of that process. Just as we helped to shape NATO, one of the most successful examples of pooled sovereignty, so we can help to shape the European monetary system. We need a Europe which is not centralised but which rejoices in diversity and draws strength from the combination of historic cultures; a Europe which is open to the world and a force through which trade can help to spread prosperity across the planet.

Above all, as members of a monetary union, we would have the opportunity to rebuild our competitive strength, to hone our confidence and to enter the next century with optimism grounded in reality—rather than in an uncertain mood steeped in nostalgia.

Why Britain must wait for the euro
Alison Cottrell

When the first retrospective of Britain's 20th century relationship with Europe rolls off the millennium presses, it will be difficult to better the title which could have been supplied by one of Britain's most celebrated leaders. "Europe is not one of us", the lady might have said. And if this sense of detachment has been of immense value to a European Union with a weakness for introspection and abstraction, the accompanying assumption of superiority has on occasion been rather less attractive.

Rarely has the Channel seemed wider than in the debate over EMU. The economic arguments for and against have been rehearsed by many, and listened to by rather fewer. The most honest conclusion may be that on economic grounds, the case for British participation is, at best, finely balanced. Certainly, most definitions of an "optimal currency area" (ie, a zone of open and diversified economies, flexible wages and prices, and mobile factors of production) do not lend themselves easily to even a narrow EMU; but then America might find it difficult to prize itself off the single currency drawing board under such criteria. Britain's dilemma, however, is at once more acute, less academic and more practical; that of choosing, not between a currency union and no currency union, but between membership of a single currency area, and living next door to that (ever more integrated) single currency area. Neither is overwhelmingly appealing. Retaining the status quo is not an option. As with old age, EMU's appeal rises sharply once you consider the alternatives.

Given the alternatives, it is easy to see why Germany and France have, in the 1990s, stuck to the goal of monetary union. Quite apart from any ideological "carrots", the "stick" of a collapsing timetable has been big enough to keep any little Euro-donkey trotting forward. Governments fear the loss of credibility by the entire political establishment; generalised policy confusion; a surging D-mark knee-capping a fragile German, and hence European, recovery; and, for non-German central banks, another decade of playing follow-the-Bundesbank.

For Britain, however, the "alternative" is less clear-cut, in that EMU entails an almost unique loss of "sovereignty"—and in this, the Eurosceptics have had the more honest case. With the European Exchange Rate Mechanism and its "anchor currency" abolished, jurisdiction over exchange rates or interest rates would be redistributed among EMU members en masse, courtesy of a German government uncomfortable with German policy hegemony in Europe (and not itself possessed of any direct jurisdiction over monetary policy to begin with). For the British government, by contrast, EMU would mean the loss of monetary powers which it has been unwilling to hand over, even to a national central-bank board of its own appointees.

Recognition of Britain's special situation requires no judgement as to the merits of independent central banks *per se*. Just as a single currency is not an end in itself, but a means to a "better" economic life—a consideration all too often forgotten in the heat of the debate—so independence is of value only insofar as it produces "better" policy. Certainly, adopting a Bundesbank-style constitution would guarantee German-style stability, provided that it is reinforced by German-style political, regional, industrial and financial characteristics, and by the implanting in the electorate's not-too-distant memory of the unpleasant consequences of extreme instability.

The British economy's sensitivity to short-term interest rates; its trade patterns; its labour markets: these and many other "unique" attributes have launched a thousand Eurosceptic editorials. But none of these characteristics are set in stone, and none, over time, are insuperable barriers to EMU. The issue of sovereignty, however, is clearly a different matter. It cannot be circumvented, but can be confronted from at least three directions: first, the practical implications of retaining or losing monetary sovereignty if EMU goes ahead; second, the extent to which sovereignty in other areas is affected; and, finally, whether national sovereignty itself is in the "right" hands to begin with.

The limits to sovereignty

For a country living in the shadow of a core EMU, the practical benefits of retaining monetary jurisdiction—often expressed as the "right to

devalue", which speaks volumes for British postwar policy—are likely to be small and diminishing. Assume, however unlikely this may seem, that there is no long-term decline in the competitiveness of the British economy of the sort which, according to some, is a justification for exchange-rate flexibility. If the pound were to stick close to a strong euro, Britain would, by definition, be pursuing similarly credible fiscal and monetary policies. But it would lack any direct input into the policies of the European Central Bank (ECB), whose stance might therefore be less "friendly" to the short-term interest rate-sensitive Britain. If the pound were to appreciate against the euro, this would be a mixed blessing for a government only too aware that exporters vote and that financial markets do not—at least not directly. Furthermore, a strengthening currency in an unprotected market is an explosive social mix, as French truck drivers have shown. And if the pound were to weaken against the euro? In a Europe still suffering from high unemployment, only the most naïve would expect to avoid a protectionist backlash—whatever the single market "rules".

The euro is most likely, on balance, to soften after a strong start. Given the political impetus necessary to propel EMU into flight and the anxiety of the new ECB to establish tough credentials, the euro-baby will emerge fighting. But its strength will evaporate the instant that a heterogeneous ECB board, faced with unreliable data, hesitates to tighten monetary policy, and/or as disputes surface between governments over exchange rate policy. From the banks of the Seine, the exchange rate is a useful policy tool; from the Rhine, it is a reflection of policy credibility. Any disagreement over the euro's value, however resolved, would undermine the currency. Light at the end of the tunnel, perhaps, for continental Europe's unemployed; but an unenviable conundrum (in the shape of a strong pound) for a Britain on the fringe.

The notion that a counterbalance to "Europe" might come from hands stretched across the Atlantic, or even from membership of NAFTA, would be amusing were it not taken seriously by some. Few relationships remain "special" for decades; none remains static. For simplicity of foreign policy, America would rather deal with a British-influenced EU, than with the EU and UK separately. Old-country loyalty to a wartime sweetheart wins few brownie points in present-day Washington.

Nor, in all probability, would a decision to remain outside EMU be popular with private sector investors—though it would be interesting to discover just how long the English language and a plethora of golf courses could sustain inward investment without liberal recourse to fiscal incentives. It is not enough to list the many, and powerful, merits of the present, competitive Britain. Nothing stays the same; least of all, the continental social model. Demographics and technology will do more to push continental Europe towards deregulation, competition and private-sector participation in areas (from pensions to policing) that were previously the prerogative of governments, than any number of White Papers from the European Commission.

If the practical benefits of retaining monetary jurisdiction are less than overwhelming, to what extent might its loss be the thin end of the wedge, with sovereignty in other areas subsequently gravitating to Brussels? Here, again, the Eurosceptics have the more "honest" argument. EMU does not entail the integration of fiscal, defence, social or environmental policy; but it tilts the balance in that direction. It is certainly possible to agree to live together without sharing a kitchen or a hallway; realistically, however, such demarcation of living space is unlikely to persist.

Only in Britain, however, would "federal centralism" not be a contradiction in terms. British concerns over a looming super-state appear outdated in a Europe where the trend is towards national fragmentation rather than continental consolidation. A Brussels-based plot might even be comforting, insofar as it revealed the existence of at least some sort of "game plan". As it is, however, most route maps towards European integration were drawn up at a time when Yugoslavia was united and Germany was not, and few of those now involved claim to have any sense of direction.

The institutions of the EU, already under strain and falling short on efficiency and accountability, may be able to bend to the demands of an enlarged EU. It is, however, unlikely that they can be so flexible as to accommodate for ever the conflicting requirements of EMU "ins", "pre-ins", and "adamantly-outs". Viewed as a rapacious eater of sovereignty, "Brussels" is a paper tiger.

EMU involves more than monetary sovereignty; but the sovereignty issue itself goes far beyond EMU, and to stand aside from the latter does not

stop the clock. Pressures other than EMU, such as the necessity for defence to be organised multinationally, are pushing the power of the nation-state both upwards and downwards. National sovereignty is no more stable than national currencies: and is that national sovereignty not, perhaps, better described in some cases as English, or Westminster, or even cabinet sovereignty? From some regions of Britain, Brussels can appear less remote than Westminster, and the currency "policy" set by Westminster as uncongenial as any dictated by a Frankfurt-based bank.

Reasons for caution

Should Britain take EMU seriously? Absolutely. To ignore the "vision thing" in European politics (as the British are prone to do) is as reprehensible as overlooking the practicalities (which the British rarely do). So should Britain seek rapid entry into EMU? Absolutely not—and not because of the likely membership of EMU, the degree of convergence, or the start-date.

The reason lies not with "Europe", but with a Britain in which half the political establishment finds its finest hour in recounting a narrow escape from a forced Euro-marriage, while the other half looks coyly at the ground and prays not to be asked to dance. The absence of a uniformly pro-European political mainstream does not render Britain unique, though it does put it in highly select company; few countries, however, combine this lack of enthusiasm with a first-past-the-post, two-party system in which incoming governments can execute policy U-turns on a scale that coalitions elsewhere can only dream about. While economic differences between basically convergent countries en route to EMU could—at a cost—be overcome, signs of a lack of political commitment would be fatal, especially during the transition period to full EMU, when national currencies are still in circulation. Unless and until all parties are committed to EMU—and it would take more than a narrow victory at a referendum to achieve that—British membership would be too risky for Britain and for its neighbours.

The stability and growth pact, agreed in Dublin in December 1996, testifies to the central importance of this political commitment. That the "automaticity" of fines has been the most contentious point is understandable; even the narrowest degree of discretion virtually guarantees that, in practice, sanctions will never be applied. Why?

Firstly—and even if the data are judged reliable—it is unlikely that only one country would "offend" at any one time. More likely, several countries would be knocked off balance by the same external shock; in which case, it is difficult to envisage a qualified majority agreeing to a spot of mutual handcuffing. Secondly, democracy muddies the picture once again (an EMU of dictatorships would have got off the ground years ago!). Would fines really be levied on a government six months before an election, prompting anti-Brussels accusations of political interference? Or just after an election, on a brand new team of ministers? Or on a shaky administration with a less palatable replacement waiting to seize its chance? Unlikely; and, as details of the stability pact have emerged, central banks have seen instantly that it has all the makings of a complete non-runner. Given the lack of long-term fiscal safeguards, the priority of the monetary bouncers has become that of ring-fencing the club and keeping "unknowns" off the premises—at least, until the enterprise is firmly on its feet.

In this they are helped by the opaque nature of the entry requirements themselves. The Maastricht convergence criteria are neither necessary nor sufficient; stability and sustainability are the key (and subjective) qualifications. A fiscal crash diet is not enough; central bankers are not paid to take politicians' promises at face value, and demand instead a track record of years of sensible eating. This does not mean that the stability pact itself is an irrelevancy. Rather like a mediaeval hell, it has to exist; there just doesn't have to be anyone in it. It functions, instead, as a litmus test in the here-and-now of fiscal correctness; a party card, a confirmation of commitment.

Where EMU is concerned, if the political spirit is weak, the willingness of the economic flesh is irrelevant; and while there might be rejoicing in the shires at an EMU brought crashing down by a British parliamentary change of heart, the damage done to the European economy would render this the ultimate exercise in self-mutilation.

Where does this leave a British administration anxious to avoid self-imposed irrelevancy? We can assume that a government troubled by such concerns would not be Conservative. A Labour government in the late 1990s would, however, have more than enough referendums to be going on with, without calling one on EMU that it might actually lose. It may

not be until a party campaigns on—and wins—an election on a pro-EMU ticket, that a British government feels sufficiently secure to hold a referendum on the subject. This pushes EMU—at soonest—to the parliament after next.

Much must be done, however, in the interim—whatever the outcome of the EMU question—to change a state of mind in which "Europe" is presumed guilty until proved innocent. This task may be easier for a party which is not so inclined to view the redistribution of power—whether between national and regional governments, or between international and national bodies—as a zero-sum game; and which shares as many (if not more) characteristics with continental Christian Democratic parties as with its traditional Socialist allies. Furthermore, re-entering the Exchange Rate Mechanism should not be ruled out as a rare chance to put "clear red water" between a new government and its predecessor, especially ahead of Britain's EU presidency in the first half of 1998. A 15 per cent ERM band would scarcely constitute a resignation issue for a minister who had waited almost two decades to tuck his or her toes under the cabinet table. Certainly, negotiations over an entry rate would be difficult; but, equally certainly, the decision would also elicit much "goodwill" from European colleagues.

Britain has much to contribute and much to gain; it would be as absurd to underestimate the bargaining strength of a "prodigal" Britain inside Europe, as to overestimate its power outside it. The role of devil's advocate is an honourable one, and tailor-made to Britain's talents; but it is only open to an "insider". What must not be lost sight of is that the subject under discussion is far more than first-wave EMU. Whether the euro runs on time matters less than how Britain resolves where it stands in relation to a Europe that is redefining itself as it enlarges. It will require more than some Euro-friendly packaging from New Labour in order to meet that challenge.

The view from Brussels
Chris Boyd

Before considering the costs of EMU, both apparent and real, consider the huge benefits that it would bring to the European and to the British economy.[1] The main economic bonus would come from improving the single market, which would function better thanks to lower transactions costs for traders, investors and travellers; to the removal of currency risk; and to greater transparency of prices. Increased competition would lead to more efficiency, greater choice and lower prices. It would help to give European firms a larger home market from which they can compete globally.

[1] *The views contained in this essay are the author's own and do not necessarily reflect those of the European Commission*

I believe that EMU will affect cross-border investment and savings even more than trade in goods and services. This is because currency risk, which will disappear, is a more important factor in long-term investment decisions than in trading. Thus EMU could have a substantial impact on the structure of Europe's economy.

On top of these direct economic benefits, one somewhat neglected effect is that the euro could become a major reserve currency on a par with the dollar. Doubtless this would be a gradual process. But there are reasons to expect a trend in this direction. First, European central banks will have very high reserves relative to the volume of foreign—ie extra-euro area—trade. Second, once their holdings of European currencies are converted into euros, dollars will form a much larger proportion of their foreign currency holdings, and they may well consider themselves overweight in dollars. Thus they will tend to sell dollars and diversify, reducing the reserve role of the dollar.

