Britain and the new European agenda

Lionel Barber

ABOUT THE AUTHOR

Lionel Barber has been Brussels correspondent of the *Financial Times* since 1992. He has also worked as the FT's Washington correspondent. He has lectured widely in the US and Europe on the EU, transatlantic relations and US foreign policy.

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Introduction: Seizing the moment

"Had I been present at the creation I would have given some useful hints for the better ordering of the universe"—*Alphonso X, the Learned, King of Spain 1252-84.*

The European Union is changing. Faster than many in Britain imagine. In the next 12 months, the EU faces a series of interlocking decisions which are likely to define the future of the continent for the next generation. The planned launch of the single European currency on January 1st, 1999 will mark the most far-reaching change in the international monetary order since the collapse of the Bretton Woods system. Enlargement of the EU to the former communist countries of central and eastern Europe will complete an historical cycle which began with the division of the continent at Yalta in 1945.

For the new Labour government, the next phase of development of the European Union involves choices no less fateful than those of more than 40 years ago, when Britain declined to join the six founding members of the European Economic Community. Now, as then, the question is whether the British are content to play the role of passive bystander, or whether they are willing to become an active partner in shaping a new political and economic order in Europe.

The answer is awaited eagerly in Europe. Most governments and decision-makers would welcome full-hearted British participation. Their motives have nothing to do with sentiment or charity. Theirs is a hard-headed calculation that British engagement would bring genuine practical advantages, while contributing to a better equilibrium on a continent where Germany and Russia naturally tend to be the dominant powers.

It is often argued that the case of Britain and Europe is a hopeless one. The British are fond of casting themselves as a nation of footsloggers:

pragmatic, puritan, and doomed to play second fiddle to an all-powerful Franco-German alliance. Or as Simon Jenkins, the *Times* columnist, wrote: “Every British prime minister must find a third way between commitment to the EU and withdrawal. Every one has. That way has been to behave relentlessly like a bad European, a cantankerous member of the club.”

Such arguments are defeatist and dangerous. They either misrepresent or misunderstand developments in a Europe which is more fluid than it appears at first sight. Despite periodic crises, such as the 1996 fracas over mad cow disease, the British have no need to view the story of their relations with Europe as a continuation of the Battle of Britain or the retreat from Dunkirk.

Since 1945 Britain’s relationship with Europe has been a catalogue of missed opportunities. At the end of World War II, the mantle of leadership was there for the taking. Germany lay defeated and divided. France was morally compromised by Vichy collaboration. Winston Churchill invoked the vision of a united states of Europe in 1946, but his attitude was at heart ambivalent when it came to Britain’s own position. As he had written twenty years earlier: “We see nothing but good and hope in a richer, freer more confederated European community. But we have our own dream and our own task. We are with Europe but not of it. We are linked, but not compromised. We are interested and associated, but not absorbed.”

Successive governments, Labour and Conservative, held the same intransigent position in the post-war decades. Britain’s task was two-fold: to defend the commitment to the Commonwealth; and to preserve the special relationship with the US. Europe came a poor third. As a result, the British persistently underestimated the prospects for closer European integration, based on reconciliation between France and Germany. The European Coal and Steel Community, the 1955 Messina Conference, and the Treaty of Rome establishing the European Economic Community—all were landmark events which passed Britain by.

Britain’s alternative, the European Free Trade Area, established in 1960, soon turned out to be a second division affair. The Conservative government reversed course and applied for membership of the EEC,

but de Gaulle was not willing to share the political leadership of Europe. Britain spent the next ten years on the outside looking in. Ted Heath finally took the UK into the EEC in 1973, and Harold Wilson's referendum in 1975 confirmed British membership. Mrs Thatcher spent her first six years in office pursuing a legitimate reduction in Britain's contribution to the Community budget, but spent the next five years treating the European Economic Community as the enemy.

In the late-1990s Britain still appears as a semi-detached member of the EU. It has exercised its opt-out from the start of monetary union in 1999. It is not a participant in the Schengen accord, permitting freedom of movement of peoples among member-states. The British are still fighting old battles. They resist Franco-German suggestions that the EU, through its embryonic defence arm, the Western European Union, should take more responsibility for collective security, but their reasons are theological rather than practical. Britain has failed to grasp that the US has blessed a European "pillar" in the NATO alliance, and that even France understands that NATO is, and will remain, the ultimate guarantor of peace in Western Europe.

From the vantage point of Brussels, Britain's position inside the EU bares little resemblance to the inflated image promoted at home. Europe admires its first class, uncorrupted civil service. The British military forces command respect. English is also an increasingly important language, thanks to the recent Nordic enlargement. But in no sense is Britain a leader. It is a power that favours the status quo and which punches under its weight.

Not since Margaret Thatcher embraced the single market has Britain shown any genuine enthusiasm for a major European initiative. Most British ministers spend their time on the back foot in Brussels. Even in areas where the British have exerted influence, such as budgetary discipline, anti-fraud and subsidiarity (devolving decision-making to the lowest appropriate level), British motives are often seen as suspect. The British have therefore rarely been able to take the credit.

Britain could do so much better. For all their faults, the 1979 to 1997 Conservative governments pursued structural economic reforms which set an example to the rest of Europe. Britain has shown the way in

privatisation as well as in the liberalisation of sectors such as air transport, telecommunications and energy. European governments are being obliged to follow, though the Labour government should not kid itself that the British model *in toto* is for export.

In the diplomatic arena, the outlook for Labour is more favourable than at any time in the past decade. The balance of power on the continent is tilting, at least temporarily, away from an all-powerful Franco-German alliance. Co-operation between France and Germany is a necessary but insufficient instrument to make Europe work. The Delors-Kohl-Mitterrand troika, which drove Europe forward from 1985 to 1995, has broken up. In a union of fifteen member-states, countries are no longer so willing to yield primacy to the French and the Germans as the motor of future integration.

Germany is going through one of its periodic phases of angst and introversion. The country is weakened by record unemployment, an over-regulated, uncompetitive economy, and a consensus-ridden political system which is apparently incapable of delivering reform. As an exporter, Germany is a beneficiary of globalisation, but its high wage costs and rigid labour markets also make it a victim. Helmut Kohl is approaching the twilight of his career. He is too strong in Europe, but too weak in Germany.

France is also weaker. President Chirac's gamble in May 1997 on early parliamentary elections backfired. He has lost control of his Gaullist party. The government in Paris is divided between an isolated president in the Elysée, and a Socialist prime minister in the Matignon who heads a rainbow coalition of the left. France faces five years of "cohabitation" which will inevitably constrain French foreign policy. Despite a modest economic recovery, the mood in France is sullen. Successive governments of right and left have approached the reform of the public sector, essential to the modernisation of France, in a piece-meal and gingerly manner.

The diplomatic opening is there. But the British need to rediscover the art of making friends and influencing people. This means building broad coalitions, not strategic alliances based solely around France and Germany. The British should not be obsessed by the magic circle which constitutes the Bonn-Paris relationship. Britain cannot replace either partner. It must seek other routes to influence in Europe.

The key is EMU. For better or worse monetary union has become the make or break project in the EU. It is the essential building block for the completion of the single market. It is the catalyst for deeper integration, ahead of enlargement to central and eastern Europe. Thus Britain cannot pursue its European objectives except within the context of the construction of EMU.

The Blair government has failed to grasp the significance of EMU as a political project. Gordon Brown's November 1997 statement to the House of Commons, in which he deferred a decision on whether to join EMU for the lifetime of the present parliament, confirms that New Labour's priority is a second term. Blair and his colleagues sometimes seem to think that the rest of Europe will stand still while Britain makes up its mind. Their approach, which often appears to involve currying favour with a nationalist tabloid press, carries grave risks for Britain's position in the European Union.

Until now, Britain's opt-out on monetary union has given the government the best of both worlds. It has had a voice in negotiations on the terms of the single currency, while retaining the right not to participate. But once the political decision is taken on the membership of the future monetary union, in May 1998, Britain will be less equal than those taking part.

The countries in EMU will constitute a new elite group. Within a few months, on January 1st, 1999, the European Central Bank will set a single monetary policy across the euro zone, with potential spillover to the UK. The Central Bank will act as spokesman for the EMU group in international economic forums, such as the Group of Eight, where Britain's voice will necessarily be diminished.

Inside the "Ecofin" council of EU finance ministers—the most important political forum apart from the heads of governments' summits—Britain's position will erode. At the Luxembourg summit, in December 1997, the French and Germans won approval for their plan for an informal EMU-group, the "Euro-X" committee, which will meet ahead of the Ecofin council. This informal club will discuss matters of common interest to euro members, such as the exchange rate—but also, the French government reckons, tax and general macro-economic policy.

Tony Blair and Gordon Brown fought hard to gain the right to membership of the Euro-X committee. With hindsight, it may have been unwise of them to expend such energies in pursuit of a goal that was never likely to be attainable. However, their efforts did secure agreement that Ecofin would remain the principal forum for the EU's economic decision-making, and that when Euro-X discussed matters of concern to countries not in the euro, they would have the right to join in.

