International Viewpoint

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A year of Yeltsin

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Markets go mad

THE explosion of the European Monetary System reflects economic tensions that run far deeper than doubts about the outcome of the French referendum on the Maastricht Treaty on European Union on September 20. These tensions will persist whatever the short-term impact of that vote.

COLIN MEADE

THE immediate cause of the excitement was a continued and apparently unstoppable fall in the value of the American dollar, sliding against the German deutschmark since the middle of July.

The reason for the dollar's weakness has been the willingness of the US Federal Reserve to take measures to combat enduring recession. According to the *Financial Times* of August 24, 1992: "In the US the consensus is that US monetary policy should be dictated by the needs of the domestic economy". This approach is felt to contrast sharply to the strong money policy pursued in Germany.

Events took a dramatic turn on Friday September 4, when the US central bank cut interest rates in response to news of an increase in unemployment.

The impact in Europe was devastating. The Exchange Rate Mechanism (ERM) of the European Monetary System (EMS) requires that the value of the various European Community currencies remain in a closely defined ratio to one another (via the mysterious European Currency Unit — the ECU).

This means that any currency that starts to fall compared to another must be defended by any means necessary. In the concrete instance this meant that as the deutschmark rose, the other currencies had to try to keep up; for weaker economies this implied drastic interest rate rises and expensive attempts to support their currencies — implying further deflation on top of an already severe recession and/or even bigger public debt.

Under pressure the Germans cut their interest rates on Monday September 14, but by such a tiny amount — much less than predicted — that it only served to underline the Bundesbank's determination to maintain a strong mark. This was the death knell of the ERM in its present form.

The Italian lira was devalued by 7% the same day and a few days later the British pound was taken temporarily out of the ERM as an alternative to further interest rate rises. The Spanish, Portuguese and Irish currencies are also in trouble.

Some of the most spectacular events so far have come in Scandinavia. The countries of this region (apart from Denmark) are not part of the EC, but they hope to join and are therefore attempting to manage their currencies as if they were part of the ERM. Finland, hard hit by the loss of Soviet markets, decided to bail out and on September 9 let its currency fall against the German mark.

The next day neighbouring Sweden, whose welfare state traditions make it highly suspect in the eyes of "the markets", raised one of its key interest rates to 75% (!) as "a strong signal that no one can doubt our commitment to defend a fixed exchange rate" (*FT*, September 10, 1992). However this was not enough, and the same rate was raised further to 500% (!!) on September 16.

That's the story so far (September 17).

Insane rationality

Financial experts and politicians view these developments as being about "strong" and "weak" currencies resting on stronger and weaker "real economies". Thus "the markets" are seen to be passing judgement on the performance of economies by buying and selling currencies — a reasonable activity.

However, unenlightened souls suffering the effects of prolonged recession may find the workings of the system as a whole somewhat perverse. Against a background of crippling worldwide recession in the "real economy", "the markets" are to be found *rewarding* economies pursuing recessionary policies and *punishing* attempts to stimulate the economy.

Furthermore, there is a strong dose of panic at work behind current market movements. Looming over the financial turmoil is the shadow of the colossal debt. The Swedish interest rate hikes have taken place against the background of a crisis of the Swedish banking system. Similar financial black holes can appear anytime anywhere — as we have seen, for example, with the American Savings and Loans or the bankruptcy of British newspaper magnate Robert Maxwell.

To stave off impending disaster, market players — the very same Maxwells, Swedish banks or Savings and Loans — are compelled to engage in more and more frenzied speculation, seeking short term paper advantages that can cover over widening cracks in their balance sheets. ★

International Viewpoint needs YOU

AS we announced before the summer break, financial constraints are forcing us to review the price and frequency of our publications.

In response to appeals made this past summer, we have received donations from across Europe and North America. Our hope is that — as people settle into another political year — further responses will come in.

Accordingly, we are renewing the call for contributions, and remind you that no donation — and no effort to promote the magazine — is too small.

Here are some ideas of how you can help us:

● Firstly, by taking an active part in our drive to increase circulation. If each current subscriber could find another our objective of financial stability could easily be met.

We are renewing our special offer of a three-month subscription for only $11/£6/60FF. We are confident that the calibre of the magazine will convince those who take advantage of this offer to renew at the end of their three months.

● Secondly, you can support the fund drive by donating directly to the fund we have established to safeguard the future of our publications.

Cheques should be sent to *IV*, 2 rue Richard Lenoir, 93108 Montreuil, France, but please indicate that you are contributing to the fund drive. For postal and bank transfers, please see details on page 2 .

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