More important will be the effect of the arrival of a stability-oriented currency, with broad and deep markets, on other central banks and international investors. The euro will become the European pole of the global monetary system. Central banks and investors have previously held back from using European currencies because markets were narrow compared to the dollar, because relatively little trade was denominated in them and because some European central banks discouraged international holdings of their currencies. All three reasons are likely to disappear after EMU.

The creation of the euro zone will significantly broaden the markets for financial assets in Europe, as the old currency divisions between them disappear. There will also be pressures to standardise securities based on debt, such as government bonds, so that investors can happily substitute, say, German government bonds with French ones. This will gradually deepen the euro markets, permitting the development of new sorts of security. This, in turn, should boost central banks' holdings of euro reserves: adequate liquidity is an important criterion in choosing one currency over another.

In the years after EMU, the euro's share of world trade should grow. If the euro area came to comprise all of the EU it would then account for some 19 per cent of world trade, compared to 17 per cent for America and 10 per cent for Japan. At present the share of world trade that is denominated in D-marks is about 50 per cent higher than Germany's own share. If one makes the modest assumption that the euro's share of world trade would be 50 per cent higher than that of its member nations, 30 per cent of world exports would be billed in euros. That compares with the 48 per cent of world exports that is today denominated in dollars.

Similarly, the use of the euro as an investment currency could be substantial. If all the financial assets held in EU currencies were converted into euros tomorrow, 37 per cent of the world's privately held financial assets would be euro-denominated, compared to the 40 per cent now denominated in dollars.

The attitude of the European Cental Bank (ECB) toward establishing an international role for the euro could be significant, especially for other central banks. The Bundesbank has never been enthusiastic about a reserve role for the D-mark—though the currency has in any case become more widely used. The ECB may take a more benign attitude, implying, once again, an enhanced reserve status for the euro.

If the euro becomes a major reserve currency, the EU would gain the kinds of practical benefits that America has enjoyed. First, movements in the dollar would not create intra-European distortions such as the upward pressure on the D-mark which followed the 1994-95 Mexican crisis. Second, Europe would be in a stronger position to defend its interests in the arena of international monetary co-ordination, which has generally been dominated by America. Finally, there would be the "seigniorage" benefits of increased holdings of euros: that countries held more euro debt would cheapen the cost of borrowing in euros, while central banks would boost their profits by printing more euros.

Of course, EMU will also have political consequences, similar to those envisioned by the European Union's founders. Namely, that economic interdependence will reduce political conflict and advance the emergence of shared political interests. EMU will reinforce the trend in favour of rediscovering, at the European level, the room for policy manoeuvre that has been fast disappearing at a national level.

The costs of EMU, real and imagined

If the gains of EMU are relatively clear, if not very tangible, what are the costs of losing the exchange rate as an independent instrument of national policy? Several of the supposed disadvantages of EMU have little foundation in reality. Take, for instance, the loss of the exchange rate as an instrument of national monetary policy. Many of those who want to keep control of national monetary policy seem to believe that lower interest rates or devaluation would solve the problem of unemployment. Yet the lessons of the 1970s and early 1980s are just the opposite. Germany, with its high interest rates and hard currency policy, came off best from the two oil shocks. Britain's and France's attempts to devalue their way out of trouble did not work. In many ways the EMU project is a reaction to those kinds of damaging currency upheavals.

Or take the old canard that the Maastricht convergence criteria are deflationary. The criteria are based on the generally agreed principle that EMU requires broadly convergent national economic performances. Otherwise the shock of a divergent country joining the currency union could cause great hardship in that country—and even destabilise the union as a whole. It is therefore reasonable to set economic conditions for membership. In fact, there is little disagreement on the need for a country's inflation rate, its long-term interest rates and its exchange rate to demonstrate that it can thrive in a low-inflation environment.

More controversial are the criteria designed to ensure that every country joining EMU has a sustainable budget policy. The method used to set the criteria was not arbitrary. A little mathematics shows that a country with a 3 per cent deficit and a debt of 60 per cent of GDP will have a stable debt-to-GDP ratio in an economy with steady 2 per cent inflation and 3 per cent real growth. Assuming those levels of inflation and growth, deficits larger than the Maastricht reference value of 3 per cent of GDP would be unsustainable over the long term: the stock of public debt as a share of GDP would rise. This, in turn, would pretty much rule out using fiscal policy to counter recessions. Thus aiming to meet the budget criteria over the medium term is a matter of economic common sense.

Then there are other critics who say that the Maastricht budget criteria are too inflexible, and that they ignore the real economy. However, the budgetary criteria are more flexible than is commonly believed. Indeed, the treaty explicitly allows for a degree of flexibility of interpretation. The "reference values" for both public debt and borrowing are just that, and are not cast in stone.

According to the treaty, if the debt or deficit reference values are exceeded, or risk being so, the commission has to prepare a report on whether a particular member-state has an excessive deficit. In its report, the commission is obliged to "take into account whether the government deficit exceeds government investment expenditure, and take into account all other relevant factors, including the medium-term economic and budgetary position of the member-state." This allows the commission considerable freedom of manoeuvre, so that it can, for instance, take into account a government's future pension liabilities, its particular accounting practices and its spending on infrastructure.

The treaty also provides for the possibility of cyclical downturns and external shocks. The budget deficit criterion specifically allows for "exceptional and temporary" excesses beyond 3 per cent , "provided it remains close to the reference value". Thus in a recession governments can let their budgetary policies have a stabilising effect on the economy. Similarly, the pact on growth and stability (agreed in Dublin in December

1996), an attempt to flesh out the Maastricht treaty's provisions for the guidance of national fiscal policies post-EMU, allows for flexibility over the economic cycle.

Critics often claim that the experience of the early 1990s shows that EMU would be a mistake. While it is always hazardous to rerun history, I believe that the lessons are less straightforward. German reunification, it is said, was a real shock affecting one country, which EMU could not have handled. What, though, would have happened if EMU had already existed at that time? For start, interest rates in countries which were then members of the Exchange Rate Mechanism (ERM) would not have risen as far as they did. This is because, in a monetary union, interest rates would be set according to economic conditions across the euro-area, and not simply those in Germany. With lower interest rates in Germany, the Bonn government, rather than initially refusing to raise taxes, might have raised them earlier, so that it could meet the Maastricht criteria (Germany would have had an excessive deficit in 1991). This might have prevented the public deficit from expanding and the West German economy from overheating. The outcome could well have been better, both for the rest of the EU (which ended up paying for German unity with higher interest rates and, ultimately, a full-blown German recession) and for Germany itself.

Britain's exit from the ERM is another favourite of EMU's critics. But this was the result of sterling entering at too high a level, and the government's refusal to devalue in time to prevent a crisis. What would have happened if Britain had been in EMU? Interest rates would not have been as high as they were when sterling was being kept, at an overvalued rate, within the mechanism, although they would probably still have been higher than conditions in Britain merited. However the British recession of the early 1990s would probably have been less profound: for, in a more stable monetary environment, the economy would probably not have been allowed to overheat as it did in the late 1980s.

I am not suggesting that joining Economic and Monetary Union would have no costs. Inside a monetary union, not being able to devalue in the face of economic shocks or temporary imbalances could have disadvantages. For instance, if a shock caused regional unemployment, divisive arguments over the appropriate monetary policy could emerge.

Such tensions are already visible within individual countries, but they, at least, automatically transfer resources from rich areas to poor ones, through the fiscal and social security systems. These are instruments that the EU as a whole does not possess.

But having accepted the possibility of real and perhaps damaging economic shocks within a monetary union, the crucial question remains this: are national exchange rates an appropriate instrument for dealing with such shocks? I would argue they are not. First, such shocks will be increasingly likely to affect sectors rather than whole countries. But second, and more important, the experience of the 1970s and 1980s has shown that devaluation hides rather than cures a country's economic problems. Indeed, often it will make them worse by causing inflation.

Devaluation, which increases the cost of foreign goods compared to domestic ones, can work only if matched by other policies such as wage restraint or efforts to increase productivity. It works only insofar as workers demand wage rises of less than the rise in inflation. That is roughly what happened after sterling's devaluation in 1992: unemployment was so high (10 per cent) that workers did not demand compensatory wage rises. Generally, however, people understand that devaluation curbs their purchasing power and insist on matching wage rises, fuelling inflation.

In normal circumstances devaluation is not a wise policy. But it can work in certain, rare cases. Furthermore, many see it as a policy of last resort at times of drastic economic imbalance—a kind of final safety valve. Support for EMU thus implies a judgement about whether the benefits of EMU outweigh the costs of giving up this last-ditch policy insurance. My view is that the benefits of EMU are worth these costs. But as a corollary, it is clear that more emphasis must be placed on the other tools of economic policy—the public sector budget, and employment and structural policies—to see off potential economic imbalances before they require drastic measures.

The question of Britain

EMU should be an objective for every member-state. But if it is to succeed the countries which join must be ready, economically and politically. They must satisfy the Maastricht convergence criteria, which should be seen as reference values in line with basic economic common sense. It is becoming clear that a majority of EU members has a chance of being ready for EMU by 1999. Many of them are in the hard core of the ERM and will not find it difficult to give up the right to devalue.

But Britain is different. Low inflation is a novelty and its exchange rate still fluctuates wildly. Its interest rates carry a large risk premium. The public deficit remains higher than most of the ERM hard core, in spite of the more favourable cyclical position. On the other hand, Britain does have flexible labour markets. Thus it is less likely than many countries to suffer from such a grave crisis—say very high unemployment and soaring inflation—that a drastic remedy such as a major devaluation would be called for. But on balance Britain still has to work at converging with the EMU hard core and at preparing its economy for EMU.

Just as important for EMU will be countries' political readiness for entry. EMU will not work in the face of popular hostility. If Britain is not yet politically ready for the single currency, there is a case for it waiting and seeing how the project develops. It will be much easier to persuade sceptical opinion of EMU's merits when it has been shown to work. Then there would be two strong arguments, one economic and one political, in favour of British entry:

* Interest rates, both nominal and real, will probably be substantially lower for the euro than for sterling, other than in exceptional circumstances. Should British industry and investment be penalised relative to competitors in EMU? The answer is No.

* British influence is likely to decline in the EU if it is perceived to be semi-detached—and even more so if this detachment looks set to last. Can Britain afford this? Again, No.

Would these arguments be sufficient to persuade the British people to favour joining EMU in a referendum? I believe that the answer is Yes—and that this could come well before the arrival of euro notes and coins in 2002.

How to make a success of monetary union

Niall FitzGerald

The nature of the British debate on the single currency is in danger of obscuring the underlying realities that should determine the government's policy on EMU. I want to go back to first principles and, in doing so, show that the option of ruling out British participation is tactically naive, and that it could seriously damage British business and the national economic interest.

The first thing to get clear is that it is still probable that Economic and Monetary Union will proceed in some shape or form. Despite continuing economic uncertainties, it is likely that at least five (and possibly seven or eight) EU member-states will participate in the first wave. The starting date of January 1st, 1999 still seems likely at the point of writing. However, the eventual nature of EMU—who it includes and on what terms—is less clear. And the long-term success of the project is not something we can take for granted, though I firmly believe it to be vital to the prosperity of the European Union and its citizens. It must be worked at and Britain should play a constructive part in that process. I remain confident that success can be achieved, but it will require supreme statesmanship from Europe's leaders to get the single currency right.

The British government's policy of "wait and see" can be interpreted constructively. Of course, only the precise terms of entry will allow us to make a final judgement on the merits of joining, but that point should not preclude a determination to join if conditions are right. "Wait and see" must not become a smokescreen for a drift towards the point at which options for Britain are effectively closed off, with the result that Britain cannot influence the development of the euro. Such an outcome would run counter to Britain's national interest as well as the interests of Europe as a whole. It is crucial that our politicians remind us of the economic reasons for pursuing EMU. A single currency is the inevitable and logical consequence of the single market. It is less a grandiose political ideal than a practical idea aimed at ensuring stability and therefore prosperity. The single currency could bring great benefits, but only if Europe gets it right.

The dangers of haste

In common with the vast majority of European business people, my long-term ambition is for EMU to be both comprehensive in membership and successful in operation. However, in the early years these imperatives may pull against each other. That is why the EU must proceed with the right mixture of caution and determination.

The economic case for a single currency is strong. It will facilitate the coherent functioning of the single market—the EU's foremost achievement to date—which can never be truly complete so long as currency risks are liable to hamper internal trade and affect cross-border investment. Eliminating this barrier is the next logical step in the ongoing process of economic integration.

The single currency would mean much more than a marginal saving on transaction costs. Exchange rate stability would have a long-term dynamic effect on the European economy. If it is soundly based and well-managed, EMU would promote lower interest rates and sustainably low inflation. That prospect, particularly in Britain, where the post-war inflation record has been so dismal, should be attractive in itself. The rapid movement of international capital from high inflation countries towards those with proven low inflation is a well-established phenomenon.

Sustainably low inflation would contribute to enhanced business confidence, heightened investment, lasting growth and greater competitiveness. When prices are denominated in the same currency throughout a market of 370 million people, and the relative performance of companies is judged against the same objective standard, the uncompetitive will be deprived of excuses. For anyone who believes in the potential of a dynamic market economy to deliver higher living standards, the prospect is truly exciting.

However, strong commitment to the principle should not make anyone oblivious to the practical problems. The main difficulty is that political

pressure to deliver something on January 1st 1999 may prevail over sober economic analysis and ultimately endanger EMU's success. If it is to work, monetary union must be introduced at the right time, under the right circumstances and with the right initial participants. If these conditions are not properly met the euro will face significant dangers.

The challenge of getting the single currency right may be the most supreme test of statesmanship that European leaders have had to face since the foundations of the EU were laid in the 1950s. The worst outcome would be a rushed or mismanaged EMU, loaded from its inception with potentially unsustainable pressures—such as those arising from widely divergent rates of inflation or unemployment—that could ultimately tear it apart. While the so-called sceptics might delight at this outcome, the demise of EMU would damage the economies of every participant, as well as those outside which depend on the health and prosperity of the single market.