Britain looks set to join Denmark, Greece, Sweden and possibly Italy on the non-EMU benches. Life on the periphery may appear to be a comfortable option, while the government buys time for the British economy to converge with the rest of the continent; but this is not a sustainable policy in the long term.

There is no future for Britain as the leader of a group of Nordic euro-sceptics. Dining with the Greeks offers little sustenance either. Britain must accept that it can only exert a leading role in the European Union if it is prepared to embrace monetary union as a political and economic enterprise. The necessary shift is as much psychological as anything else. It requires the British government to confront the issue which politicians have consistently evaded since Britain became a member of the EU, 25 years ago. That is, to accept that the Community, now the Union, is much more than a free trade zone and a single market. It is a collective political enterprise in which nation-states are committed to pooling sovereignty in pursuit of the greater political and economic security of Europe.

Once the EMU nettle is grasped, Britain's status within the Union would be transformed. The case for membership is, in part, to avoid the mistakes of the past, when the French and Germans wrote the club rules and the British were obliged to follow later. It happened in the Common Agricultural Policy (CAP), and it could happen with EMU—even though Britain has influenced much of the technical preparation for the launch of the single currency. When the European Central Bank starts operations, in January 1999, Britain will have no seat on the executive board.

But perhaps the most important argument for joining EMU is that British participation would be a constructive act, more likely to help the enterprise become a success. In this respect, the Europeans—not the

British—find themselves in the role of *demandeurs*. The size of the UK economy and the importance of sterling as a reserve currency are such that British participation in EMU would add to the critical mass and to the credibility of the enterprise.

Finally, having made what continental Europe considered to be an irrevocable commitment to a project as far reaching as the Treaty of Rome, Britain's motives would be less suspect. Inside EMU, Britain would have a stronger hand to influence future developments that are crucial to British interests, such as reform of the Common Agricultural Policy, the regional funds and the EU budget. And it would have a better chance of shaping enlargement to the East, a British objective since the days of Mrs Thatcher, which should ensure that the Union evolves into an enterprise that is more flexible, outward-looking and tolerant of diversity. The new European agenda ranges from reform of EU institutions to a renewed examination of the European social model—and in particular labour market reform in the perspective of economic and monetary union.

Instead of fighting old battles and treating national sovereignty like virginity, the British need to move into a new age—an age where countries pool their sovereignty in some areas such as monetary policy while retaining national rights and vetoes over others, such as defence. As Max Kohnstamm, the former collaborator of Jean Monnet, says: "Small countries know they are small. Big countries are small too. They just don't know it."

There is a temptation to preach the virtues of the "British model", but Tony Blair should resist it. If the British government really does choose to change course—as opposed to tone—on Europe, it should realise that it has much misunderstanding to overcome, and much catching up to do. Listening and engaging rather than preaching would be a far more profitable approach.

None of the above should be seen as a plea for the government—or anyone else in business, finance or the media—to drop the traditional British role in the EU of useful trouble-maker. Europe often needs a dose of British common sense. The trick is how to be pro-British without being anti-European. It is difficult, but surely not impossible, as was shown during the final stage of the inter-governmental conference (IGC) which concluded in Amsterdam in June 1997.

The Treaty of Amsterdam

Shortly before dawn, on June 20th, 1997, EU leaders stumbled out of the swing doors of the Netherlands central bank in the centre of Amsterdam. They looked tired and fraught. Hours of negotiation had ended in a chaotic round of last-minute horse-trading, a hard-fought compromise on French demands for a new package to boost EU growth, and a new treaty on closer integration which fell short of initial expectations.

The Treaty of Amsterdam has since been widely dismissed as a mouse. It is without doubt modest by comparison with its illustrious predecessors: the 1986 Single European Act which opened the way for the free circulation of goods, services and capital, and the 1992 Maastricht treaty which fixed the timetable for monetary union by the end of the century.

The new treaty certainly bears all the signs of a holding operation. In the most sensitive areas of sovereignty—such as defence, foreign policy and international trade negotiations—the nation-states signalled clearly that they were not willing to hand over more powers either to the European Commission or to the EU acting as a collective legal entity. For the new Labour government, the Amsterdam negotiations provided none of the difficulties its predecessor encountered at Maastricht.

The most far-reaching provisions cover justice and home affairs. The new treaty envisages the complete freedom of movement of persons across internal frontiers within five years. Britain, however, has opted out of those provisions. In parallel, asylum and immigration matters, external border controls, measures to combat financial fraud against the EU and customs co-operation come within Community law.

These new arrangements, coupled with the prospect of the European Commission gaining the right to propose policies in these areas, offer substantial scope for common action in the future. Most members are now committed to closer co-operation—within the Community legal framework—on matters of internal security, an area which only five years

ago was deemed too sensitive for the pooling of national sovereignty.

The new treaty increases the power of EU institutions. The president of the Commission gains new legitimacy, through confirmation by the Parliament, and wins more say in choosing his or her own commissioners. With luck, this may lead to fewer second-raters and political rejects becoming commissioners. The European Parliament, meanwhile, gains more powers of co-decision over EU legislation.

The treaty also attempts to strengthen the EU mechanisms for co-ordinating foreign policy, creating the post of "high representative" to represent the EU to the rest of the world, and introducing limited scope for majority voting on foreign policy decisions. And the treaty establishes the principle of "flexibility", whereby some countries can co-operate more closely, most notably in the area of justice and home affairs, without being held back by laggards. Britain saw it as essential to restrict the use of flexibility, fearing that it could divide the EU into an exclusive grouping and a second division. It won the right for the member-states to veto moves towards flexibility as, indeed, they can *in extremis* block the use of majority voting on foreign policy.

The new Treaty of Amsterdam repairs several of the faults in the Maastricht treaty, but its chief weakness is that EU leaders failed to settle the institutional issues related to enlargement. These are, essentially, the number of commissioners per country; the necessary adjustment in the balance of power between small and larger member-states; and an increase in majority voting to prevent paralysis in a Union whose decision-making procedures have changed little since the Treaty of Rome.

Prior to Amsterdam, indeed throughout the 18-month long IGC that reviewed the Maastricht treaty, Europe's leaders, with the exception of a do-nothing Tory government in Britain, had argued that institutional reform lay at the heart of their deliberations. Indeed, the more ambitious countries, such as Belgium and Germany, were tempted to play up the prospect of early enlargement in order to generate pressure for deeper political integration.

The agreement to disagree on institutional issues in Amsterdam left EU leaders embarrassed by their own rhetoric. The issue of whether the

European Commission should be reduced from its present 20 commissioners (with two from each large member, and one from each of the small countries) has been deferred; so has the re-weighting of votes in the Council of Ministers in favour of the bigger countries, which—just about everyone agrees—is necessary to prevent the smaller member-states wielding disproportionate influence in an expanded Union.

The fact that the bigger countries have agreed in principle to give up one of their two EU Commission seats, as the Union enlarges to 20 countries scarcely mitigates the failure in Amsterdam: for the offer is conditional on a re-weighting of votes in the Council of Ministers to compensate those member-states losing their second Commissioner.

This means that before the EU reaches the 20-member mark, yet another inter-governmental conference will have to be convened. As Peter Sutherland, the former Irish commissioner, former head of GATT, and potential candidate for president of the European Commission, has pointed out, this postponement risks creating more uncertainty and delay over the expansion of the Union eastwards.

The failure to resolve institutional reform is serious, but not fatal. The EU has always been a creature of compromises, usually struck at the last minute. Since the prospect of the first new members joining is at least five years away, it is not surprising that smaller countries such as Belgium and Luxembourg, which stand to lose from a re-weighting of votes, preferred to put off the time of reckoning. The decisive moment in Amsterdam came when Germany's Chancellor Kohl went along with them.

Kohl's stand—highlighted by his refusal to consider more than token increases in qualified majority voting—turned official German policy upside down. Even his own foreign minister, Klaus Kinkel, was caught flat-footed in the final hours of negotiations. Yet much of the subsequent commentary on the German U-turn has been wide of the mark. Too much attention has been paid to Kohl's tactical retreats, rather than his long-term European strategy, for which economic and monetary union remains the overriding objective. His retreat on institutional questions was designed to shore up domestic political constituencies, to rally support behind EMU.

Kohl was adamant, too, that the IGC should not drag on to the point where it risked disrupting the EU's crowded political timetable in the last years of the decade. This calendar already requires decisions on EMU membership, enlargement and the future size of the EU budget—as well as preparations for the Chancellor's own bid for an unprecedented fifth consecutive term in office in September 1998.

The lesson of Amsterdam is that EMU doomed the IGC to secondary importance. Member-states are hedging their bets on deeper political integration until they know the shape and membership of the future monetary union. EMU, for better or worse, has become the catalyst for closer integration upon which almost all of Europe's hopes have come to rest. For a Britain which will not participate in the first wave of EMU, this ought to be a disconcerting message.

