CURRENT ACCOUNT

Stormclouds and Snakes

This past March a crisis erupted in the European Community that not only received remarkably little attention on this side of the Atlantic but was just as little understood. In fact, the ramifications of that crisis could have been quite serious, and scarcely a corner of the outside world—America included—would have been left unscathed. Europe may no longer dictate the destinies of nations, but in economic affairs at least it still throws around a good deal of weight. Europe's economic stormclouds cannot be ignored just because they are over the horizon.

Superficially, the March crisis involved nothing more than exchange rates. The immediate issue was a technical arrangement called the European Monetary System, which links the currencies of most of the Common Market countries in a joint float vis-à-vis such outside currencies as the dollar and the yen. First created in 1979, the EMS is the concrete manifestation of the long-standing ambition of many Europeans to merge their separate national monies into a common currency. Eight Community currencies—all except the British pound and the Greek drachma—are closely aligned in a so-called "snake," which wriggles and writhes as a unit in today's world of flexible exchange rates. The idea is that ultimately these currencies will become so interchangeable that one day it will be possible to dispense with them altogether in favor of a single European currency.

But there is a catch. For such an arrangement to succeed, the participating countries must make progress toward the convergence of their economic policies and performance, and *this* requires a genuine political commitment by all participants to surrender a portion of their traditional economic sovereignty. Such a commitment is not easy to obtain. Yet if it is not made, sooner or later the arrangement will suffer the strain. Persistent differences in rates of inflation inevitably set in motion strong centrifugal forces that pull the joint float apart. Participating governments must choose between altering their exchange rates in order to avoid a build-up of speculative pressures—making a mockery of the ultimate goal of currency unification—and significantly compromising their policy autonomy for the sake of achieving greater convergence in performance. They cannot have it both ways.

It is precisely this dilemma that had stymied the Europeans. The EMS is not their first attempt at moving toward a common currency. An earlier snake was hatched back in 1972, only to come apart almost immediately under the pressure of divergent national policies. Within two years all that remained was a subsystem of smaller currencies grouped around the German mark. But the dream refused to die. When Helmut Schmidt, then chancellor of West Germany, issued a call in 1978 for a new "zone of monetary stability" in Europe, Community members quickly responded by launching the EMS. They insisted that this time their initiative was backed by the necessary political commitment, particularly by the two major members, France and Germany, and specifically in the persons of Helmut Schmidt and the then President of France Valéry Giscard d'Estaing. For these two men the EMS became in effect a test of their joint de facto leadership of the Community. Both were clearly prepared to make policy compromises to ensure the arrangement's success.

But then national politics intervened—first in France, where Giscard was succeeded by François Mitterrand, and then in Germany, where Schmidt was replaced by Helmut Kohl. Neither the Socialist Mitterrand nor the conservative Kohl shared his predecessor's personal commitment to the EMS. President Mitterrand, in fact, marched to an entirely different drummer—the dream of the French Left, out of power for over a quarter-century, for a grand Socialist revival *à la française*. The incoming Mitterrand government made a dash for growth that was to be fueled by huge public spending and across-the-board wage increases. The unfortunate but all-too-predictable result in a stagnant world economy was an acceleration of France's inflation rate and a swift deterioration in its trade balance despite two devaluations of the French franc within the EMS in October, 1981, and June, 1982. By March, the franc was again under pressure in exchange markets. The crisis had begun.

What made the situation so dangerous was the deep split within Mitterrand's own government between moderates who favored more restrictive domestic policies to reverse France's inflation and trade deficit and an influential left-wing faction that argued for continued growth even if it required leaving the EMS and retreating behind a wall of protectionist trade measures. The latter would have meant failure not only of the dream of a European currency but of the Common Market itself—and could have triggered an international trade war reaching far beyond Europe. That President Mitterrand rejected the "Fortress France" approach in the end, opting instead for austerity at home and a third devaluation of the franc, is evidence of his awareness of such consequences. But how long will he be able to resist the demands of his own working-class constituents, who understandably are frustrated by his failure to carry through on his expansionary electoral pledges?

And here we have the heart of the matter, since this story is not really about exchange rates at all but about the much deeper problems of economic growth, employment, and prosperity. The persistent stagnation of the world economy breeds frustration. If even France, for all of its commitment to the Common Market and the EMS, can contemplate resorting to import restrictions to stimulate jobs and growth at home, then none of us is safe from the specter of protectionism. The longer it takes to bring about a genuine global economic recovery, the greater the danger becomes. Stormclouds hang over us all.

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