Unilever, like any other European business, has benefited greatly from the single market and the operational coherence that the removal of trade barriers has facilitated. Were the single market to be damaged by an EMU break-up, all European businesses and all European citizens would suffer an immense and permanent loss.

This doomsday scenario is certainly not my personal forecast of what is likely to happen. I have confidence in the collective wisdom of Europe's political leaders—whose successive generations over the past 40 years have so often put pragmatic judgement ahead of unrealistic vision. My only worries on this occasion are that too many national leaders may equate prudent postponement with abandonment of the single currency project for all time; or that they may opt for a political fudge on the grounds that an inclusive Europe is more comfortable than a small inner core where the sheep are very publicly separated from the goats.

With so much to gain from its success, but so much to lose from its failure, it is imperative that Europe's leaders are careful with the convergence criteria, realistic about deadlines and serious about the "stability and growth pact" (of which more below). Furthermore, they must do more to make labour markets flexible.

Convergence criteria and deadlines

The initial choice of countries is probably the most crucial determinant of the future success of the single currency. The Maastricht treaty's convergence criteria provide the basis for this choice, but they should not be interpreted mechanically. The treaty allows the heads of government to use their judgement in deciding which countries are ready for EMU. Indeed, it would be a mistake for Europe to consider only a single year of snapshot economic appearances—few suggest, for example, that Belgium should be excluded for its excessive debt or that Britain should be kept out because of its failure to rejoin the Exchange Rate Mechanism.

But I agree with the chief of the European Monetary Institute, Alexandre Lamfalussy, who said recently that deviations from the convergence criteria "should be granted sparingly". The one fundamental criterion that Europe cannot afford to fudge is the achievement of sustainably low inflation. Some member-states have been criticised for one-off taxes or for massaging the figures to meet the debt criteria. But a more important issue is whether aspiring EMU participants can demonstrate that they can sustain low inflation levels without letting the inevitable tensions, such as persistent high local rates of unemployment, jeopardise the continuation of monetary union.

Italy and Spain must demonstrate not just for twelve months, but for a period of years, that they can pursue the right policies for sustainably low inflation. Technically, they are guaranteed membership when they meet the Maastricht criteria, but they should first be required to prove that their recent display of fiscal responsibility is not just a short-term fix or a temporary phase. In the absence of such proof, states should not be included within the first wave. Initial membership must not be granted for reasons of European sentiment or for fear of damaging the national pride of non-qualifying countries. Countries not admitted to the first wave should be given firm targets for admission at a later date, to encourage their governments not to slip back into their old ways. Maintenance of prudent domestic policies should be clearly rewarded, but the underlying purpose of the Maastricht criteria, namely economic and exchange rate stability, should not be forgotten.

In 1989, the Delors Committee on EMU concluded that "the conditions for moving from stage to stage cannot be defined precisely in advance... The setting of explicit deadlines is therefore not advisable." This was an admirable recognition of the supremacy of economic convergence over political timetables, but it proved unrealistic. It is no doubt the case that, without a political timetable to honour, the momentum towards monetary union would have been lost. States like Spain and Italy would not have concentrated so intently on meeting the convergence criteria, without the discipline of the Maastricht treaty's timetable.

But it must also be accepted that monetary union involves targets and conditions more important than any calendar. A pursuit of EMU that is a race against time runs the risk of leaving vital issues unresolved. If monetary union is to work, it must be seen as irrevocable. Europe's leaders owe it to future generations to stick to economic fundamentals rather than to political timetables.

Some say that any postponement of the single currency would inevitably lead to its terminal decline. The president of the European Commission recently stated that "if we postpone the date in 1999, we risk a delay for a generation." I disagree with this pessimistic viewpoint. Monetary union is not so fragile a project. If it is necessary, Europe should not shrink from adjusting the timetable. Such an adjustment should be interpreted not as a sign of weakness but as a genuine commitment to the success of monetary union. One way forward could be for a small group of countries to go ahead in 1999, with others committing to join over the following two or three years. Such a phased completion of the first wave would allow countries to make a firm commitment to join, but within a more flexible framework than envisaged at present.

The stability pact and labour markets

At the Dublin summit of December 1996, EU leaders agreed on a stability and growth pact that sets down rules on budgetary discipline for those in the monetary union. The pact also gives EU finance ministers the possibility of fining governments which run "excessive deficits". This agreement is to be welcomed, for it shows the EU leaders' continuing commitment to economic convergence. If properly enforced, the pact should help Europe to avoid boom and bust economic cycles. Arguments over the nature and level of the fines are bound to persist, but it will be much easier to be indulgent over fines if states admitted to the first wave have already achieved fundamental economic convergence.

The stability and growth pact is good for Britain whether it is inside or outside monetary union: the success of the British economy is intricately linked with the success of European economies, so any agreement that minimises the chance of instability—caused, for instance, by one country suddenly hiking up its budget deficit—is welcome. The pact should lead to a soundly based single currency and provide Britain with a stable euro zone to be part of or to trade with.

With or without a single currency, the European Union needs more flexible labour markets if it is to remain competitive. But the imminence of monetary union makes the need for this even greater. A single currency zone that consists of states at widely different stages of development, but which cannot devalue, will not work without labour market flexibility.

Regional disparities are a fact—and one that will become even more evident when the European Union is enlarged. Markets must be allowed the freedom to respond to this reality. Any attempt to legislate for high pan-European social standards, before all EU members have achieved levels of productivity that can pay for them, will lead only to high regional unemployment. In the absence of labour market flexibility there would be strong pressure to ease the disparities with fiscal transfers. The political consequences of that—sceptics would jump at the chance of exploiting such difficulties, sowing the seeds of widespread disillusionment with EMU—would threaten the survival of the euro.

Thus making a success of EMU requires hard-headedness about who should join at the start, but not absolute rigidity in interpreting the Maastricht rules. It demands firmness of purpose about the goal, but not total inflexibility about timetables and deadlines. We are talking about finely balanced decisions: getting them right is the test of statesmanship facing European leaders.

Don't leave Britain's destiny to others

Britain's decision on whether to join monetary union will ultimately be political. On economic criteria, Britain is likely to qualify as a first wave participant. Some have argued that, whether or not it meets the headline convergence criteria, Britain's underlying "real" convergence is insufficient for it to join EMU successfully. This is, we are told, because Britain is less integrated into the European economy than most of our continental

partners; economic fundamentals may change in ways which impact on Britain differently from on our partners.

Labour market flexibility is a vital concern, but the argument that there is something unique about Britain's economic fundamentals has been greatly exaggerated. The states of the EU all have a broad economic base. They are much less specialised than those of the United States. No potential participant in EMU is as reliant on a single industry as Texas is on oil or Kansas is on agriculture. When economic fundamentals change, their impact is more likely to affect particular sectors or particular regions of Britain than the nation as a whole. Furthermore, Britain has lower wage costs and more flexible labour markets; it is internationally competitive and has relatively low unemployment. By these standards, Britain would actually have a comparative advantage within monetary union.

Rather than dwelling on external shocks and other illegitimate reasons for opting out of EMU, Britain should face economic realities.

First, if it remains outside EMU, it is likely that half of Britain's total trade will be with countries that are inside the single currency bloc. To be isolated from this venture would lead inevitably to greater isolation from the European core, and perhaps in time to gradual exclusion from the single market. There can be no complacency about Britain's long-term place in the single market if Britain turns its back on EMU.

Second, whether or not we participate, Britain's economy would be affected by monetary decisions taken within the euro zone. After all, Britain is currently affected by Bundesbank decisions, as it would be by interest rate changes of the ECB even if we were outside a single currency. Whether we like it or not, the concept of national economic sovereignty in the modern world has been rapidly eroded. Britain must therefore shape the nature of what will be an influential currency zone to suit British interests. It would be a mistake to abstain from the negotiations, only to later join an EMU designed by—and for—others.

Third, a Britain that voluntarily relegates itself to the EU's second economic division runs the risk of higher interest rates, higher inflation and diminished competitiveness. Future inward investment is far more likely to go to states which enjoy low interest rates and sustainably low inflation, and which can provide secure access to the euro zone.

For all these reasons, Britain should seek to play a leading role in getting the single currency right. It must do so with the intention of joining a monetary union that is launched on the right principles. Britain's attitude should not be merely to wait and see what our partners come up with, but rather to participate positively in the negotiations to build an EMU that is good for British interests. Britain is right to have concerns about rushed or fudged criteria, about ensuring sustainable convergence and about labour market flexibility. But these concerns will not be heeded unless they are presented in a helpful and positive way. Britain should be constructively critical, not stubbornly cynical.

The best way, indeed the only way for Britain to defend its economic self-interest is for it to take a central role in ensuring that the single currency is soundly based on practical economics: Britain should act as the guardian of EMU's integrity. Only by stressing our commitment will we be listened to, and thus able to shape an EMU that is in our interest.

Clearly, uncertainties persist over the nature of Europe's progress towards a single currency. But none of the caveats considered in this article should be regarded as a reason for Britain not to join EMU. They are not convenient excuses for political delay, but the legitimate concerns of an EMU supporter. The prize of a sustainable single currency must not be jeopardised by those whose scepticism is simply a thinly disguised Europhobia; nor by those whose enthusiasm for monetary union has led to a fixation with the deadline of January 1st, 1999.

The failure of much of the political establishment to give real leadership on Britain's participation is creating damaging uncertainties for British business. Industrialists have to explain that the success of EMU is crucial to Britain's future prosperity. We need to ensure that the single currency is set up properly and is sustainable—and that while keeping our options open we do not hold back in our commitment to the goal.

At last, a chance to make Britain a low-inflation country

Diane Coyle

The ultimate symbol of an economy's strength, and its very identity, is its currency. The debate on EMU in Britain has reminded us that no aspect of economic policy provokes greater passions. However, the national mythology of a currency—stamped with the heads of our sovereigns and heroes—can easily obscure a basic truth. Namely, that the exchange rate depends on the economy at least as much as the economy depends on the exchange rate.

The British debate has often overlooked this point, giving it a curiously Alice in Wonderland flavour. The discussion of the pros and cons of taking part in European monetary union has revolved mainly around the economic impact of losing the freedom to alter the exchange rate. To concentrate on this alone is the economics of the Mad Hatter's tea party, for the pound has had only one freedom during the last half century—the freedom to get smaller and smaller in value, because of both structural weaknesses in the British economy and failures of economic policy.

Those sceptical of monetary union ignore the possibility that exchanging the pound for the euro would help to correct those weaknesses and to avoid repeating those failures. They overlook the fact that inclusion in the single currency club could strengthen the British economy to the point where it would no longer—desperate as a junkie looking for the next fix—need to resort to a devaluation. Participation in a European monetary union would probably lead to substantial and beneficial changes in British economic performance.

The basic argument that EMU-sceptics advance against joining the single currency is that Britain's economy has a fundamentally different structure to those on the continent. They go on to say that the loss of an independent monetary policy could therefore have grave economic consequences.

In the past, for example, Britain's labour market has been far more likely than Germany's to amplify an inflationary shock into a general wage-price spiral. Higher average inflation in Britain has translated into a steady decline in the pound's nominal value against the D-mark, from DM9 20 years ago to around DM2.25-2.50 today. Despite the improvement in Britain's performance in recent years, its inflation rate has remained consistently above the EU average. Britain would fail to meet the inflation criterion set out in the Maastricht treaty if the decision were based on 1996 data. So there is no reason to believe that the long-term trend for sterling to fall in value has ended.

The pound's real, or inflation-adjusted, exchange rate against the D-mark has declined far less. With the exception of the period following the ERM crisis in September 1992, devaluation has turned out to have been mainly an inflationary phenomenon which has failed to deliver lasting improvements in competitiveness. Devaluation has proved as significant a cause of inflation—through the effect of higher import prices—as the more visible wage-price spiral.

The sceptics argue that, deprived of the chance to devalue, Britain could only cope with declining competitiveness by undergoing a recession. The result would be permanently high British unemployment. These critics of EMU argue that any country which could not react to specific economic problems with a tailor-made interest rate and exchange rate policy would have to adjust somehow, and that the real economy—unemployment and growth—would necessarily act as the buffer.

Eddie George, the Governor of the Bank of England, who has seemed increasingly sceptical about EMU, apparently had a sophisticated version of this argument in mind when he delivered a speech in May 1996. He said: "The risk is that macroeconomic imbalances become locked in—either because of inadequate economic convergence between the participating currencies at the outset or because of particular asymmetric shocks affecting particular participating countries after the single currency has come into being."

The result could be undesirable pressures for budget transfers between countries, for migration from high unemployment areas, or for protection against imports, he argued. Economic shocks will have

consequences somewhere if flexible exchange rates cannot soften them.

Conservative Eurosceptics have updated this tale to take in the fact that labour market deregulation has supposedly delivered a British economic miracle. The economy is booming and, thanks to liberal labour markets, this line goes, inflation is at its lowest for a generation. A single currency would spoil all this because changes in interest rates designed for the sclerotic continental majority would send the dynamic British economy into boom or bust.

Here too the Governor has offered some oblique words of support. He has strongly argued that if countries like France and Germany reform their labour markets, the pattern of real exchange rates that ought to prevail in Europe will be very different from the current configuration. It would be much easier to achieve this adjustment through changing nominal exchange rates, rather than altering wage levels. Thus Britain should hold back from a single currency until the continental economies have made these structural adjustments and become as flexible as Britain.

Others have embellished the argument by pointing to the greater dependence of Britain's housing market on variable rate mortgages, or to the greater reliance of its businesses on short-term bank loans. The British housing market is on the brink of another boom. As things stand, the government can control this by increasing base rates, but imagine how that boom would be fuelled if interest rates were being set by a European Central Bank with an eye to the sluggish French and German economies.