The transition to economic and monetary union

EMU is a once-in-a-century experiment which will transform the political and economic governance of Europe. It will touch the ordinary citizen as much as the international financier. It will affect daily travel, the operation of the capital markets, the management of national economies, and the power of national institutions. The launch of the euro will also affect Europe's perception of itself: political leaders will be seen, at last, to have redeemed a big promise.

Yet EMU remains a trip into the unknown. Those in favour argue that the single currency will usher in a new era of prosperity, built on stable prices, enduring fiscal discipline, and lower interest rates leading to higher investment, stronger growth and, ultimately, higher employment. But opponents see EMU as an act of folly which will divide Europe, reinforcing the post-Maastricht deflationary spiral, robbing nation-states of their sovereignty, and alienating a European public which is worried about the political legitimacy of European institutions and decision-making.

But now the political reality is that Europe's leaders have gone beyond the point of no return. Kohl of Germany, Chirac of France, Dehaene of Belgium, Prodi of Italy, Aznar of Spain, and Guterres of Portugal and Santer at the European Commission, among others, have tied their fates ineluctably to monetary union to a degree which few could have imagined five years ago. Even the new Socialist government in France, which wobbled briefly in the aftermath of the Left's upset victory last May, has closed ranks behind a policy of (moderate) fiscal retrenchment in an effort to ensure that France is a founder member of EMU. The prospect of an orderly delay, widely canvassed as recently as a year ago, is no longer feasible.

The political will driving EMU forward has led to an extraordinary

collective effort to squeeze inflation and reduce budget deficits to within a whisker of the Maastricht treaty's entry criteria. At the latest count, five countries—Denmark, Finland, Ireland, Luxembourg and the Netherlands—meet the deficit criterion of 3 per cent of gross domestic product. Austria, Belgium, France, Germany, Italy, Portugal, Spain, Sweden and the UK will either hit or come very close to the target next year. Only the Greeks are behind the pack on deficits.

For Britain, where memories of sterling's humiliating exit from the ERM in September 1992 still linger, the depth of the others' political commitment to a future fixed exchange rate regime is hard to grasp. There is a tendency to dismiss the daily mantra in support of EMU as an example of political correctness. The strength of the post-ERM recovery in Britain reinforces the view that the Europeans are adopting an ideological approach in pursuit of an objective whose economic merits are questionable.

The British are right to point out that Europe's leaders have largely ignored public opinion on EMU. It is still a project conceived and executed by an elite which would have difficulty winning a referendum in either France or Germany. Yet EMU is a project with a 30-year-long pedigree, stretching back to the 1969 Hague summit. And as Lord Cockfield, the former British commissioner, later wrote in his Brussels memoirs, the British have long failed to understand the import of covenants entered into at European level, such as the 1986 Single European Act which laid the groundwork for the single currency.

The result is that the political classes as well as business and financial interests in Britain have failed to take EMU seriously. They have been slow to wake up to the fact that it is likely go ahead on schedule, with direct consequences for the national interest. The Labour government's agreement in principle to join monetary union after the next election is a real step forwards, but does not go far enough. Nobody should underestimate the depth of commitment to EMU on the continent and the collective investment in its success.

This is particularly evident in the case of Germany. We have been constantly told in Britain that the Germans would never agree to monetary union because it would mean sacrificing the D-Mark, their

symbol of prosperity, stability and respectability since 1945.

Helmut Kohl is a statesman with a sense of history, especially of the 20th century. When he signed the Maastricht treaty, he made a solemn commitment to German participation in a future monetary union. The sole condition was that the countries aspiring to join EMU should meet entry criteria covering inflation, interest rates, exchange rate stability, public deficits and stock of government debt.

Kohl intends to honour his treaty commitment. He sees it as a rendezvous with history, a means of binding a united Germany of 80 million people irreversibly into a united Europe. Of course, nothing in history is irreversible. The Chancellor knows this, but exchanging the proven D-Mark for an untested euro comes close to an act of faith, at least in German terms.

Both the Bundesbank and the German finance ministry opposed Kohl's decision at Maastricht to yield to Franco-Italian pressure for an automatic starting date for EMU. They recognised that Kohl had made a fundamental concession. Germany's counter-demand in Maastricht was to insist on rigid entry criteria for countries aspiring to join the single currency zone. This was to be the insurance policy against admitting suspect economies. Italy, with its combination of political instability, weak governments and a mountain of debt, was perhaps the country whose entry posed the most difficulty for the Germans, if only on psychological grounds.

Yet the Germans were forced to compromise. The treaty's deficit and debt criteria of 3 per cent of GDP and 60 per cent of GDP are not immutable fixed targets, but reference values. In layman's terms, this means that countries can qualify for EMU membership if they can show sufficient and sustainable progress toward these targets.

As a final reminder to the Germans that EMU is about more than just decimal points, the treaty stipulates that EU leaders will take the decision on which countries qualify for EMU, albeit acting on recommendations of the European Commission and the European Monetary Institute, the precursor of the European Central Bank.

In short, the treaty states categorically that politicians have the last word, whatever the verdict of the independent professionals in Frankfurt or the financial markets. But in practice, as we shall see, the room for political manoeuvre is limited. Few seem likely to dare to reject judgements based on economic fundamentals which, if challenged, could unleash chaos on the foreign exchanges.

The German government has sought consistently to impose its terms on the Maastricht bargain. Kohl insisted successfully that the future European Central Bank should be located in Frankfurt. He also carried the day with his argument that the single currency should on no account be christened the Ecu. The official explanation was that ordinary Germans would never accept a name associated with the eponymous basket of euro-currencies in the European Monetary System, whose value has declined steadily against the D-mark. Another view is that Ecu sounded either too French or too much like the German word "Kuh", which means "cow". For once, it seems the German public's views have been taken into account!

More substantively, the Bundesbank and the German finance ministry have pressed for strict new rules to enforce budgetary discipline among future members of the single currency zone. These new arrangements form the centre-piece of the so-called Stability and Growth Pact agreed at the Dublin summit in December 1996.

At times, German demands have come close to seeking to re-open the Maastricht bargain. During 18 hours of negotiations in Dublin, Theo Waigel and his steely deputy, Jürgen Stark, pressed unsuccessfully for automatic sanctions against countries running excessive public deficits above the Maastricht ceiling of 3 per cent of GDP. Both the British and the French opposed the German position.

The dispute quickly developed into a matter of principle: the conflict between German demands for a "stability culture", automatically enforceable through numerical targets, buttressed by an independent European Central Bank; and French counter-demands for maximum ministerial discretion in the imposition of penalties, under the slogan of "national sovereignty", and for a political counterweight to the unelected technocrats in the central bank.

The eventual compromise in Dublin struck a balance between fixed targets, at which penalties can be triggered, and leaving the final decision on sanctions to politicians. The Stability pact was renamed the Stability and Growth Pact and, at the Amsterdam summit, survived the new French government's attempt to reopen its terms.

Observing the twists and turns of the past five years, I have come to one conclusion: the Germans, though clearly nervous about the terms on which countries will be allowed into EMU, have no intention of walking away from a solemn treaty commitment.

Their insistence on a strict interpretation of the criteria should not be read as a ruse to delay the project, but simply as a necessary tactic to win over a sceptical public that the D-Mark is not be exchanged for esperanto money. No doubt some populist politicians such as Edmund Stoiber and Gerhard Schröder will be tempted to use the single currency as a vote-winner. But the evidence to date is that the German public is not willing to support anti-Europeanism and that the broad swathe of the political class will back, albeit grudgingly, Kohl's crusade for the euro.

From Europe's stand-point, monetary union is a political tool for containing rather than consolidating German power. The creation of a new European Central Bank is a response to the French-led debate over the assymetry of the European Monetary System, which has forced its members to follow the monetary policy of the country with the strongest currency, in this case the D-Mark.

In the short-term, moreover, the paradox is that German weakness—not German strength—is one of the most powerful forces pushing in favour of EMU going ahead on schedule. Germany is paying the price for failing to address the structural weaknesses of economy, which were apparent in the late 1980s but which were overlooked as German unification became the overriding preoccupation after the fall of the Berlin Wall. Uniting the western and eastern halves of Germany has not only cost more than DM100 billion a year; it has also cost five lost years in modernising the arthritic German economy.

The chinks in Germany's economic armour were noted in a speech to the European Parliament delivered by President Rainer Herzog on October

10th, 1995. For the first time, a senior member of Germany's political establishment made the link between an overvalued D-Mark and rising unemployment. As Herzog pointed out, the strength of the German currency was not solely in the gift of an inflation-obsessed Bundesbank. It was dependent, too, on the degree to which foreign markets were open to German exports, which accounted for 30 per cent of German GDP. More important, more than two-thirds of these exports went to European markets. If a super strong D-Mark was pricing those exports out of neighbouring markets, unemployment in Germany was bound to rise.

These arguments have gained ground as the number of people out of work in Germany has soared. By early 1997, unemployment had passed 4.7 million, the highest level since Hitler came to power in 1933. In the meantime, a significant exchange rate adjustment has taken place. The D-Mark has lost 25 per cent of its value against the pound, and 17 per cent against the dollar in the past 18 months.

EMU supporters in Germany have turned the devaluation of the D-Mark to their own advantage. They argue that a postponement of monetary union would be ruinous to German exporters, for it would almost certainly trigger a flight back into the D-Mark as a safe haven currency. With an overvalued currency, Germany would catch the equivalent of the Midas touch: Standort Deutschland would turn inexorably into a gilded industrial wasteland.

This sorry state of affairs leads us to the final and most surprising element in the single currency debate in Germany. The introduction of the single currency is seen by some German industrialists not only as a guarantor of stability in export markets in western Europe, but also as an explosive force for change inside Germany itself.

With a tight monetary policy, a commitment to fiscal discipline and fixed exchange rates, plus competition from the German hinterland in eastern Europe as well as Asia, the pressures for more labour market flexibility, more wage differentiation and less centralised wage bargaining are bound to increase. Germany will also experience a further blast of competition from the introduction of transparent pricing in cross-border trade in euro-denominated goods and services. As one senior German banker puts it, the single currency may represent the best chance in a generation

to sweep away the gild mentality still gripping the country.

In the debate over whether EMU will go ahead on schedule on January 1st, 1999, it is often overlooked that a de facto fixed exchange rate system has existed in western Europe for 10 years. It is called the D-Mark bloc. Member countries—Denmark, France, Germany, Austria, and the Benelux countries—have linked their currencies without the need for substantial exchange rate adjustment during this period. Their commitment to a constant D-Mark value and an anti-inflationary monetary policy has survived shocks inside and outside the system, to the point where they are within a whisker of their goal of a fixed exchange rate regime.

Perhaps the most striking example is France. British commentators in the City and in the press have frequently cast doubt on France's ability to stay the course on EMU. Bernard Connolly, the renegade European Commission economist, has argued that successive French governments' attachment to the D-Mark link is symptomatic of a Vichy-style desire to seek accommodation with Germany.

At times, the willingness of the French authorities to pursue a tight monetary policy has looked like a one-way ticket into a *cul de sac* of slow growth and high unemployment. But successive French governments have retained a stubborn faith in the *franc fort* policy, despite wobbles during the currency crises which erupted in 1992-93 and the public sector strikes which have swept France periodically. France's long-term goal has been to end the Bundesbank's monetary hegemony in Europe, and to recapture a degree of monetary sovereignty through a European Central Bank. Its politicians have stuck doggedly to that objective.

French forbearance has been all the more striking because the pressures on the franc were not the result of a fundamental disequilibrium between the French and German economies. They stemmed from high German interest rates imposed by the Bundesbank, to counter the inflationary pressures of Chancellor Kohl's financing of German unification through borrowing rather than higher taxes.

After the 1993 ERM crisis, many were tempted to write off EMU for good. *Bild Zeitung*, the mass-market German daily, summed up the mood:

"Euro-money is stone dead—hurrah the D-Mark is still here". But the obituaries were premature. The real lesson of the ERM crisis was the ability of the EU to improvise in order to salvage long-term political goals.

Thus, the decision in August 1993 to widen the fluctuation bands of the ERM from 2.25 per cent for strong currencies, and 6 per cent for weaker ones, to 15 per cent for all members, gave EMU a new lease of life. The speculators were stymied. EMU aspirants resisted the temptation for an early cut in interest rates. The surprising result was that the pattern of European exchange rates, at least for the inner group of countries, soon reverted to its pre-crisis mould.

In the run-up to the currency turbulence of 1992-93, the chances of Italy, Portugal and Spain meeting the entry criteria seemed remote. Italy was still the sick man of Europe: its budget deficit was around 10 per cent of GDP; consumer price inflation in 1990 was 6.5 per cent, more than double the level of France and Germany; the debt was more than twice the 60 per cent of GDP Maastrict ceiling. In September 1992 the lira was forced out of the ERM. As for Spain and Portugal, both had been forced to devalue their currencies; inflation was still not under control; and budget deficits were well above the Maastricht 3 per cent limit.

In the past three years, however, a remarkable turnaround has taken place. Portugal and Spain are within a jot of meeting the deficit targets; inflation seems under control; and their currencies have experienced a period of relative stability. The only shadow over their prospects is high unemployment, particularly in Spain – though the figure of 20 per cent may be inflated because it takes no account of the black market.

The most extraordinary success story is Italy, where successive reformist governments, exploiting the popular clamour for change in response to corruption scandals, have pushed through a series of courageous budgets. This year, Italy's public deficit should be close to 3 per cent of GDP. Inflation is running at under 2 per cent, the lowest for 18 years. In late 1996, the Rome government agreed terms with its EU partners for the re-entry of the Italian lira into the ERM, thus meeting one of the criteria for EMU membership.

Yet the most important development of all is the convergence between Italian and German interest rates. Long-term Italian rates fell from 13 per cent in April 1995 to below 6 per cent in December 1997. The differential with the corresponding German yields had narrowed by December 1997 to an historical low of 0.4 per cent. As a result, the cost of serving Italy's debt mountain, on which interest payments account for around 20 per cent of public expenditure, has fallen sharply. Meanwhile, Italy is basking in a primary current account surplus of more than 6 per cent of GDP.

Italy, in short, is benefiting from a virtuous circle. It is using the confidence of the financial markets to complete the Sisyphean task of reducing the debt and therefore the public deficit. The reduction in the deficit is in turn helping to maintain that very market confidence. The result is that Italy should move close to the 3 per cent deficit target for 1997. The near collapse of the centre-left government in the autumn of 1997 raised doubts over the country's ability to take the extra measures needed to curb the ballooning costs of state pensions. Prodi's Lazarus-like recovery has failed to dispel the fundamental question as to whether Italy's effort is politically sustainable.

Yet the improvement in the southern countries' economic performance makes it much harder hard for a German-led rump to argue in favour of their exclusion. There is no political stability criterion in the treaty. Whatever doubts the Germans may have about Italy, they seem more a reflection of the past rather than the present. If the figures are "clean" and supported by the European Monetary Institute and the European Commission, and if the treaty's provisions are respected, the Germans would find it hard to mount a coalition against the Italians in May 1998. To do so would be the contemporary equivalent of a declaration of war.

Excluding an economy the size of Italy would also create problems for the single market. France, a major trading partner of Italy, has good grounds to fear a "pirate" lira. In June 1995, President Chirac provoked a diplomatic incident with Lamberto Dini, the Italian prime minister, when he complained about the weak lira. Dini rightly pointed out that the countries calling for an appreciation of the lira in 1995 were the same ones calling for a depreciation of the lira in the summer of 1992. In 1995, fortunately, the European Commission resisted France's pleas for compensation for the currency fluctuations which were hurting exports of furniture, cars and aerospace projects.

Martin Wolf, of the *Financial Times*, once criticised the idea that a market required a currency to complement it: "A single market is simply a more integrated customs union. It is possible that a single market for goods and services, combined with separate national labour markets, as in the EU, needs many currencies in order to work better....It is, as in all economics, a matter of costs and benefits."

Yet the single market would also clearly benefit from the introduction of a single currency. This is not so much because of the well–publicised reduction of transactions costs. At around 0.4 per cent of EU GDP, the savings are hardly enormous. The more important factor is intangible: the degree to which investment and cross-border economic activity will flourish as a result of businesses no longer holding back because of the risks of currency fluctuation and the costs of currency hedging.

The Union's combination of a highly competitive single market and low inflation makes businesses extremely sensitive to even small exchange rate changes. This explains much of the strong support that big business is bringing to the project.

Companies have benefited from the dismantling of barriers to the free movement of goods, services and capital; but governments continue to put barriers in place in order to protect their own domestic markets. The European Commission regularly publishes the violations. The temptation to put these barriers in place will be all the greater if governments can use the excuse that others are cheating through unfair exchange rate manipulation.

The idea that Britain could allow sterling to become a rogue currency, seeking to boost exports through competitive devaluations, without consequences for its access to the single market, is fanciful. A British government might argue that an exchange rate reflects economic fundamentals and that there is no such thing as a competitive devaluation. But at some point, the provisions of the Maastricht treaty, to which Britain is after all a signatory, would be invoked. All member-states are required under the treaty to treat exchange rates as a matter of common interest. Even though the treaty has no provisions for sanctions, the euro-group would be sorely tempted to take action against British exports. Britain could expect no favours from the European Commission as

independent arbiter and guardian of the treaties. The conclusion should be obvious: in today's EU, there are evident constraints on the freedom of any member's exchange-rate policy.