Hair shirts can be healthy

Although the current Governor of the Bank of England is professionally wary about British membership of EMU, one of his predecessors is firmly in favour. Lord Kingsdown's central argument is that the only thing a Governor of the Bank of England (or the British government) has any freedom to do is to be too lax about inflation. He can run a permanent "sterling fort" policy by joining the single currency; or he can devalue.

These are the two credible policy options. The in-between position that the British government claims it could accomplish—keeping the pound as strong as if it were bolted to the D-mark, but, just in case of a particular kind of economic shock, retaining the freedom to devalue—is not credible.

It boils down to the devaluation option. There is certainly more for a Governor of the Bank of England to do in that case, but he should not want to do it. (I am assuming, of course, that the European Central Bank will have an anti-inflationary culture closer to that of the Bundesbank than that of the Bank of Italy.)

The crucial problem for the British economy, in or out of EMU, is that it is still structured to both cope with and deliver inflation. This is why many home loans and bank loans carry variable rates of interest. And it is why real wages can more easily be lowered through devaluation and inflation than through lower growth of money wages. But suppose we were to ignore the problem and take the plunge. It is far more realistic to think that the economy's mechanisms for adjusting to shocks would change than to suppose that the economy would not adjust, causing permanent recession and high unemployment.

This is clear from the example of strong currency countries such as Germany and Japan. Although they have ruled out the option of devaluation as a means of adjustment for most of the post-war period, this has not damaged their wealth, level of exports or growth. On the contrary, the discipline of not being able to compete in overseas markets primarily on price has forced German and Japanese exporters to rely on improvements in products and quality. British companies have tended to go for the stack'em high and sell'em cheap end of export markets, encouraged by the predictable weakening of the pound. To be sure, Germany now suffers from high structural unemployment, but that is more due to labour market rigidities than the exchange rate (over-valued though it may be at present).

It is fashionable to argue that the franc fort has damaged French growth and employment. Yet it has been accompanied by strong gains in exports and a balance of payments surplus. The OECD judges that French joblessness is mainly due to underlying structural causes, such as the huge social charges that companies must pay for each person they employ, rather than monetary policy or the effect of a strong exchange rate on the competitiveness of French firms.

To put it in language that would go down well at the Bank of England, membership of EMU would, at a stroke, provide a credible monetary

policy regime. For Germany, with decades of accumulated monetary policy credibility, retaining the option of an occasional devaluation or revaluation might make sense. For Britain, it does not.

Make us good—but not just yet

Now, this does not answer all of the concerns raised by the more thoughtful EMU-sceptics such as Eddie George. In his speeches the Governor has argued that there might sometimes be a need for a change in one country's general price level, relative to another's, as a result of a specific economic shock (such as the discovery of North Sea oil or German reunification). And this would, the argument goes, be most easily achieved by an exchange rate change.

In theory, he is right. But in practice exchange rates overshoot—over-compensating for whatever adjustment is needed—with dire economic consequences. Think only of the over-valuation of sterling in 1981, due to the surge in North Sea oil production. In inflation-prone Britain, most depreciations of the exchange rate have knock-on effects that generate an inflationary spiral. The theoretical advantages of a flexible exchange rate are outweighed by the real life disadvantages.

As for the Governor's argument that EMU should wait until the continental economies have deregulated their labour markets and adjusted their exchange rates accordingly, it overlooks the political economy of the Maastricht process. European governments are using the need to meet the deadline for the single currency as a reason for introducing unpopular structural reforms. Is there any other argument as powerful for reducing social costs, deregulating labour markets, privatising companies or trimming costly and ineffective welfare programmes? Without suspecting a conspiracy amongst the governing elites to use EMU as an excuse for these measures, it is easy to see that without the over-riding need to get the single currency off the ground they would have much weaker motives for introducing them.

The structure of the European economies will converge as a result of their moving towards a common currency and common monetary policy. And there will be more "real" convergence after EMU comes into effect.

For Britain to stay out of the single currency would be for it to lose the chance of becoming a low-inflation country. It would remain a weak economy with a weak currency. Taking part in EMU would improve policy and performance enough to eliminate many of the strains that sceptics predict would emerge without the safety-valve of devaluation. They look at the British economy as it is, and do not imagine what it might be with a more disciplined policy framework.

Whether the British public and political classes care very much about low inflation is another matter. The signs are that it is a low priority. British inflation has not yet converged to the European level. It has not reached the 2.5 per cent target set by the government. Yet most commentators, including many in the City of London, do not think monetary policy ought to be tightened to improve the inflation performance, even with the economy clearly accelerating. The stage is set for another classic British inflation cycle, in 1997-98, of domestic boom, import surge and sterling depreciation. There appears to be little appetite outside the Bank of England for erring on the side of caution.

Perhaps, then, it should come as no surprise that there is little whole-hearted support for joining the single currency in the first wave. Perhaps Britain has too deep-seated a national preference for flashy consumerism and inflating out of trouble at the expense of long-term economic strength. For anybody who hopes that it might be otherwise, EMU offers the opportunity for Britain to have a currency that would help to deliver a strong economy, as well as an economy that would help to underpin a strong currency.

The danger of dithering
Martin Wolf

Britain shows symptoms of a nervous breakdown. It is not merely unable to make the choice that confronts it; it is unable to admit its existence.[1] As in the 1930s and again in the 1950s, the country would prefer not to think about the alternatives, in the hope they will go away. They will not.

[1] *This essay is based on two columns which appeared in the* Financial Times, *on October 1 and 8, 1996*

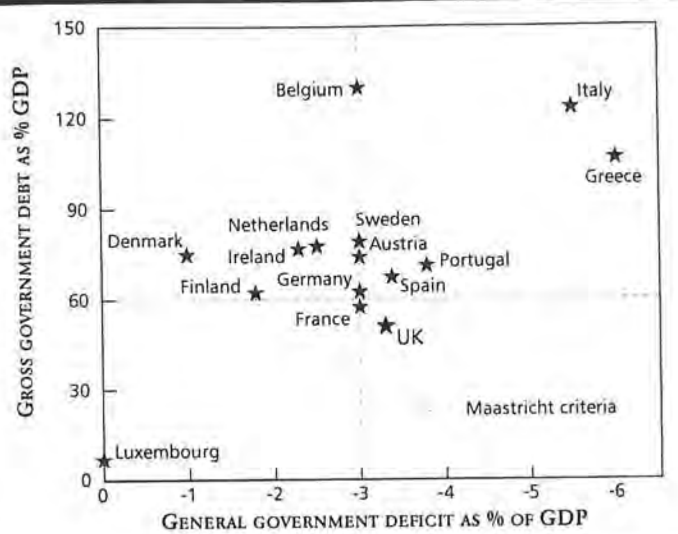
The choice facing Britain is about whether to join European monetary union when it begins, either in 1999 or shortly thereafter. Not only will EMU happen, but virtually every member of the European Union will join—if not immediately, then in a few years.

The two largest parties would like to ignore the choice altogether. But hopes that the move to EMU would be slowed by fear of division or that such division would put Britain at the head of a coalition of 'outs' are just sad delusions. All, or nearly all, shall win the euro prize. And not because they are all likely to pass the tests for membership of the single currency cleanly next year, but rather because so few of them will.

Even that paragon of virtue, Germany, will fail the strict test on indebtedness—that gross government debt should be 60 per cent or less of gross domestic product. It may run a general government fiscal deficit in excess of 3 per cent of GDP. As for France, it will pass the fiscal test only with the help of much creative accounting.

If member states were going to be strict, then virtually nobody would be in—not Austria, not the Netherlands, not France, not even Germany and certainly not Belgium. Only little Luxembourg would definitely be in. But that is not going to happen, given the determination of Helmut Kohl, the German chancellor, to achieve monetary union.

HOW MEMBER-STATES MATCH UP TO MAASTRICHT



IMF FORECAST FOR 1997

If all these countries are to be let in, then so, in all probability, are Finland, Ireland, Portugal, Spain and Sweden. Even Italy and Greece are beginning to make serious efforts. Maybe the last two will not be allowed in by 1999. But by 2001 they could have done enough to scrape a pass.

It would be impossible to keep Italy out if it failed only the indebtedness test, unless Belgium were also excluded. And if everyone bar Britain were in, would Denmark stay out? It has become too difficult to distinguish hard-currency sheep from soft-currency goats. So the choice is between monetary union for all or for nobody. The former is what the member-states will choose. Above all, it is what Germany will choose. If so, Britain alone cannot stop it.

Fog in the Channel—Britain cut off

But the financial markets have been far less cut off than the politicians. In the spring of 1995, Italian long-term interest rates were more than 5 percentage points higher than British ones. Today there is little or no gap between them: indeed, the Italian debt now often trades at a lower interest rate than British gilts.

Similar shifts have occurred in Spanish and Swedish bonds. German and French bond yields, previously one third of a point below the British, are now more than 1.5 points lower. French and German bonds are now equivalents.

Meanwhile, sterling securities have been downgraded. This has not happened only because the pound is expected to languish outside EMU. It must also be because of the clashes between the Chancellor and the Governor of the Bank of England over monetary policy; the Tory clamour for tax cuts; the slow pace of fiscal consolidation; and the rapid monetary growth. All these help persuade punters that Britain is back to its old ways. Who could say they are wrong?

So, monetary union will happen. And it will shortly include most member states. But this does not make it any less of a gamble. As Professor Rudi Dornbusch of the Massachusetts Institute of Technology noted in a recent article: "If exchange rates are abandoned as an economic tool, something else must take their place. Maastrict promoters have carefully avoided spelling out just what that might be. Competitive labour markets is the answer, but that is a dirty word in social-welfare Europe."[2]

[2] Foreign Affairs, *September/October 1996*

An optimist would argue that once they have eliminated the exchange rate, lowered inflation and started to tackle their fiscal problems, member-states will have to address their distorted labour markets. This pig might fly. Then again, it might not, in which case there would be trouble.

Conflicts will loom whenever some members suffer from greater structural or cyclical difficulties than others. Countries will fight over the freedom to use fiscal policy in response to cyclical disturbances—the proposed "stability pact" to set limits on government borrowing will ensure such arguments. And populist politicians will translate domestic difficulties into fierce campaigns against the European Central Bank.

EMU is indeed a gamble, but one that will be taken. The question is how Britain should respond. The immediate choice is simple: either the country tries to enter among the first participants or it decides not to do so. It is also urgent. If Britain is to join in 1999 it should rejoin the exchange rate mechanism in early 1997 and it must have legislated for an independent central bank by July 1997.

These steps need to be taken if the option is to be kept open. Otherwise Britain will have decided against early entry. Of the two requirements, the more important (and more desirable) is to establish an independent central bank—requiring legislation shortly after the next election.

Opponents of EMU argue that it must be resisted because it is part of a drift towards a European superstate under technocratic control. The charge has force. But how can one make it credible when the policy of both big parties in the general election that precedes this great decision, is not to have one: to be resolute only in being irresolute? This is not democracy. It is a betrayal of democracy. A choice needs to be made. To wait and see is not a choice. It is a refusal to choose when the nature of the decision is quite clear. This is, in truth, pathetic.

Nothing is likely to happen between today and 1998 or between today and the early years of the next millennium that will change the calculation significantly. The fundamental choice is the same. However much it dislikes the alternatives before it, Britain must decide. It must not cower in the hope that the choice will go away.

Sir Winston Churchill has often been invoked—by both sides—in such discussions. It is impossible to guess how he would have responded to the present choice. All we know is that he recognised the great issue of his own time: whether or not to confront Hitler's Germany.

Join for influence, not prosperity

Today's great issue is whether Britain ought to be inside EMU, or outside it, probably on its own. It will become a choice between having a voice within the governing arrangements of Europe and not having one. In time it will be between being inside the EU and being outside it.

So what should Britain do? Its first option is the one it is most likely to choose: wait and see. This is what Britain did in the 1950s. It waited, saw—and then joined late. A short-term approach would consist of waiting only to see how many countries joined and how soon. This would postpone the evil day. But it would reduce Britain's initial influence and

demonstrate its doubts about the wisdom of its neighbours, without giving it any obvious benefit from so doing.

A longer-term version would delay entry until it was obvious whether or not EMU would work. This would take not years but decades. Such a delay would become increasingly fraught. Britain would come under pressure to limit fluctuations of its exchange rate, it would be excluded from discussions of European monetary policy and it would face a growing shortage of allies on other issues.

Britain would, in short, be semi-detached. As the years of waiting for the time to become ripe rolled by, the impulse towards a complete break would become stronger on both sides. What would be the sense in remaining a member of a club whose pet project—monetary union—Britain rejected? Britain's nay-saying would be resented by other Europeans, their ambitions would be feared by Britain. The marriage would end in divorce.

Such a divorce from the EU would be the second option. Many assert that leaving would be suicide. That is nonsense, as is demonstrated by Brian Hindley, of the London School of Economics, and Martin Howe, a specialist in European Law.[3] Neo-mercantilist claptrap too often impairs analysis of the economic benefits of EU membership. Many assert, for example, that Europe needs a big market and a single currency to compete with America and Japan. Neither theory nor experience supports this: the world's highest incomes per head are enjoyed by America and Switzerland; and Singapore's 2.9 million are now richer than France's 57.9 million.

Since the quality of people and politics largely determine the wealth of nations, the EU can enrich Britain only to the extent that it affects one of these. In practice, conclude Messrs Hindley and Howe, the net economic benefits of EU membership are roughly zero, with the cost of the Common Agricultural Policy and the benefits of the abolition of internal trade barriers offsetting one another.

This implies that the judgement must be made on other grounds. There are three reasons for Britain to stay in. First, a Britain that prefers independence to close involvement with its neighbours would be parochial, if not narrowly chauvinist. Second, leaving the EU would

[3] *Better off Out? The Benefits and Costs of EU membership, IEA occasional paper 99, October 1996*

threaten the dissolution of the United Kingdom, with Scotland preferring independence within the EU to union with England. Finally, Britain would lose much of its capacity to influence developments in Europe and, through Europe, the rest of the world.