Making a success of EMU

The new Labour government has pledged that it will do nothing to undermine the movement towards monetary union, which will accelerate during the British presidency in the first half of 1998. The risks for a successful launch of EMU on January 1st, 1999 are manageable, but they are by no means negligible.

The calendar is tight. In line with the Maastricht treaty, the EU must select countries qualifying for EMU and ensure that the European Central Bank is up-and-running in time for the introduction of a single monetary policy on January 1st, 1999. This will require delicate diplomacy, some difficult personnel decisions, and an important brokering role for the British presidency.

The process will start in late February 1998, when the European Commission and the European Monetary Institute produce recommendations on which countries meet the criteria for EMU. The crucial argument will turn less on performances in 1997, as many have been led to believe during the debate over decimal points in Germany, but on the sustainability of current policies.

The EMI's role as independent professional judge is critical. It will make use of other independent evaluations, notably those of the International Monetary Fund and the Organisation for Economic Co-operation and Development, which are constantly monitoring the European economies. Whatever its own pro-EMU inclinations, the Commission will be forced to follow the EMI recommendations, lest a divergence in opinion unnerve financial markets. The EMI and Commission reports will also be the subject of debate among member-states, notably in the German Bundestag. The European Parliament is also entitled to give an opinion.

Political leaders have the final word at a summit under British chairmanship in early May 1998; but even their margin of manoeuvre is severely constrained by the recommendations of the experts. They know

that disregarding the verdict of, say, the EMI would cast doubt on the credibility of the EMU process and the prospects for a safe, stable launch of the euro.

There is a risk is that the markets may be unsettled in the period between the EMI/Commission recommendations and the formal summit decision. However this risk has been reduced, now that EU leaders have pledged to announce the bilateral conversion rates among EMU participating countries in May 1998, at the same time as the selection of countries. Provided the choice is credible and there are no surprises, there is a reasonable chance of stability ahead of the irrevocable fixing of exchange rates on January 1st, 1999.

Decisions on the senior appointments for the European Central Bank look more straightforward in terms of the financial markets but they are, however, still politically sensitive. The diplomatic fracas over the post of president of the European Central Bank has more than amply illustrated this. The front-runner was Wim Duisenberg, who took over as president of the EMI from Alexandre Lamfalussy in July 1997. Lamfalussy, a man with sharp political instincts, deliberately left his post six months early in order to give Duisenberg the chance to establish a track-record and occupy pole position for the ECB job. These arrangements reflected the interests of a cosy central bankers' club.

President Chirac's surprise nomination of Jean-Claude Trichet is a solely political manoeuvre. Now the post has become a proxy battle for the conduct of monetary policy in the EMU world: Duisenberg, although a Dutchman, represents the Germanic orthodoxy that the ECB should be super-independent and super-aggressive against inflation; Trichet is a symbol of the French view that the ECB, although independent, should remember that it operates in a political "context", and that although low inflation should be the prime goal, growth and employment should not be ignored entirely. Britain will have no vote in these appointments, but in its capacity as EU president will have to play the role of honest broker.

None of the above addresses the economics of EMU, which remain as problematic as ever. In a semi-fixed but adjustable exchange rate system such as the ERM, it is always possible to correct an exchange rate

misalignment. With monetary union that escape route would no longer exist. The German-backed Stability Pact allows little scope for a fiscal adjustment to cope with an external shock. Nor are member-states willing to contemplate the creation of a new short term financing facility or an extension of the EU budget.

In political terms this is hardly a comforting scenario. EMU risks becoming a scapegoat for Europe's economic inadequacies. Moreover, as Eddie George, governor of the Bank of England, has pointed out on numerous occasions, the Maastricht convergence criteria address nominal rather than real convergence, for example of the deep-seated structural differences among the European economies.

Insufficient real convergence could mean slower growth or higher unemployment in some countries than others. In that case, the imbalances would probably have to be addressed by a combination of four adjustment mechanisms: longer-term unemployment, falling wages, migration or fiscal transfers. There are, in other words, considerable economic risks in the project.

These differences have been obscured by the impressive collective effort to reduce inflation and public deficits. But they are apparent in the differing levels of unemployment, which remains unacceptably high in, for example, France and Germany. The numbers out of work, especially amongst young people, reflect inflexible labour markets, inadequate training and a continuing reluctance to tackle the excessive costs of hiring labour.

Over the past four years, since the publication of the Delors white paper "Employment, Growth, Competitiveness", European governments have accepted the intellectual case for labour market reform. But they still lack the political strength to make the requisite changes. This is manifestly true in France, where the new left-led government is as chary as its right-wing predecessor of tackling a cosseted public sector. Paradoxically, it is less true of Italy, where successive coalition governments of the right and left have made steady progress.

Only the British Labour government has so far made the direct connection between labour market reform and a soundly functioning monetary

union. Until others do so, there must be a question mark about the enterprise. For all the dozens of declarations in favour of EMU as a political goal, France and Germany have different notions about how economic and monetary union may work in practice. The differences between the French and Germans are deep, because they go to the heart of their respective political cultures.

Germany's post-war economic success story is built on anti-inflationary rigour, the so-called Stability Culture. The guarantor of this culture is the Bundesbank, whose independence is enshrined in the constitution. It has become fashionable to point out that, on occasions, political leaders have overruled the Bundesbank. The most famous example was Chancellor Kohl's decision to dismiss the central bank's misgivings and insist on a one-to-one swap between the D-Mark and the Ost-Mark after German unification. But these are the exceptions to the rule. Stability *uber alles* and confidence in the national currency—each guaranteed by independent professionals acting above the political fray—still exercise a powerful hold on the German popular imagination.

The French tradition is very different. The French state may have been compromised in World War II but it was not destroyed, as it was in Germany. The tradition of state interference or state management of the economy is ingrained, going back three centuries to the days of Colbert.

The notion of an independent central bank, by contrast, is new. Legislation guaranteeing the independence of the Banque de France—a necessary for qualification for EMU—was only passed in 1993. In France, it is still inconceivable that all power should rest with unelected central bankers. As the French have stressed time and again, there must be a political counterweight to the future European Central Bank, with responsibility for economic co-ordination and the euro's exchange rate policy.

Britain can bridge this cultural divide, playing to both traditions and to the needs of both countries, neither of which completely trust each other. Former Chancellor Kenneth Clarke pointed the way during the fraught negotiations on the Stability Pact, siding with the Germans on the principle of fiscal discipline and with the French on political accountability.

The Stability Pact, discussed earlier, is a somewhat artificial attempt to guarantee fiscal discipline among member-states in the euro-zone. The details are less important than the solemn and binding commitment to avoid budgetary overshoots. The pact's job is one of deterrence, rather than to be a mechanism for imposing fines on recalcitrants which can, in any case, plead exceptional circumstances such as a severe recession. The head of one EU central bank has likened the provisions to a torture chamber in which the instruments are simply too horrible to apply.

Britain's brokering role could become more important once EMU goes ahead. The challenge is to balance French demands for an active pro-growth, pro-employment policy with German insistence on no new EU spending programmes, iron fiscal discipline and ECB independence. These tensions surfaced at the Amsterdam summit, and will continue to play a role as Europe struggles to tackle unemployment of 18 million.

What the new Labour government brings is a fresh approach, marrying a responsible approach to public finances with a flexible labour market policy, within a context of a welfare state that is to be reformed. This "third way", as Tony Blair showed in his keynote speech at the European Socialist Congress in Malmo in May 1997, could offer the British a chance to shape the post-EMU world.

Yet in order to earn the trust of the French, Britain will have to move towards accepting the French desire for a new economic government in Europe, to counter-balance monetary union. This is, in fact, less difficult or controversial than it sounds. For it is no more than acknowledging the primary role of Ecofin, the council of finance ministers, in providing the macro-economic policy framework. The French hope that concerns over inflation and fiscal discipline will be subsumed into a broader agenda, including tax and employment policy.

Ecofin's role has developed beyond recognition since the signing of the Maastricht treaty and the introduction, in 1994, of the procedure whereby finance ministers submit their national economic programmes and budgets for judgement by their peers. This peer pressure, designed to achieve policy convergence, will intensify after EMU, and the British should welcome it. It is also in Britain' s interest to build up Ecofin in order to contain the potential power of the new informal Euro-X club.

Properly managed, the co-ordination of economic policy in the EU should pose few difficulties for the British. The nation-state will still have discretion over tax and employment policies, but it will have to take into account collective constraints.

Enlargement of the European Union

Every time the European Union opens its doors to new members, the result is culture shock all round. The entry of post-imperial Britain marked the end of the intimate club of six, built around France, Germany, the Benelux countries and Italy. When Greece, Portugal and Spain joined, the centre of gravity shifted southwards and the demand for extra financial resources increased dramatically. The entry of Austria, Finland and Sweden in 1995 tilted the balance toward open government, women's equality and free trade, away from the closed, male-dominated, spendthrift world which has long dominated Brussels.

Nothing – not even the Club Med enlargement – compares with the plans to admit 11 applicants: the Czech Republic, Hungary, Poland, Slovenia, Estonia, Latvia, Lithuania, Bulgaria, Romania and Slovakia, plus Cyprus. The EU's own population will increase by one-third to nearly 500 million; but total gross domestic product will rise by barely 5 per cent. Although Greece, Spain and Portugal were poor, they had market economies; and they had fairly extensive civil societies with reasonably embedded legal systems which had survived the scars of dictatorship. By contrast, the former command economies of central and eastern Europe spent more than 40 years trapped in a political and economic time-warp.

Eastern enlargement will require the EU to transform the way it does business. It will have to streamline its institutions and decision-making, which have barely changed in 40 years. This means governments re-thinking the national veto, the right to an EU commissioner in Brussels and even the right to work in one's own language. It also means reforming and adapting core policies such as regional aid and the CAP, both of which enjoy the support of powerful political constituencies in the Union and are resistant to change.

Britain has a vital role to play in organising a coalition of member-states committed to early enlargement. It is well placed to do so because of its long-standing commitment to expand the Union beyond the Oder-Neisse

line, as part of a strategic imperative to anchor the new democracies and market economies to the West. The British also see enlargement less as a threat to existing rights and privileges and more as an opportunity for accessing new markets. A successful enlargement could tilt the Union in a direction favourable to Britain.

But, if Britain is to succeed, the Labour government needs to strike a balance between what might be termed "the old" and "the new" Europe. There are limits on how far Britain can use the admission of agricultural economies such as Poland as a lever for reforming the CAP. Too overt a link between CAP reform and enlargement risks triggering a backlash in France and the Mediterranean countries. On the other hand, the expansion of the Union to more than 20 countries will obviously require a re-examination of the national veto. It may well serve Britain's interest to argue in favour of more majority voting on trade policy, in order to weaken protectionist pressures that may stem from the admission of poorer eastern bloc countries.

A divide has already opened up between EU countries committed to early enlargement and those in favour of delay. Britain stands alongside Denmark, Finland and Sweden, in the first camp, supported by a Germany torn between powerful farming interests and Chancellor Kohl's strategic commitment to stabilise his country's eastern borders through the admission of the Czech Republic, Hungary and Poland.

The Benelux countries are nominally committed to enlargement but are reluctant to see their own position in the Union diluted, unless it moves in an explicitly federalist direction. The southern countries, led by Spain, see enlargement primarily in terms of a financial net loss and a "German design" to shift the political centre of gravity towards the north and east. And there is the problem that, as Jean-Claude Juncker, Luxembourg's prime minister, frequently warns, enlargement has no natural political constituency amongst the European public.

The starting point for debate is Agenda 2000, the European Commission document of July 1997 which assessed the merits of the ten applicants. The Commission's opinions are based on criteria agreed at the 1993 Copenhagen summit, stipulating that entrants should have a functioning market economy; respect the rule of law, human rights and ethnic

minorities; and be capable of taking on the *acquis communautaire*, including monetary union. Another criterion was that the EU itself should be sufficiently integrated and streamlined to be able to take on the newcomers.

The Commission recommended that five countries should join Cyprus in the first wave of countries negotiating to join the Union. The favoured five are: the Czech Republic, Hungary, Poland, Estonia and Slovenia. Five failed to make the first cut: Bulgaria, Latvia, Lithuania, Romania, and Slovakia.

Hans van den Broek, the EU commissioner responsible for enlargement, resisted heavy pressure both in and outside the Commission to restrict the short-list to the Czechs, Poles, and Hungarians who, in July 1997, were invited to join NATO. The EU leaders endorsed the Commission's short-list at the Luxembourg summit in December 1997.

Despite the summit agreement, geopolitical interests will continue to influence the enlargement process. The Swedes, supported by the Danes and the Italians, had wanted negotiations to begin with all 10 applicant countries at the same time. This had been mainly a gesture to the two disappointed Baltic states of Latvia and Lithuania. France is likely to continue championing the cause of the new reformist government in francophile Romania.

Finally, there remains a dilemma over Slovakia. The Bratislava government's application was judged to be on course for meeting the criteria regarding economic performance, but it fell dramatically short on political criteria such as the freedom of association, the rule of law, democratic institutions and the rights of minorities. Of all the applicant countries, Slovakia was the sole to receive a negative verdict on this count.

The Union has to avoid drawing new lines across the continent and yet offer encouragement to those candidate countries, such as the Czech Republic, Hungary, and Poland, which have made the most progress in economic reform. So the Union plans a standing pan-European conference, to which all existing and aspirant members will be invited, to be held first in London in March 1998. It has also adopted a Commission

plan for “accession partnerships”, which will offer financial assistance and regular assessment of candidates’ progress towards membership.

The whole process of enlargement could yet founder, if the problems of Cyprus and Turkey are not resolved. The divided island of Cyprus has a guaranteed place in the accession negotiations, thanks to Greek pressure. However, in the absence of a settlement between the island’s Greek and Turkish communities, the decision to set talks in train looks like a high-risk gamble.

The optimistic view is that the economic benefits of future membership will encourage the Turkish Cypriots in the north to strike a deal with the Greek community in the south. But this underestimates the personal animosity and mistrust between Rauf Denktash and Glafcos Clerides, the ageing leaders of the respective communities, and it also depends crucially on a rapprochement between the patron states of Greece and Turkey.

There does not seem to be much prospect of that, following the virtual breakdown in relations between Turkey and the EU after the Luxembourg summit. The heads of government placed Turkey, which first applied for membership in 1963, in a third division of applicants: not in the first wave, nor in the second, whose countries will benefit from accession partnerships, but by itself in the bottom division. True, they did say that Turkey was, in principle, eligible to join, but Juncker’s comment that the EU could not let in torturers was hardly designed to sooth Turkish sensibilities.

Turkey reacted by rejecting its invitation to the London conference and by saying that it might withdraw its membership application. It also threatened to absorb northern Cyprus if the EU let in the Greek Cypriots. This reaction was so strong because the Turks were already fed up with their treatment at the hands of the EU. Greece has proved adept at mobilising human rights activists in the European Parliament to block long-promised financial aid. And in 1996 a gathering of European Christian Democrat leaders had concluded that Turkey should not be allowed to join because it was predominantly Muslim.

Chancellor Kohl has been one of the EU leaders most reluctant to endorse

Turkish membership. He knows that many Germans, thinking that there are quite enough Turks in Germany already, say the following: "We agree to give up our currency, we'll even let in the Poles, but do not ask us to take in the Turks too."

There are real problems about letting Turkey into the Union in the near future—its 60 million population is poor, torture does occur in its police stations and prisons, its military plays too prominent a role in politics and it has no strategy for dealing with the Kurdish insurrection other than to meet violence with violence. But the EU must make an effort to entice Turkey into a dialogue, for example through the European conference, to cement its western orientation. A loyal NATO member, Turkey is one of the few countries in the Middle East that is largely democratic. As the Americans rightly point out, Turkey is a potential bulwark against Islamic fundamentalism.

Britain could play a crucial role in binding Turkey into a closer association with the Union. For it is one of the few members to enjoy good relations with Ankara. Britain should work to ensure that the EU's acceptance of the principle of Turkey's eligibility for membership looks genuine rather than grudging. Turkey should be given a set of clear criteria that it can aspire to meet over the coming decades; it should be assured that, when it can meet them, negotiations on entry will start. A more positive EU stance would encourage the right sort of economic and political reform in Turkey. A rapprochement between the EU and Turkey would, hopefully, give all parties a breathing space to reach an accommodation on Cyprus.

Of all the challenges thrown up by enlargement, deciding which countries to let in is probably the easiest. The most difficult may be money. The European Commission claims that enlargement can be funded without any real increase in the EU budget. So do net contributors such as France, Germany, the Netherlands and the UK. They are adamant that their own national contributions will not increase during the lifetime of the 1999-2006 budgetary package. The Germans and the Dutch are even campaigning for a net reduction in their contributions.

Agenda 2000 attempts to strike a balance betwen the interests of net beneficiaries and net contributors to the budget. The strongest reason for

thinking that enlargement will be financed within the current ceiling of 1.27 per cent of EU gross domestic product is that any new budget deal will require the unanimous consent of all 15 member-states. Britain should argue in favour of the Commission approach, which is based on the following assumptions:

The EMU factor
EU governments are not going to commit to higher contributions to the EU budget, to fund enlargement, at the same time as they are making unprecedented sacrifices at home to meet the public deficit rules for EMU.

The German factor
The first and second Delors budgetary packages, agreed in 1988 and 1992 in Brussels and Edinburgh respectively, were largely funded by Helmut Kohl's largesse. In Brussels in 1988, Germany could afford to pay; in Edinburgh in 1992, Kohl was willing to stump up extra money simply out of gratitude for German unification. Post-unification, Germany is poorer and meaner.