If waiting outside EMU is not sustainable in the long run and membership of the EU remains politically desirable, the third option—entry into EMU—is to be preferred. Of course, regardless of the political arguments Britain could not take this course if it were likely to prove economically ruinous. But, fortunately, both the benefits and costs of EMU are commonly exaggerated.

In his polemic in favour of early membership of EMU[4] Christopher Johnson, formerly of Lloyds Bank, argues that "the consequences of the UK staying out of the first group of countries would be adverse, in terms of a lower exchange rate and economic growth rate, and a higher inflation rate and interest rate". The only compelling point is the last.

[4] *In with the Euro, out with the pound: the single currency for Britain, Penguin 1996*

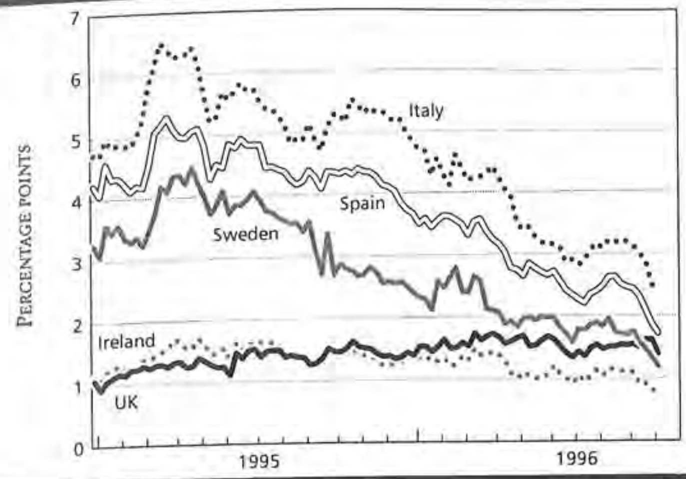
With its poor inflationary credibility and defective monetary regime Britain would for some time suffer higher long-term interest rates outside EMU than within it. As the chart on the next page shows, Britain already pays higher long-term interest rates than Ireland.

The remaining items in Johnson's list are highly questionable: Britain could have whatever inflation rate it chose; and both theory and evidence suggest that monetary arrangements have a modest impact on long-term growth, provided both high inflation and deflation are avoided. Those who regard depreciation as the panacea for almost all economic ills and those who put most of their trust in fixed exchange rates are selling quack remedies.

Since exports of goods and services to the rest of the EU amount to only 14 per cent of British gross domestic product, an optimal domestic monetary policy and a floating exchange rate should deliver greater economic stability than membership of EMU. In practice, however, monetary policy is unlikely to be optimal. Policy mistakes by the goverment caused the last two recessions. To argue that Britain needs monetary independence in order to rectify its own mistakes seems quite perverse.

CLOSING THE GAP WITH GERMANY

YIELD DIFFERENTIALS ON 10-YEAR GOVERNMENT BONDS OVER GERMANY



SOURCE: DATASTREAM

In short, commitment to entry would give an immediate boost to British monetary credibility and reduce long-term interest rates. But the medium- to long-term performance of Britain economy should be much the same within EMU as it would be outside.

The upshot is that early entry into European economic and monetary union would be best for Britain. Yet it would only be workable and acceptable under certain conditions:

★ Britain must avoid all EU interference in its ability to run a competitive labour market. Without strong market pressures, speedy adjustment to external shocks would become difficult, if not impossible.

★ Britain must enter EMU at a sustainable exchange rate, probably close to DM 2.30 to the pound.

★ Britain should insist that no restrictions be placed on budget deficits whenever goverment indebtedness is substantially below the Maastrict reference level of 60 per cent of GDP.

★ Prospective members of EMU should have demonstrated their capacity and will to control public spending and fiscal deficits.

★ The people must give explicit assent to a proposal from the government for Britain to join EMU. That can only be obtained by a referendum.

Britain could thrive outside the EU but it can also thrive within it. The same is true for EMU. What would be most painful is for the country to remain inside Europe legally, but outside it psychologically.

It is, then, essentially a political decision. The EU is not doomed to be an over-regulated, centralised behemoth, though it could turn into one. With its global perspective, stable democracy and liberal traditions, Britain can play a valuable part in preventing it from doing so. That, in turn, requires participation in EMU. Choosing this path would be as fundamental to Britain's future as was the decision on membership of the nascent European Community in the 1950s.

Britain's choice: to share the euro or to shadow it

Alman Metten

We can all agree that a single market is good for European business. The argument is over whether it is possible to share a common market without also sharing one currency. I contend that a viable single market depends on EMU. To be sure, the market can endure one currency crisis. It can endure perhaps two or three. But with each new crisis, there will be growing pressure to retaliate against competitive devaluations.

Such devaluations can give some companies a rapid and dramatic comparative advantage. In 1992 and 1993 Italian competitiveness improved by 35 per cent, thanks to devaluation, while Britain, Spain and Portugal all gained improvements of greater than 20 per cent. Some of the currencies concerned have subsequently recovered some of their value. But competitors from hard currency countries have not forgotten the wound and will surely ask for counter-measures the next time there is a currency crisis.

It should not be forgotten that during the devaluations of 1992-93, those who suffered did kick up a fuss. Farmers from strong-currency states won financial compensation on account of "unfair" competition. The French car industry demanded restrictions on imports of Spanish and Italian cars whose prices in French francs had fallen significantly. It is true that the French car companies did not get their way. But they won widespread sympathy in France, and also with car makers in Germany and Belgium. The EU found it hard to contain the pressures created by the Spanish and Italian devaluations, despite the fact that neither was a deliberate governmental strategy. Evidently, it would be economically disastrous for the single market if, following future devaluations, the EU allowed national quotas or compensation for special interest groups. It would effectively put the single market process into reverse gear.

If Britain intends to stay outside EMU in order to keep open the option of devaluation, it should think again. Whenever it tried to exercise this option, agricultural and industrial interests on the continent would try to protect themselves against cheapening British exports and Britain would find that it had few allies. If the devaluation was seen as deliberate economic strategy, which could well be the case with Britain, import quotas on British goods could well ensue.

Long before such an outcome, Britain would experience the disadvantages of solitude: it would be unlikely to win fresh foreign direct investment from firms which expected their exports to face continental restrictions. For the same reason, companies already present in Britain would be reluctant to invest further. So, paradoxically, monetary union is required to rescue the viability of one of the EU's great successes, the single market.

The single market could survive quite happily with Britain outside EMU so long as the pound followed the value of the euro closely. But such a strategy would surely spur the financial markets to test the resolve of the British government and, without active support from the euro bloc, could prove hazardous. Unless Britain negotiated an agreement with the euro bloc, it could find itself facing the speculators on its own.

If it did conclude such an agreement, Britain would have to give assurances on monetary and fiscal policy. Any agreement could hardly exclude a British commitment to join the Exchange Rate Mechanism mark two, and to accept some of the multilateral surveillance procedures elaborated in the pact on growth and stability. And yet those are the very things which many Britons hope to avoid by staying out of EMU! With such an agreement, Britons would pay only moderate risk premia when borrowing capital. Without such an agreement, such premia would be significant. Already, reflecting the uncertainty over British participation in EMU, Britain has the second highest real interest rates in the EU.

So Britain does not have to become a member of EMU. But if it wants to stay in the single market it will have to give up the possibility of using devaluation as a policy instrument, and shadow the euro closely. Thus Britain would have to give up virtually the same amount of sovereignty

that countries joining EMU will have to cede—but without gaining the same advantages, such as the chance to influence monetary policy and to enjoy lower interest rates.

Wanted: a counterweight to Germany

The countries in EMU will be determined to prevent Britain from trying to profit from the single market at the same time that it uses the exchange rate as a policy instrument. The current argument over British participation in TARGET, the currency clearing system for those in EMU, is merely a gentle warning of what may follow. If Britain shuns EMU not only central bankers but also politicians will be determined to exclude British banks from TARGET. The British would meet much more of this attitude, if their policies threatened to hurt the economic interests of EMU participants. You cannot have your cake and eat it.

As I have tried to show, much of the British discussion of monetary sovereignty is theological. The extent to which EMU weakens the country's fiscal sovereignty will depend, paradoxically, on whether Britain participates in EMU from the very start. The rules for the co-ordination of economic policy, which will cover the freedom of manoeuvre that is left to member-states, are being written now and will be further developed and determined in the years to come. For instance the balance to be struck between further reducing inflation, on the one hand, and stimulating growth and employment, on the other, will have to be worked out—but by EMU participants only. The same applies to the details of the exchange rate regime that will link the euro to other currencies, which will evidently impact on competitiveness and employment.

Of course, Britain has a long tradition of standing back from Europe and letting others decide, only to join in when the rules of the game have been fixed. As a continental European, I believe this tradition to be against the fundamental interests of Britain, and bad for the rest of Europe. The EU needs a counterweight to Germany, which is too obsessed with inflation and monetary stability, and too afraid of politicians influencing monetary policy. If Britain was a full participant in EMU from the start, it could wittingly or unwittingly help to ensure a more balanced economic and monetary policy for the whole of Europe.

How EMU would strengthen the City of London

Graham Bishop

The capital markets seem to have decided that EMU will start on schedule, and endure.[1] Forward interest rates[2] provide a fair indicator of investors' views on the starting date, because when EMU does start the gap between three-month French and German interest rates ought to be minimal. By that reckoning, investors have expected EMU to begin on January 1999 since March 1996. Moreover, the spread between the two countries' ten year bond yields has now disappeared—implying that the market does not expect any long-term, structural shift in the exchange rate between the two currencies during the next decade.

[1] *The views expressed in this paper are the author's own and are not necessarily shared by Salomon Brothers International or any of its affiliates*

Of course, the convergence of the French and German yield curves does not *prove* that investors believe EMU is 100 per cent certain, but they do expect it to start on schedule (even if some doubts have crept in recently). Yet it is evident from conversations with investors that few of them believe that general government budget deficits in 1997 will hit the Maastricht treaty "reference value" of 3 per cent (or not without debatable creative accounting). Thus investors think an enduring EMU can start with deficits above that level. After all, the EU's aggregate budget deficit peaked in 1993 at 6.2 per cent of GDP and only fell to about 4.5 per cent last year. Yet inflation has declined steadily, from 4.1 per cent in 1993 to about 2.5 per cent last year, despite these deficits. The European Commission expects inflation to continue declining—hitting a 36 year low of 2.2 per cent in 1998.

[2] *That is, the interest rate for a specific future maturity, derived from the yield curve current at any particular time*

The scale of modern capital markets gives them, almost, the power to veto EMU. It is their natural and legitimate function to avoid risk, which can mean making errant governments pay a heavy price for their lack of discipline. In Britain the build-up of financial assets, and thus the size of its capital markets, was driven in part by the need for citizens to save for their own retirement. In other EU states, an ageing population, combined with the pressure on public pension systems, makes it certain that the scale of retirement savings will increase enormously in the years ahead.

The savers in these countries will, if they feel the purchasing power of their savings threatened, use—whether individually or via financial institutions—the economic freedoms of the single European market to move their capital anywhere within, or outside, the European Union. The scale of the assets involved is enormous. In Britain, for example, the sum of private pensions and individual holdings of equities and gilts already exceeds GDP. Eventually, the EU—with a current GDP close to ECU 7,000 billion (£5,000 billion)—can expect to have a colossal pool of liquid financial assets.

There will only be financial assets of a similar magnitude to the EU's GDP when most of its governments have completed the process of shifting from "pay-as-you-go" schemes, in which pensions are funded directly from new contributions, to British-style "funded" schemes, in which contributions are invested in capital markets. In recent years, many governments have recognised the dire arithmetical consequences of having growing numbers of the elderly trying to retire on pensions funded by shrinking numbers of workers. They have already taken unpopular measures to restrict over-generous state pensions, while the pendulum has continued to swing towards encouraging citizens to save for their own retirement. Some countries will move faster than others, but the trend in this direction is inevitable.

The single currency's critics claim that it will, through budgetary centralisation, oblige British taxpayers to fund the pension liabilities of broke continental governments. This is incorrect. The Dublin summit of December 1996 agreed on a pact for growth and stability, designed to discourage and, eventually, penalise "excessive" deficits—whether they are to pay for pensions or anything else. The taxpayers of any country are free to increase contributions to their own pensioners' needs, but their government is not free to run up debts that are unsustainable. Furthermore, the Maastricht treaty provided a "no-bail out" rule, article 104b, to ensure that states cannot become liable for each others' debts. Thus British taxpayers need not lose any sleep over the problems of continental pension systems.

Meanwhile the combination of the single market programme and technological change is stimulating the rapid integration of European financial markets. It is difficult to see either of these driving forces being thrown into reverse. As the legal shackles are steadily removed, European markets are now well advanced in their evolution towards an American-style capital market—with a full yield curve and all the associated swaps, futures and repos. Moreover, the technical specifications for futures contracts are becoming ever-closer, regardless of the currency. The removal of the final barrier, multiple currencies, could produce a highly unified EU capital market surprisingly quickly. The building blocks are already in place, and technology is cementing the cracks almost by the day.

The fact that there is already a fairly unified European capital market increases the potential damage—if investors suddenly started to doubt that EMU would happen. In the economic sphere, currency upheavals could damage the fragile recovery in investor and consumer confidence that is now under way. And the resulting political strains could seriously damage the current negotiations at the inter-governmental conference. More broadly, the failure to achieve EMU might embitter political relations to the point of jeopardising further steps towards integration. Looking into such an abyss, those political leaders committed to the vision of European unity will surely redouble their efforts to make sure EMU happens on schedule.

Preparing for the euro

January 1999 seems far away, but by the beginning of April 1997 there will be only around 440 business days to go—not long for the task of preparing for EMU. It is not surprising, then, that policy makers are "encouraging" London's capital markets to prepare for conversion. For the City should be a major participant in euro capital markets, whether or not Britain joins EMU.