The absorption factor
The Commission argues that it would not make sense to offer full access to the regional aid budget because the new members would never be able to absorb the funds productively. The most they could usefully swallow is around four per cent of GDP, says the Commission, and that acts as a natural constraint on the growth of the budget. The British suspect that even this figure is too high.

The British rebate
Contributions to the EU budget are made up of a share of customs duties and of VAT receipts, and of a payment based on a general assessment of per capita wealth. After a long campaign Mrs Thatcher succeeded in winning a rebate from the rest of her European partners, which was later confirmed in the 1992 Edinburgh budget agreement. The Commission blueprint leaves British rebates untouched, but signals that it is likely to be open to review in the budget negotiations due to start in 2006.

Britain will have to tread warily between the conflicting claims of net contributors such as Germany and the Netherlands, which are pressing for British-style rebates, and net recipients, led by Spain, who are

desperate to preserve their privileged financial position. Tilting too far towards the Dutch and Germans risks provoking a southern veto on early eastern enlargement. However, as a net contributor to the budget, Britain has a strong self-interest in curbing the cost of regional aid especially since Britain is likely to lose out under new objective criteria for structural fund assistance.

Britain will probably have to give some ground on the multi-billion dollar Cohesion Fund, set up in 1992 to reduce economic disparities between the poorer countries—Greece, Ireland, Portugal and Spain—and the rest of the Union. Spain argues that if the last three of those countries join EMU in 1999, they should still be able to draw on cohesion money, as long as their per capita GDP stays below 90 per cent of average EU GDP. Spain looks likely to win this argument. The best deal Blair can hope for is the tapering off of the Cohesion Fund early in the next century, combined with a review clause to ensure that all regional aid is thoroughly re-examined in 2006.

The second difficult challenge is the reform of the CAP. Agenda 2000 spells out a clear message to farmers and consumers: the status quo will not hold. Without reform, the Commission projects that rising agricultural output would create a new EU grain mountain of 58 million tonnes, twice the previous record. The beef surplus would be 1.5 million tonnes, 50 per cent above its 1980s peak. Furthermore, new World Trade Organisation talks on agriculture are due to open in 1999. These will almost certainly impose strict limits on EU exports unless the Union ends the system of export subsidies whereby farmers are compensated for the gap between internal and world prices.

Yet the CAP retains a mythical grip over political leaders in Europe. It is one of the EU's "core" policies, a symbol of solidarity between town and countryside, north and south. Anyone pushing change must tread carefully, especially in the context of enlargement. As Felipe González, the former Spanish prime minister once declared, enlargement will not occur on the backs of the Mediterranean farmer.

The Commission's proposals build upon the successful 1992 McSharry reforms. They reduced the amount of money used for intervention to support prices, and shifted toward income subsidies for farmers. Under

the old system, farmers would produce regardless of demand because they knew they were working inside a system which provided an effective price guarantee.

Under the Commission's current proposals, support prices would be cut by up to one third, freeing farmers to export world-wide instead of being rewarded by Brussels for producing excess stocks. Direct income payments would rise, but a ceiling would be introduced to prevent grain barons scooping up the bulk of the aid. However the reforms are not cheap: the net cost of the CAP would actually rise because direct aid would exceed the savings generated by a cut in support prices.

The other key issue is how soon the new member-states from the east could expect to gain access to the CAP. Extending it willy-nilly to unreformed economies in the east would not only be prohibitively expensive; it would also line the pockets of the farmers and create a new nomenklatura on the land.

Franz Fischler, the EU's agriculture commissioner, suggests that eastern European countries will need five to ten-year transition periods. With the first new members unlikely to enter the Union until 2002-03 at the earliest, the fully enlarged CAP may not operate until 2010. This suggests that the real negotiations on CAP reform will take place in 2006, at the same time as the next round of EU budget negotiations. The British are still inclined to talk tough, as if they could kill the CAP; in practice this is unrealistic. A full-scale assault on the CAP would merely provoke a southern veto on enlargement. Therefore the best hope is to continue the slow but steady transformation of the policy which began under the McSharry reforms.

The toughest nut to crack in the enlargement negotiations is how soon the aspiring members assume the full rights and obligations (the *acquis*) of the present 15 members of the EU club. The most difficult subjects are social and environmental policy. Some gradual harmonisation of rules may be needed to avoid different regulatory standards acting as barriers to trade; but to expect the newcomers to take on the full responsibilities would increase costs and undermine competitiveness, just as these countries are gearing up to face the full blast of the single market competition.

Spain and Portugal were both forced to accept lengthy transition periods for their agricultural products, during their own enlargement negotiations which, it should be stressed, lasted more than seven years. On fisheries, the Spanish had to swallow a 20-year transition. It seems unlikely that countries like Spain will be overly generous when it comes to dealing with the newcomers from the east.

Yet Spain is not the only source of hard bargaining waiting in the wings. When it comes to countenancing freedom of movement of labour for the newcomers to the east, the Germans, the self-styled champions of enlargement, seem certain to press for lengthy transition periods. The idea of Polish dentists, doctors or other professional workers streaming west over the Oder is enough to send most German politicians into a spin.

Once again Britain will have to strike a balance between two conflicting approaches. On the one hand, it makes sense to press for the shortest possible transition periods, to ensure meaningful early membership for the central Europeans. On the other hand, the British have as big an interest as the Spanish in ensuring that the Eastern newcomers are capable of enforcing the minimum standards of product regulation in the single market, which points to lengthy transition periods. In terms of negotiating tactics, Britain may need to position itself at the short end of the transition period debate, if only because so many countries are likely to use transition periods as an excuse for keeping the club doors shut, for as long as possible.

The most worrying aspect of eastern enlargement is that it is so obviously still hostage to the EU's own internal agenda. The successful launch of EMU has become, fairly or unfairly, the pre-requisite of expansion in the mind of a French-led bloc, if not Germany. A delay or postponement of EMU would set in train a political crisis and certainly delay enlargement.

Enlargement is also hostage to further constitutional reform. The European Commission wants another inter-governmental conference as early as possible after 2000, in order to streamline decision-making and institutions in anticipation of new members. At present, no-one expects a long-running IGC on the lines of Maastricht or Amsterdam, but it is too early to predict the outcome of a discussion which must be resolved among the 15 existing member-states. A failure to agree on institutional reform could easily delay enlargement.

Outside factors could also upset the EU's timetable. The enlargement of the NATO military alliance seems certain to influence EU enlargement, at least indirectly. The EU is adamant that Union membership cannot serve as compensation for NATO membership, but the pressures exist. For example, many Americans argue that because NATO will not allow in the Baltic republics in the foreseeable future, the EU should hasten to let in all of them.

Russia, which has so far exuded a benign attitude to EU enlargement in contrast to its hostile response to NATO expansion, may change its attitude in the coming years. The Baltic states, including Estonia with its big Russian minority, are an obvious point of sensitivity. Much will depend, therefore, on how the EU manages its own bilateral relationship with Moscow, including the plans to strengthen the partnership and co-operation pact, and trade links.

Similar potential for friction exists in Romania and Slovakia, with their sizeable Magyar minorities. They will need every incentive not to backtrack on their commitments to neighbouring Hungary on the minority issue. Hungary has an even greater incentive to avoid stoking tensions, because it looks like being one of the first in line for membership.

Enlargement will only succeed if it appears to be an inclusive process in which the prospect of membership is real and the cost for the existing EU members is manageable. It will undoubtedly take longer than many predict. But it is also entirely possible that public opinion in the candidate countries may also change regarding EU membership. NATO membership may be seen as the sufficient answer to some countries' search for security. Public support for EU membership is unrealistically high in countries such as the Czech Republic and Poland and could easily fall if—as appears to be the case—the Union increasingly comes across as a bureaucratic monolith, insensitive to national identity and the competitive pressures of the global economy.

These have been Britain's concerns about the EU for many years. Britain may well find the emerging free-market democracies in the east willing allies in arguments over the EU's future direction. And the British would be on the right side of history.

Conclusion: a bridging strategy for Britain

Most British people think it desirable for the UK to be an influential member of the EU. Evidently, given the central importance to the Union of EMU, Britain cannot stake out a claim for the highest levels of leadership until such time as it joins the single currency. But in order to maximise its clout in the intervening years, Britain needs a bridging strategy. Such a new European strategy has to recognise that EMU will dominate much EU business, and that many other policies will become subservient to it. But it can also play on Britain's considerable strengths in areas such as employment, diplomacy and defence, as well as on the genuine good will that many Europeans feel towards the new government.

One: Commitment to EMU

The Labour goverment has promised to act as a responsible midwife for the birth of the single currency. That is fine, but it could do a lot better.

The selection of the founder members of EMU in May 1998 will have a powerful psychological impact. For many people, including the British, it will be the moment when the single currency becomes a reality. For Tony Blair it offers a second chance to affirm Britain's intentions to join EMU as soon as is economically sensible, moving beyond Gordon Brown's cautious statement to the House of Commons in November 1997.

Even if Blair remains reluctant to commit the government to a notional timetable, he could indicate a willingness to join the reformed, mark 2 Exchange Rate Mechanism that is being set up for countries outside the single currency zone. This new and more flexible ERM will be very different from the old, narrow band ERM that many in Britain still associate with the bleak 1990-92 recession. It is debatable whether Labour's stated wish of a "period of stability" before joining EMU is realistic if the UK stays outside any form of exchange rate system.

Of course, joining an ERM mark 2 would require a huge marketing effort by the government; it would have to point out, for example, that Britain had joined the old ERM at the wrong time, at the wrong rate, and that the British economy had begun to take off even before sterling fell out of the ERM in September 1992. If the government did change its current policy and join an ERM mark 2, a part of the battle over EMU would already have been won: the pound would have to join at a much lower rate, which would subsequently make joining the euro a less risky enterprise. In any case, a referendum on EMU will not be won without a huge effort of salesmanship. If the government is serious about seeing through its policy on EMU, it will have to risk the ire of the tabloid press sooner or later.

A declaration of intent to join the ERM mark 2 might also help to bring down sterling's exchange rate, offering a boost to exports and inward investment. These effects should give a fillip to UK growth and allow the economy to move closer to the continental cycle. And finally, joining the ERM would fulfill what many consider to be one of the essential conditions for participation in EMU, as laid down in the Maastricht treaty. By removing a nagging doubt over whether Britain was fulfilling the letter and spirit of that treaty, this act would augment British influence.

Two: Shaping EMU's development

Britain has elected to stay out of the first EMU wave. Now it must find a way to influence the EMU project from outside. Its strongest card is its low rate of unempoyment and its evidently successful labour market policy. Having signed up to the Social Chapter, Labour has gone some way toward removing the misgivings of those Europeans who suspect that Britain is a Trojan horse for US-style labour market flexibility. Labour's "Third Way"—emphasising fiscal prudence, training and education, and minimum standards of social protection—has a fair chance of occupying the centre ground in Europe.

This British message could well find a hearing in Germany, where the political classes are struggling with the reform of an overgenerous welfare state and the need to compete in a global market. And it could help to wean France's left-wing government off its tendencies to resort to 1970s-style, old-fashioned dirigisme. The November 1997 European summit on employment underlined how the Blair formula has cross-party appeal:

both José Maria Aznar, representing the centre-right coalition in Spain, and Romano Prodi's centre-left Italian government applauded.

The British focus on employment policy is also a timely reminder to all governments that EMU will require a greater degree of labour market flexibility. It remains a crucial antidote to the high unemployment which threatens to undermine the independence of the European central bank by stoking political pressures for a softer monetary policy. And that could lead to higher inflation and severe tensions between governments and the central bank, threatening the whole project of EMU.

Three: Championing enlargement

Britain will preside over the launch of enlargement negotiations with five central and east European countries, plus Cyprus, in March 1998. It must ensure that these negotiations do not become bogged down in pomp and ceremony, and that they move quickly into substantive exchanges. That will be difficult, given that France and Germany will be distracted by the simultaneous preparations for EMU and the launch of the euro on January 1st, 1999. Eastern enlargement threatens the privileges of the current members of the club, so Britain will have to be ready to cajole the doubters forward. Labour should champion enlargement, but be prepared to let other countries, notably the Scandanavians and the Germans, share the lead. While some southern European governments, fearful of losing regional and agricultural aids, are understandably inclined to drag their feet, the Northern Europeans share a natural common interest in pushing enlargement ahead.

Britain's big disadvantage is that its motives for supporting enlargement are often viewed as suspect. Even today in Brussels, experienced officials claim that the British will use enlargement, combined with a dearth of reform to EU institutions, as a means of damaging the Union's effectiveness. The British need to think about how they can remove these suspicions. They could, for example, open high-level contacts with the French, Germans, Italians and Spanish on the kinds of institutional reforms that would be needed to cope with a Union of 20-plus countries.

The fruit of such exchanges could be a blueprint for the future which would balance practical steps (the organisation of meetings, the use of languages and external representation) with constitutional issues such as

the size of the European Commission and the voting weights of small and large countries. Such a blueprint would help to fill the intellectual vacuum which exists today about how the new, wider Union will operate in the early 21st century.

This document would help to prepare the ground for the next intergovernmental conference, which must tackle the issues which the Amsterdam summit left unresolved. But this institutional blueprint should not be published until after the ratification of the Amsterdam treaty, lest talk of further reforms clouds the debate over the treaty itself (as happened during the accident-prone ratification of the Maastricht treaty).

Four: Strengthening the Common Foreign and Security Policy

Without Britain, Europe's attempt to forge a common foreign and security policy will never be credible. Britain's armed forces and its diplomatic service are the objects of envy in Europe, as is the fact that English is the unchallenged language of international commerce and diplomacy. Britain has the assets to play a leading role in strengthening the CFSP; but it can only do so if it abandons many of the outdated preconceptions of the past ten years.

The Labour government should take a more constructive attitude to the Western European Union (WEU), the fledgling defence arm of the EU. Five years ago, Franco-German efforts to strengthen the WEU might have, at the margin, threatened the solidity of NATO. That is because NATO itself had little clear idea of its post-Cold War role. But NATO's rapid moves towards an eastward enlargement and its "out of area" peacekeeping mission in Bosnia have given it a new purpose. There are no longer any serious doubts that NATO has a future.

Thus if Labour supported the French and the Germans in strengthening the WEU as the "European pillar" of NATO, there would be few costs. The Clinton administration signalled support for a greater European role three years ago, when it agreed to the concept of "combined joint task forces", whereby the Europeans can call on US military assets under a NATO umbrella. Furthermore, an increasingly inward-looking US Congress is also pushing for the Europeans to shoulder a greater share of the burden of European security.

The obvious area for a British initiative is peace-keeping, starting with Bosnia. The preservation of peace in Bosnia will require the presense of foreign troops for many years to come. In June 1998, the mandate for the NATO-led "S-For" peacekeeping force expires. President Clinton will probably persuade Congress to let him keep American troops in Bosnia beyond that deadline for another year or two. But no one can be sure that American troops will remain for as long as is required to sew Bosnia together again.

The British and the French say that whenever America does withdraw, they will too. That is irresponsible: a total western withdrawal would risk undoing the considerable progress that has been made in Bosnia since summer 1995. Britain should propose that, in the absence of American troops, the Europeans should take over responsibility for the NATO mission, with the Americans providing air cover and logistical support. Such an initiative would dispel accusations that Britain is never prepared to think "European" on security issues. It would also confound those Americans who claim that the Europeans do not contribute enough to their own continent's security. It would certainly impress the many Americans who have—with good reason—always assumed that Europe could never be a serious partner in the field of foreign and security policy. In the event, the Americans might decide that, in practice, they would rather keep troops in Bosnia, for as long as the Europeans demanded, so that they could retain command of the mission. In any case, the transatlantic relationship would undoubtedly benefit from the Europeans showing some pluck.

Five: Refining the rhetoric of leadership

The Labour government has made a good start in Europe. Britain is rediscovering the art of winning friends and influencing people. Britain has—EMU excepted—fought its way back to the mainstream.

The weakness in Labour's strategy is that it has problems marrying its domestic priorities with the European agenda. Labour took office asserting that it would give leadership to Europe; but, as Gordon Brown discovered when the French and the Germans rebuffed his claims to a full seat on the Euro-X forum of EMU-ins, such aspirations are hard to square with prevarication on EMU. When it comes to the single currency, Europeans insist on "the full Monty".

So far, Labour has done little to recast the time-honoured British strategy of sallying forth to Brussels, waging battle and returning home, bloody but unbowed, with trophies. Labour's focus groups have reported that the British like Europe when they feel they are not being bossed around by Brussels, or the French or the Germans. That may explain the concern of British ministers to appear a strong and unyielding. But the difficulty with this warrior style is that it may store up future problems at home: sometimes the British lose, as they did in the fight to join the Euro-X committee; and it may be harder to win a future referendum on EMU if public opinion has not been exposed to some positive persuasion on the merits of the Union. The combative style also feeds resentment abroad, making it harder for Britain to win allies: British politicians often fail to understand how closely continental leaders follow the UK's domestic debate, perhaps because Britons seldom pay much attention to theirs.

It is fine to talk of leading Europe when you hold the presidency and control, at least to some extent, the policy agenda and its presentation. But what happens after June 30th, when Britain cedes the presidency to Austria? As Britain, uninvolved in the EMU project, is seen to have less sway over the Union's trajectory, there is a danger of British opinion again swinging in a hostile direction. Tony Blair should ensure that the euro features strongly in the British presidency agenda. For if the ground is not softened up at such a propitious moment—with a charismatic politician in the EU's driving seat—it may prove too hard for a euro referendum to be won a few years' hence.