The Private Sector. The Bank of England is orchestrating preparations via its quarterly report and the inauguration of a "Joint EMU Forum". The London Investment Banking Association has already published several reports on aspects of the conversion and is co-operating closely with the British Bankers Association and the Association for Payment Clearing Services. Organisations such as the London International Financial Futures Exchange are examining the detailed implications for their own range of products. And, at the Bank's instigation, the Gilt Edged Market Makers Association has reviewed the implications for the operation of the Gilt market, whether Britain is in or out. The Hundred Group (comprising the finance directors of major British companies) and the Association of Corporate Treasurers are preparing a joint report on the implications for British companies, to include the effect on capital markets. Yet all these preparations relate to the City's wholesale markets. The retail banks seem unwilling to make large investments to convert their mass market operations, without a clearer idea of Britain's position.

The Public Sector. In 12 of the other 14 member-states, there are active project groups co-ordinating preparations in the public sector. Typically, these groups work closely with the private sector, especially the banking community. Yet in Britain there appear to be no significant public sector preparations. This could become a key impediment to joining EMU in the "first wave"; after the next general election it may be too late to catch up with the other governments' 18-month head start.

The European Commission. The commission is mainly fulfilling a co-ordinating role because detailed preparations, in the name of "subsidiarity", fall to the individual states. However, where the commission has been convinced of the need for legislation it has been prepared to use its power to initiate proposals. Its recent proposals for two regulations on the legal framework for the euro are an excellent example of the commission's response to private sector concerns. To ensure that the fears of market participants were met, the commission held wide-ranging and frequent consultations on the texts. Britain's legal and financial communities have been heavily involved, to ensure that the City's position is fully protected. It is thus particularly unfortunate that the British government has not managed to agree to these regulations. That this is preventing the creation of the necessary legal framework, throughout the EU, is causing concern to many City institutions.

Will Britain be able to get into EMU?

The answer to this question will have a bearing on the pace of private sector preparations. At one end of the spectrum, if it is obvious that Britain will not qualify, then there is little point in making expensive investments in systems. Yet in his 1996 budget, Chancellor Kenneth Clarke made a point of promising that Britain's public finances would, just, meet the criteria—and without fiddling the books.

Perhaps the most confusing signals are coming from the financial markets. Though easily meeting the lax interest rate criterion in the Maastricht Treaty, British government bonds are now the highest yielders in Europe. Sterling was reasonably stable against the D-mark until August 1996. But the currency has since appreciated by around 20 per cent, returning to the levels of 1993/4. Such a swing could be used as a powerful argument that sterling is not yet stable enough to enter EMU. This could be a problem even if Britain managed to garner enough political capital to get around the fact that it breaches another condition of the Maastricht treaty by not being in the Exchange Rate Mechanism.

That obstacle to EMU entry could be growing—notwithstanding contrary statements from the Chancellor of the Exchequer. In a speech in November 1996, Alexandre Lamfalussy, the president of the European Monetary Institute (the forerunner of the European Central Bank) went out of his way to highlight the "strong majority position within the EMI Council"—namely that formal ERM membership was a requirement for joining EMU. In practice, the problem might be overcome if sterling were broadly stable and if bond yield spreads had declined as a result of growing market confidence. But this, in turn, will rest on market perceptions of the extent to which the British government is committed to low inflation and sound public finance.

The balance of advantage for the City

What if Britain is out? The key issue would be whether "they" discriminate against "us". As yet there is no definitive answer. The heated debates between Britain and its partners over access to TARGET, the post-EMU cross-border payments system, show the kind of problems that lie ahead. In fact the highly technical arrangements for TARGET will not affect the City a great deal. What was ominous, however, was the apparent statement of principle on the part of the obviously "ins" that "out" central banks should not expect equal treatment.

The EMI's initial blueprint for the ECB was published in January. Many important questions have been left to the ECB to decide, such as whether there should be minimum reserve requirements, and the terms of access to TARGET. Assuming that the pound is out, Britain will be excluded from these decisions. It is abundantly clear—and understandable—that the central bank will conduct its money market operations—the engine of any financial system—*inside* the euro area. London-based dealers should be able to use subsidiaries within that area. But they could be vulnerable to regulatory changes that impede their access. Given a world of highly mobile capital and star performers, slight shifts in technical regulations may affect wafer-thin profit margins enough to push firms into moving.

What if Britain is in? The table below shows the scale of the world's main bond and equity markets. In total, EU government bond markets are significantly bigger than their US counterpart. However, dollar-denominated markets, overall, are 25 per cent larger than those of Europe. This reflects both the fact that securities markets in America play a greater role in extending credit to corporations and public bodies, and the securitisation of residential mortgages. The role of the US dollar as a world reserve currency also makes a difference: nearly 8 per cent of all dollar bonds are the classical Eurobonds that London started issuing in the 1960s.

TABLE: FINANCIAL MARKET SIZE IN TRILLIONS OF ECU
OCTOBER 1996

Currency	Total of publicly issued bonds *End 1995*	Tradeable Govt Bonds *Fixed rate over one year life remaining*	Equities *Based on the proportion of market capitalisation available to investors*
EU combined	5.5	2.2	4.5
of which:			
UK Sterling	0.4	0.3	1.0
US Dollar	7.0	1.7	4.5
Japanese Yen	3.0	1.0	1.4

SOURCES: SALOMON BROTHERS INC:
WORLD GOVERNMENT BOND INDEX, WORLD EQUITY INDEX
"HOW BIG IS THE WORLD BOND MARKET? 1996 UPDATE"

This opens an intriguing prospect for London's capital markets. If the American trend towards extending credit via the securities markets rather than the banking system spread to the EU, and the euro became a reserve currency to rival the US dollar, euro-denominated bond markets could double in size. The existing European markets would inevitably, when denominated in one currency, capture a share of the dollar's reserve currency role. The City, with its sophisticated array of financial products and its depth of talent, should be able to capture a substantial share of the euro market. That would be a prize indeed for Britain joining EMU. British participation would allow the City to deploy its well-known strengths and to build on its pre-eminence in Europe. This would benefit not merely Britain but also—through providing improved terms of finance—the entire European economy.

The view from Paris
Pascal Lamy

The choice that Britain faces over whether to join EMU is not just about monetary union. Britain's decision will have a profound impact on the entirety of its relations with Europe—not only financial, but also commercial and political. I shall argue, in particular, that the health and viability of the City is at stake; that the criticisms commonly levelled at EMU cannot stand up to serious argument; and that a rejection of the single currency would mark the start of a British divorce from the continent.

Crédit Lyonnais, the bank I joined two years ago, is spending about Ffr1 billion (£110 million) on preparations for EMU. Other continental banks of a similar size are spending about the same. The more that such institutions invest in information systems, in training and in explaining the implications for clients, the harder it will be to stop the momentum towards a single currency. The closer we are to the deadline of January 1999, the higher the probability of EMU happening—but the greater would be the damage inflicted by the project's collapse.

Suppose that the Exchange Rate Mechanism burst apart, dashing all hopes for a single currency. The D-mark would rise to unacceptable levels, while other currencies gyrated up and down. This would corrupt the single market, for countries that suffered from others' competitive devaluations would be bound to resort to protection. The EU treaties have plenty of provisions which allow national governments to restrict trade in an emergency.

In the long run, of course, such restrictions require the approval of the European Commission or the Court of Justice. But the EU institutions have no troops and, in any case, the fall-out from the explosion of monetary union could lead to such ill-feeling that governments would be disinclined to respect those institutions. Whether EMU flourishes or fails, I do not believe that EU members will allow each other to manage exchange rates for economic advantage.

Leaving aside such depressing scenarios, there are several solid commercial reasons for Britain to join the first wave of EMU. For one thing, the concept of a single monetary unit fits well with the country's economic experience and tradition. Britain was one of the principal architects of the Bretton Woods system of fixed exchange rates—a system that supported a global economic recovery from 1945 until 1971. Britain has always favoured the elimination of barriers to free trade—and was thus an enthusiast for the EU's single market programme, of which EMU is the logical extension.

The euro will promote trade and investment within the EU by removing transaction costs and exchange-rate uncertainties, for both exporters and importers. Now that we have built a single market with few tangible barriers to trade, would it not be going against a historical trend to shore up one of the final ones, exchange rate uncertainty? The pursuit of monetary integration is all the more justified because EMU would make prices more transparent and, by increasing cross-border competition, would improve market efficiency and reduce inflation.

Membership of EMU would also remove exchange-rate volatility, which has caused Britain considerable problems in the past. British commentators tend to forget how damaging such volatility can be: exchange-rate "overshooting" has often aggravated the country's boom-and-bust economic cycle. The devaluation of sterling in 1992 is seen by some as an excellent example of the advantages of exchange-rate flexibility. But was it anything other than the correction of an earlier mistake, namely to set the rate at which sterling joined Europe's Exchange Rate Mechanism too high?

One of the great penalties of economic uncertainty is that interest rates tend to be higher than if such uncertainty did not exist. It is already clear that Britain's medium and long-term interest rates would be lower if the financial markets believed that it would join EMU at the outset. The benefits to growth and to national budgets that flow from durably lower interest rates are well understood. The advantages to Britain, where widespread home ownership gives special importance to mortgage interest rates, should be especially obvious. It would be a mistake for Britons not to share this benefit.

Maintaining London's pre-eminence

If Britain were to join the single currency, London would probably become a primary centre for the euro money market, even if significant activity still took place elsewhere in the EMU area. London would do especially well if the European Central Bank (ECB) conducted its money market operations on a decentralised basis. The City's concentration of banks, and therefore the number of counterparties available for interbank dealing, would give it a huge advantage.

Britain's money markets would benefit from its banks having full access to euro liquidity, through the ECB's open market operations. But if Britain stays out of EMU, its banks could not be sure of funding in euros at competitive rates: they would not have the opportunity to act as counterparties to the ECB's open market operations, except at a higher cost via one of their branches in the euro zone.

Indeed, Britain's interests could suffer if the rules and provisions for a single currency are established without its full participation. For instance the imposition of minimum reserve requirements and—if some continental banks get their way—the exclusion of British banks from the TARGET clearing system could adversely affect the City. This would be a blow, not just to Britain, but to Europe. The City's impressive array of talent and expertise is one reason why Britain's partners are so keen for it to contribute to this phase of the construction of Europe.

Overall, EMU should boost investment, for it removes uncertainty over future exchange rates and thus makes business planning easier. This could be especially important for small companies, which often lack the expertise to hedge their currency risks. At present, currency risk is still deterring institutional investors and private clients from investing in the equity markets of countries expected to be outside EMU. If Britain joined the first phase of EMU, its equity markets could benefit from substantial inflows of investment.

Countries inside the euro zone could well succeed in attracting more foreign direct investment, as the risk of devaluation—relative to the investor's own currency—would be reduced. Indeed, the countries in EMU would to a large extent, like America, be insulated from the effects of currency fluctuations (only about 10 per cent of America's GDP depends on trade in goods and services). The British economy outside EMU would be far more vulnerable to exchange-rate volatility: about 30 per cent of its GDP depends on trade.

EMU presents Britain with an opportunity to improve on its already impressive performance in winning foreign direct investment. The presence of Japanese manufacturers in Britain is a demonstration of this achievement. But there is no doubt that if Britain were outside the euro zone some of these companies would reconsider their commitment.

In January 1997 the president of Toyota, Hiroshi Okuda, said that, in the case of Britain's absence from EMU, "if we are to make fresh investments, we would prefer to make them in continental Europe rather than Britain". In the same month the chief executive of Siemens, Juergen Gehrels, commented on the billion pound microchip factory his company is building in Britain: "If it had been clear Britain would be out of a single currency at the time we invested in North Tynside, that decision would have gone another way." Then in February 1997 the chairman of Unilever, Niall FitzGerald, said the following about EMU: "If Britain absented itself, that would certainly lead to reconsideration of certain investment decisions. If the UK was gently floating off into the Atlantic, we'd have to reconsider things." In March New Holland, the world's second biggest tractor manufacturer, said that it would reconsider investment at its Basildon plant if Britain opted out of EMU. Enough said?

How the opponents of EMU get it wrong

One of the main arguments against early British participation in EMU is that by not joining, Britain would retain its exchange-rate autonomy. But this is a dubious benefit, for it means the government retains the option of devaluing, and devaluations lead to higher inflation. This leaves investors uncertain about the future real value of their savings, which means they will tend to demand an interest rate premium. Thus interest rates in countries outside EMU will tend to be higher than those inside.

Recent newspaper reports have suggested that Britain could become liable for future pensions liabilities of continental European countries. This is not the case. There is nothing in the Maastricht treaty which implies large fiscal transfers between countries. The Edinburgh summit of 1992

agreed that, until 1999, the size of the EU budget would be limited to 1.27 per cent of the Union's GDP. No new budgetary regime can be agreed without the consent of every EU member.

Another widespread fear is that adopting the euro could be a first step towards a federal Europe. Of course, supporters of a federal Europe are likely to support EMU, but a common currency and a federal Europe are very different things. Britain and Ireland shared a common currency between 1921 and 1979, but they were not federated; if anything, they were moving apart politically. Plenty of countries have tied their currencies to the US dollar, for example Hong Kong, Argentina, Estonia and Lithuania. But these countries are certainly not governed by the United States. EMU should be considered on its own merits, rather than as an engine for federalism.

Those who want Britain to shun the euro should be aware that staying out would, in time, reduce the country's ability to influence a whole swathe of decisions at EU level. There is no reason why Britain should not win many of the arguments in Europe: its Rolls-Royce diplomatic machine, its powerful financial markets and its widely-read press, to mention just a few of its assets, could all help the British to obtain their objectives. But the trouble is that Britain appears to have few objectives other than to opt out.

I remember watching John Major "win" the opt outs from EMU and the social chapter at the Maastricht summit. I believe that ever since, Britain's influence has declined, one reason being that people have assumed it will boycott one of the Union's principal objectives, a single currency. The opt outs have tended to obscure from the British the truth—namely that their country is becoming a semi-detached member of the Union. EMU offers Britain a chance to reintegrate with the rest of Europe. But if Britain rejects the euro both Britain and Europe will miss a tremendous opportunity.

Don't forget the E in EMU

Alan Donnelly

At the end of 1996, whilst many Eurosceptics continued to declare the project of European integration doomed, the EU heads of government, meeting in Dublin, confidently and skilfully put together the final pieces of the EMU jigsaw puzzle. Depressingly, the response in Britain from the government and much of the media was to discount these political agreements as insignificant. In fact the decisions of the Dublin summit virtually guarantee that a monetary union will begin in January 1999.

The Irish presidency of the EU, and particularly of ECOFIN (the council of finance ministers) under the leadership of Ruari Quinn, resolved three potentially explosive issues:

- ★ The legal status of the euro was established. This is crucial, given the need for both international confidence in the viability of the new currency and domestic consumer confidence.
- ★ The stability and growth pact was concluded. This compromise agreement on post-EMU budgetary discipline was of special importance to the Bonn government, given the nervousness of many Germans over the prospect of the euro replacing their beloved D-mark.
- ★ The plan for the mark II Exchange Rate Mechanism was spelt out, effectively establishing the future relationship between the euro-zone and those countries unable or unwilling to join the single currency. A mark II ERM is essential to guarantee the proper operation of the internal market.

It is hardly surprising that the significance of these accords passed largely unnoticed, given the poor quality of the British debate on monetary union. Indeed the government has done its best to stifle informed discussion. It is indefensible that, when all the major parties are committed to holding a referendum before Britain joins the euro, Conservative ministers have deliberately excluded the British from an EU programme which provides background information on EMU.

Two broad questions have dominated the British debate on EMU, and are often seized upon by critics of the single currency. As such they deserve close attention.

Two questions from the past

The first is the question of whether EMU will actually go ahead according to the agreed timetable. Many claim that EMU will not come into being in 1999, or that if it does, it will require a statistical fudge. Let us examine the progress that member-states have made towards fulfilling the Maastricht criteria. If you consider inflation rates, in 1997 all EU members, with the exception of Greece, will meet the Maastricht criterion. All countries, with the possible exception of Italy and Greece, will have acceptable long-term interest rates. Whilst three countries (Britain, Sweden, and Greece) have free-floating currencies, the remaining 12 member-states are managing their currencies within the normal fluctuation bands of the ERM.

The careful wording of the Maastricht criterion for government debt means that a substantial majority of member-states can, thanks to the downward trend of their national debt, be judged to be within the spirit of the treaty's 60 per cent of GDP rule. That leaves only the budget deficit, measured as a percentage of GDP, as an area of potential difficulty. However, projected budget balances for 1997 suggest that the Netherlands, Belgium, Sweden, Denmark, Finland, Ireland and Luxembourg will meet the criterion strictly; that France, Germany and Britain will be on the borderline; and that Spain, Austria and Portugal will all be within half a percentage point of the 3 per cent target.

Most member-states will meet the spirit of the Maastricht criteria, so there will be no grounds for risking a delay in the starting date for EMU. Of course it is argued in some member-states, including Britain, that EMU should not proceed without convergence in the real economy. Such indicators as output, productivity and employment are cited. Goldman Sachs examined this question in the Spring 1995 issue of

Economics Analyst, and assumed the following set of real convergence criteria:

- ★ unemployment not higher than 2 per cent above the EU average
- ★ a current account deficit no greater than 2 per cent of GDP
- ★ a growth rate within 1 per cent of the EU average
- ★ commercial competitiveness, relative to Germany, within 10 per cent of its 1989, pre-unification level

Goldman Sachs found a strong correlation between the countries qualifying, or on the border of qualifying, under the normal Maastricht criteria, with those qualifying under the "real economy" criteria set out above. So if one accepted the argument that the nominal convergence criteria are arbitrary, and that they should be broadened to take account of real economic performance, there would be no basis for changing the existing EMU timetable.

The second issue often raised by those opposed to the single currency is the need for Britain to retain an independent national monetary policy. They point to our experience of the ERM and, since sterling was ejected from it in September 1992, to our relatively strong economic performance and the apparent absence of inflationary problems.

However, this argument is based on an inflation record derived from an unrepresentative period of only four years (1992-1996), and it ignores the fact that when Britain left the ERM, our economy was in the depths of a serious recession. It is extraordinary that, in order to justify Britain standing aloof from monetary integration, so many senior politicians have chosen to forget the policy mistakes of successive post-war governments—errors that eroded sterling's value from 12 D-marks in the early 1950s to around 2.5 D-marks today.

The opponents of EMU talk of maintaining monetary sovereignty. Yet throughout the 1990s, finance ministers from all 15 member-states have come to the European Parliament and explained that their policies depended heavily on the performance of their currency against the others, and especially, of course, the D-mark. They have all stressed the importance of stable, low, long-term interest rates. At no time has any finance minister from any member-state suggested that he or she could even begin to pursue policies that ignored the growing co-ordination and interdependence of and between EU partners, particularly in exchange rate and interest rate policy.

Therefore any government that truly wishes to exercise influence over these policies should seek to do so in the forums designed to prevent the dominance of one member-state. In the case of interest rates, that means replacing the dominance of the Bundesbank—which has understandably put German concerns first—with a European Central Bank that allows all partners equal voice and thus greater influence over European monetary policy.

The forum that determines the euro's external exchange rate will be the council of finance ministers. But only ministers from countries in the euro zone will have a vote on exchange rate policy. British ministers may choose to sit in glorious isolation, while these collective decisions are taken, but they can hardly claim that such jealous guarding of "sovereignty" serves the national interest.

Eight questions for the future

Britain's preoccupation with timetables and monetary sovereignty is understandable, but it should not obscure the discussion of other questions vital to the success of the EMU project. With the establishment of fixed exchange rates less than two years away, the European Union—and that includes Britain, in or out of EMU—needs to consider some of the issues that will determine whether or not the euro succeeds:

★ Unemployment in Europe currently stands at about 11 per cent. How can this be tackled when the stability of the new currency will demand a high degree of budgetary discipline and convergence?

★ Given that the EU budget is only about 1.2 per cent of the Union's GDP, what policy instruments will be available to the EU to meet asymmetric economic shocks within the Euro area, and to ensure solidarity between the single currency's "ins" and "outs"?

★ How do we minimise the risk of currency speculation during the vulnerable period from spring 1998, when the decision on membership of the first wave will be taken, and the irrevocable fixing of exchange rates on 1st January 1999?

★ How can we reinforce the European internal market when a majority of countries are within the euro zone and but some currencies—the pound, the Swedish crown and the Greek drachma—are floating against the euro?

★ What policy instruments or inter-governmental agreements are required to ensure the smooth co-ordination between, on the one hand, the ECB's monetary policy and, on the other, a decentralised fiscal policy that remains the responsibility of national governments and parliaments?

★ Since the Maastricht treaty gives the European Central Bank control over monetary policy, and ECOFIN responsibility for external exchange rate policy, what arrangements will enable the ECB and ECOFIN to co-ordinate these two crucial areas of policy?

★ What further steps need to be taken at European and national levels to ensure that businesses, and retailers especially, understand the issues raised by the transition to the single currency and are prepared for the euro?

★ Finally, with the establishment of a new interbank settlement system in the euro area, is it inevitable that there will be some discrimination against the commercial banks from the "out" countries?

There is genuine and growing concern in many European capitals—and indeed in Brussels—that as we enter the final stages of the establishment of the single currency, Paris and Bonn are attempting to shape these outstanding issues to suit their own domestic agendas. This should be as unacceptable to Europe as the attempts by the British Conservative government to manipulate the EMU agenda to suit its own political priorities.

These questions should not be sorted out by political "fixes", brokered within the EU's monetary committee (which consists of top finance ministry officials) or among the central bank governors. Many of them are as much political as technical. If monetary union is constructed behind closed doors it will never win the support of public opinion, which is vital for the project's success.

Either ECOFIN, whose ministers are accountable to their national parliaments, should be strengthened to make it a political counterweight to Europe's central bank; or a new EU council, consisting of heads of government and finance ministers, should be created to address these outstanding issues.

Indeed, the European Commission could team up with the Dutch or Luxembourg presidencies—which will run through the course of 1997—to launch a debate on these questions. The objective should be the establishment in 1998 of a political counterweight to the ECB.

If we fail to launch this debate and to achieve a deeper, Europe-wide system of economic co-operation within the framework of the Maastricht treaty, the consequences could be dire. Those in France and Germany now advocating an informal "stability council" could succeed in creating a "premier league" of finance ministers. They would meet informally, outside ECOFIN, and then use the meeting of the 15 finance ministers as a rubber stamp for their decisions. It goes without saying that the more Britain isolates itself from discussions on EMU—whether or not it joins in the first wave—the greater would be the danger of such an informal group emerging.

Such an arrangement, lacking any legal basis in Europe's treaties, would divide Europe, destroying the solidarity that the birth of the euro should engender and challenging further progress on the internal market. Of course the euro must be stable, and all member-states, both those inside and those temporarily outside, must contribute to that stability. Nevertheless, stability is best guaranteed through inclusive treaty-based arrangements, rather than through exclusive or elitist inter-governmental "clubs".

There is another reason for ensuring that the ECB is balanced by a political counterweight. As Jacques Delors has recently argued, if the ECB is the only European institution with any economic clout, it is bound to become the focus of popular discontent when it has to take unpopular decisions. It would be much better for a body made up of accountable finance ministers to share responsibility for the thrust of EU economic policy. Otherwise hostile public opinion could undermine the legitimacy of the ECB and thus of the euro itself.

Despite the many difficult questions which have to be sorted out, the prize of a successful euro will be well worth the effort. What is at stake is the prosperity of the 370 million people—a number soon to grow with enlargement—who live in an increasingly interdependent Union. Jobs have never been created by high inflation, high interest rates or unstable exchange rates. We now face the real prospect of achieving, within Europe, a system of economic and monetary management that will guarantee low inflation, low interest rates and a stable currency zone. Europe's greatest achievement over the past 50 years has been the creation of a framework that enables its countries to co-operate peacefully. Is not the natural next step the construction of a system that will provide long-term economic security to all Europe's citizens?

Why EMU could be good for employment
John Monks

Britain is in the middle of a debate between those who oppose taking part in EMU in any circumstances, and those who think the country should wait and see whether and how the single currency goes ahead, before deciding if it wants to join. It is high time that the case for British involvement from the start got a hearing. Many people have been surprised that the Trades Union Congress is so positive about a single currency. But it is perfectly obvious to us that if any trade union, or any government, is going to have real influence on the globalisation of the world economy, it must act together with others.

That is why the European Union is so important for Britain—both as a means of enabling us to deal more effectively with the world economy, and because of its job-creating internal market. We regard the movement towards EMU as an organic process, growing out of the past twelve years of building a single market—a process which is still unfinished.

The European Commission's report of October 1996 shows that the single market has, since its inception in 1985, created around 900,000 jobs, that GDP was 1.1 per cent to 1.5 per cent higher, and investment 2.7 per cent higher, than they would have been without it. Trade within the EU has risen faster than trade between the EU and the rest of the world—with the share of imported manufactured goods that comes from the EU rising from 61 per cent in 1985 to 68 per cent in 1995. The commission found that the EU absorbed 44 per cent of world foreign direct investment in the early 1990s, compared with 28 per cent between 1982 and 1987. Furthermore, the abolition of customs documentation and formalities within the EU has saved businesses about 5 billion ecus (£3.6 billion) a year.

Much more needs to be done to make the market a success. But Europe cannot merely be a single market. To be sure, there are the abovementioned advantages, but there are also disadvantages like dominant companies getting even stronger, growing job insecurity, and increasingly rapid—and thus disruptive—economic change. So, just as the Social Charter balanced the single market programme, as did the Social Chapter the Maastricht treaty, the creation of a successful currency union will require further progress on social policy. We accept that employers wish to see greater labour market flexibility, but that must be complemented with new sorts of protection for workers. We want the EU to hurry along measures that are outstanding from the commission's "social action programme"—such as the directive on rights for those on part-time or temporary contracts. And, of course, we want to end Britain's opt-out from the Social Chapter.

A single currency also has to be balanced by new measures to boost employment. We want education and training in the workplace to be a greater priority—and we wish that Britain would participate more fully in the various EU programmes that help in this area. We think that working time should be reorganised and reduced, to ensure that the economic recovery is more employment intensive. We want the commission to reappraise, together with the social partners, the effectiveness of EU structural funds from the point of view of employment; Britain alone will receive £11 billion from 1994 to 1999, and the use of that money should be more focused on job creation. Finally, job placement services should be strengthened to encourage labour market mobility throughout the European Union.

The dangers of the status quo

The Conservative government remains hostile to the very concept of European integration, just as it does to social partnership. Its attitude towards Europe becomes more negative by the day. But Britain now faces one of the most important decisions it has ever had to take: whether to join Economic and Monetary Union.

The TUC believes that for Britain to opt out would be dangerous for working people and their families, harmful to growth prospects and job creation, and injurious to the national interest. Shunning the single currency would give Britain structurally higher interest rates than the rest of Europe—in fact they are already higher, partly because the government's wait-and-see policy is causing speculators to hedge their bets. Outside the euro zone, sterling would be vulnerable and unstable; it could only maintain its parity if Britain practised a sterner monetary policy than that of the European Central Bank. If sterling devalued, our exporters might have to contend with the members of EMU—annoyed at Britain gaining an "unfair" competitive advantage—imposing surcharges on their goods.

If Britain stays outside the euro zone, the share of its trade with the rest of Europe would decline. Inward investment into Britain, which has given us such a significant economic boost in recent years, would dry up. The City would lose its role as a world financial centre. And European co-operation on a whole host of issues, such as the environment, would be undermined. Britain would be marooned outside our main market, with no influence over decisions that could mean success or failure for whole sectors of our economy. Staying out of EMU would be a way of accepting that, finally, we were resigned to our relative economic decline.

It is time that the Euro-sceptics were honest about the alternatives. However wonderful the Commonwealth is as a political organisation, the Empire is economically dead. There is no going back to the days of Imperial Preference. And there is no transatlantic alternative: the "special relationship" simply does not exist. Nor does Norway provide another model for us. The Norwegians have invested their oil revenue, which in any event is, per head, much greater than ours. Britain has squandered its oil revenue on mass unemployment and tax cuts. At £1.6 billion per year, our current oil income cannot provide a launching pad for growth. In 1984, when earnings peaked at £12 billion a year, the story could have been different. Britain belongs to the European Union, which is based on the twin principles that the single market boosts everyone's prosperity, and that its citizens deserve a secure system of social protection.

A euro for growth and stability

Joining EMU would offer multiple benefits, such as stable macro-economic conditions to stimulate growth, and structurally lower inflation rates. International currency speculators would have fewer opportunities to do their mischief. As part of a powerful euro bloc, Britain would be better able to prize open markets elsewhere in the world. Citizens and employers would enjoy significantly lower transaction costs. Furthermore, those inside a currency union would be more likely to agree on stronger common rules on employment and environmental protection. In all these ways, the euro would be good for jobs.

Undeniably, joining EMU would carry disadvantages as well as advantages. Britain would lose the ability to adjust the exchange rate and some influence over domestic monetary policy. The EMU on offer to us is far from ideal. We might have liked a longer timetable. We would have preferred the convergence criteria to have covered growth, employment and investment. But we have honestly recognised that the odds are in favour of the euro going ahead on time, and that there is little chance of changing the convergence criteria set out in the Maastricht treaty.

If EMU is to succeed, the convergence criteria will have to be applied with great flexibility, over the whole economic cycle. In fact the Maastricht treaty provides for this. I do not accept that the rules for EMU that are emerging are fundamentally deflationary. Obviously, there must be some limits to the size of budgetary deficits. To those who say that the rules in the treaty are arbitrary, I would respond: "OK, if you were running the system, what would your rules be?".

The stability and growth pact, worked out in draft at the Dublin summit in December 1996, will be adopted at the Amsterdam summit in mid-1997. The European Trade Union Congress called for growth to be included in the concept of the pact. So did the French Government. Thus at the Dublin summit what would have been called simply the stability pact was renamed. It was agreed in Dublin that the responsibilities of the central bankers for monetary policy would have to be balanced by the responsibilities of politicians for overall economic policy. So fines would not be imposed automatically on countries running "excessive" budget deficits, normally defined as over 3 per cent.

If a member's GDP had fallen at least 2 per cent over the year, its deficit would not normally be judged excessive. If the drop of GDP had been between 0.75 per cent and 2 per cent, the finance ministers could impose a fine, if the recommendations they had made to correct the situation were disregarded, but they would be free to be lenient. A country whose deficit exceeded 3 per cent of GDP, and had not experienced a GDP fall of as great as 0.75 per cent, would—if corrective recommendations were not followed—face a fine. But even in such a case, if "exceptional circumstances" were to blame for the deficit, the finance ministers could waive a fine. Thus the door has been opened to a flexible rather than a mechanical interpretation of the Maastricht treaty's rules on budget deficits.

From the perspective of employment, it is important to flesh out the growth side of the new pact. We need a greater co-ordination of macro-economic policy. The member-states have wisely agreed that, in their efforts to constrain over-borrowing, they will give priority to investment in human capital, innovation and infrastructure. The profitability of European businesses in the mid-1990s has been comparable to the levels of the 1960s, yet investment rates have been much lower. The problem is that many businesses lack confidence in the future. Policy co-ordination among EU governments should—together with the stable, low-inflation, low-interest rate economic environment that will stem from the euro—boost business confidence.

The result should be more investment and thus job creation. We have to explain that, to dispel the myth that EMU will create mass unemployment. Those who claim that Britain would face £10 billion to £15 billion of public expenditure cuts, in order to meet the Maastricht criteria, are mistaken. On present trends Britain is likely to meet the budgetary criteria.

The reality is that Britain can neither influence the future development of the stability and growth pact, nor have a real say in how EMU evolves, if it is not fully committed to Europe. Britain should be playing an active part in council of finance ministers, to ensure that the central bank does not become excessively cautious. Only a Britain that plays a full, positive role in European affairs can hope to influence the many elements which determine the EU's growth rate. This is why the TUC believes that, if EMU goes ahead, Britain should join the first wave.

EMU is about much more than money

Peter Sutherland

In the intensifying debate over the prospects for economic and monetary union, there is a danger of losing sight of the most fundamental fact about EMU.[1] Like everything else in the push for European integration, it is essentially a political undertaking. To underline that truth is not to deny the compelling economic rationale for EMU but to emphasise that there is more at stake.

The economic rationale is based on the inherent logic of Europe's single market strategy; EMU may well be essential to the single market's survival. But it also has become a test of both the European Union and the political commitment of its 15 member-states, one that goes beyond the technicalities of the project. If Europe fails the test, the consequences for integration will be serious.

The critics maintain that EMU will not work because the member-states will fail to reform their rigid labour markets and burdensome welfare systems. Such reforms are exceptionally difficult, to be sure, and will be resisted by vested interests. France's current attempts to solve structural problems relating to social security and public employment, and Germany's push to modify pension and sick leave benefits are meeting the resistance one would expect. But predicting that those efforts will not succeed seems unnecessarily pessimistic. Their inevitability is widely recognised, as evidenced by privatisation programmes under way virtually everywhere in Europe. There is also new realism and a sense of the need for constructive engagement on these issues among many of Europe's trade unionists.

Above all, the competitive liberalisation of the global economy will require such reforms even without EMU. Would the social partners in the

[1] *This essay is a revised version of a contribution to the Jan/Feb 1997 issue of* Foreign Affairs. *Copyright (1997) by the Council on Foreign Relations, Inc.*

German economy, for example, choose to commit collective suicide rather than carry out such reforms? Or would the German body politic be more reluctant to engage reform with European monetary union than without it? Anglo-Saxon economists have written off the German economy so many times, and so prematurely, that it seems foolhardy to do so once again. No doubt the liberalisation and deregulation of the German economy, like similar efforts in France or Spain, will be less than ideal. But it is unreasonable to assume that they will not occur.

EMU is an act of political will

The member governments adopted the EMU project because they were persuaded that it was based on a sound economic and monetary rationale. Specifically, they were convinced that the single market, including the free movement of capital, was not compatible with stable exchange rates and stable monetary policy, except within a single currency. Having tried several schemes to stabilise exchange rates, all of which stopped short of a single currency and all of which failed, they decided to aim for a single currency. It is almost inconceivable that they would have embarked on an undertaking of such ambition and inherent uncertainty had they not been persuaded of the project's political efficacy as a means of furthering integration.

By the same token, however, both governments and central banks have been dogmatic in their pursuit of the Maastricht convergence criteria, and their treaty-driven efforts to control inflation and cut budget deficits may have unnecessarily aggravated the recessionary tendency in the economic cycle. But they have had to tread a narrow path, maintaining the Maastricht process's credibility while dealing with difficult social and economic issues. After all, what is involved is a secular change in economic policy, economic behaviour, and, above all, public opinion. Economic and monetary union will not occur at all unless the Bundesbank, the Bundestag, and the German people all believe that the new currency is as good as the D-mark. Economic and monetary union will not work well unless the public in each participating country is persuaded that low inflation is inherently desirable and that the new low-inflation policy is serious and permanent. The Bundesbank and the Banque de France may have been conservative in their strict pursuit of the Maastricht criteria, but if they had appeared to have had only a conditional commitment to the policy of low inflation during this critical

period of transition to the single currency, they could have jeopardised the credibility of the entire enterprise.

Once the single currency arrives, Europe will be in a different ball game. Government deficits will have been reduced, automatically easing recessionary factors. Moreover, if the practise of low inflation has been established and accepted, central bankers will feel more confident that they can lower interest rates without triggering inflationary reflexes. Once Europe is through the white water of the transition and achieves the single currency, the balance of constraints in the system will significantly change: the European Central Bank and the national governments will together have to ensure a constructive trade-off between fiscal and monetary policy, so as to combine low inflation with reasonable growth. But the nightmare scenario—that Europe's central bankers will bear down ruthlessly hard on inflation while the Maastricht criteria bear down on demand management, driving the entire European economy into permanent recession—is implausible.

European governments are shooting for monetary union not as a mindless act of dogma but as an act of political will. When the member-states decide, in the first half of 1998, which of their number qualify for EMU, they will apply the Maastricht criteria in such a way as to give monetary union the best possible chance of survival. After that, the countries taking part in the first wave will be required to do whatever is necessary to ensure that monetary union works properly. I believe this is fully understood and accepted.

The need for political judgement

Everybody knows that the key Maastricht convergence criteria—budget deficits at less than 3 per cent of GDP and government debt at less than 60 per cent of GDP—do not measure some sacred truth; they only suggest which member-states can be counted on to deliver economic policies that are stable, disciplined, responsible, and unlikely to spur inflation. Paradoxically, much of the public controversy over the convergence criteria has focused on parameters that may in some cases be of secondary importance, such as the level of public debt, while little attention has been paid to the most important indicator of all: low inflation. The size of its public debt would apparently exclude Belgium from the first wave of monetary union, but in terms of the more important criterion of monetary stability, it should clearly qualify. Economists may differ on whether the lowest possible level of inflation is inherently desirable, or whether—as the evidence seems to suggest—a slightly higher level may be optimal for faster economic growth. But from the business point of view, the prospect of stable and predictable economic policy is EMU's most desirable characteristic. The target figures in the Maastricht treaty are designed as indicators of the ability and willingness of each national political system to conform to that general objective.

What is ultimately at stake is a political judgement. The final decision as to who will advance in the first wave of EMU will not be made on the basis of the economic numbers chalked up by the end of 1997. It will instead be a group judgement as to which member-states can be counted on to meet the future obligations of monetary union—in essence, a political judgement on each others' political systems. This is not usually acknowledged in public, largely because the connotations are uncomfortable, even invidious. But it is unavoidable.

If this is the realpolitik of the Maastricht decision-making process, and if monetary union is to have a reasonable chance of working, the first wave of participating member-states should be selected carefully. At one end of the spectrum, the most natural candidates for membership are member-states like the Netherlands that are, in a sense, already in the D-mark bloc; they are the countries least vulnerable to questions about their ability to compete inside a monetary union. At the other end are the member-states that are converging on the Maastricht criteria but have not yet established a stable political or economic record of convergence. EMU will be a high-stakes enterprise, and the European Union cannot afford to include member-states that can and should be ready for integration in the near future, but are not ready now.

However, there must be no premature rejection of a candidacy. If a member-state meets the criteria in a comparable manner to France or Germany, they cannot reasonably be rejected. Furthermore, it is only legitimate to postpone a country's membership of EMU if that country would fail to comply with the criteria in a sustainable manner, thus damaging the system.

The euro zone must include the Rhine

If EMU is to happen both France and Germany will have to be members from the start. With a year to go before judgement day, it is too early to know whether both will succeed in achieving strict compliance with the criteria. But it is important to understand the consequences of the project collapsing. If EMU fails to take place essentially on time, the European Union will face a dilemma of major crisis proportions. If it was to put the single currency on hold, the temporary delay could well become indefinite. The response of the markets could make it very difficult to put the train back on the tracks. It is to be hoped that the EU will consider the broad intent of the criteria and apply them reasonably, rather than dogmatically.

It seems obvious that the other member-states will be anxious to give either France or Germany the benefit of the doubt, provided that their budgetary figures are not too far from the Maastrict targets and that they are moving in the right direction. For a consistent policy of low inflation and currency stability has not been merely true of Germany. France has maintained for a dozen years, under successive governments of both left and right, a constant policy that lends credibility to the French establishment's political commitment to EMU. In addition, President Jacques Chirac has resisted the populist temptation to revert to the old Gaullist model of French nationalism. Real economic convergence has been evident in the majority of the countries which are likely to form the core, for a considerable period, and is not really in question.

But even if the member-states are irreproachably rigorous and ensure that EMU proceeds as anticipated, the European Union has a vital interest in developing the entry process for those member-states left to the second wave. It can do so by building strong institutional links between the "ins" and the "not-yet-ins" on matters both of currency stabilisation and macro-economic policy management. This is the logic of recent negotiations between European finance ministers and central bankers. If successful, those negotiations should help blur the sense (or fear) of political discrimination among the "not-yet-ins", without jeopardising the credibility or stability of the monetary union itself.

There is, of course, another paradigm among the member-states: the United Kingdom. Britain has a strong and stable political system, which ought to promise the predictability of policy. In principle, it should also be able to meet the Maastricht criteria, if not quite in time for the January 1999 starting date, at least not long thereafter. In practise, it seems unlikely that a Conservative government would even advocate membership in EMU. And it cannot be taken for granted that a Labour government would be an early candidate.

Under Tony Blair, the Labour Party is adopting a more positive tone, toward the European Union in general and toward economic and monetary union in particular. It is possible that after the general election a Labour government would seek membership in EMU. But Labour is committed to holding a referendum before joining the single currency, and this would require a powerful campaign of persuasion, since support for monetary union does not yet exist. Public opinion could be brought round to the idea; what is in question is whether it could be brought around in the nine months or so between a British election and the moment of decision in Brussels. The real trouble is that Britain has an uninterrupted record of resisting the political implications of closer European integration in general, and of monetary union in particular.

For the majority of the EU member-states, the ultimate rationale of monetary union lies in its contribution to the larger political strategy of European integration. Those who wish to be part of economic and monetary union should make clear to their electorates that this is a profoundly political act. It is time to come to terms with the essential nature of the European integration process; it's not about losing one's nationality, but it is about sacrificing some degree of sovereignty. The evidence suggests that an overwhelming majority of the EU's current members are willing to take the next step, and that even the laggards will soon follow suit.

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