

A Turning Point for Europe

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Every so often Europe reaches a turning point. In 1967 the turning point was Europe's response to a financial crisis in its weakest economy. That economy was, of course, the United Kingdom, popularly known as Europe's sick man. The financial crisis was a run on the pound and the British financial system.

Desperate times require desperate measures. Seeing no alternative, the UK government in early 1967 signaled its wish to enter the European Community where it might receive support from the other member states. The French head of state, Charles de Gaulle, rudely rebuffed it. It was not the role of the six member states embarked on their single customs union project, he insisted, to support an aspiring member in financial distress.

It is worth recalling de Gaulle's exact words:

“...the very situation of the pound sterling prevents the Common Market from incorporating Britain. The very fact that the organization of the Six is entirely freeing their mutual trade necessarily implies that the currency of the member countries has a constant relative value and that, if it happened that one of them were disturbed, the Community would ensure its recovery. But this is possible only due to the well-established soundness of the mark, the lira, the florin, the Belgian franc and the French franc. Now, without despairing of seeing the pound hold its own, for a long time we would not be assured that it will succeed. . . . Monetary parity and solidarity are the essential conditions of the Common Market and assuredly could not be extended to our neighbors across the Channel, unless the pound appears, one day, in a new situation and such that its future value appears assured...”

In other words: Your financial crisis is your problem. First put your own house in order if you want our help.

The predictable result of de Gaulle's famous “non” was the collapse of the pound sterling later in 1967. Also predictable, though less widely appreciated by the politicians, was the blowback felt by France. Sterling's collapse undermined confidence in other currencies. Its depreciation undermined the competitiveness of other countries' exports. The result was pressure on the franc, forcing in its disorderly devaluation in 1969. In turn this ratcheted up tensions with Germany, undermining European solidarity and the Community's ability to prepare for the impending breakdown of global monetary arrangements. By rebuffing an aspiring new member, the Western Europeans thus ended up shooting themselves in the foot.

The names today may be different but the problems are similar. Now it is Eastern Europe rather than Britain that is out in the cold. Financial pressures are intense as Western European banks in distress curtail their credits to the East and repatriate their funds. The collapse of external demand has accentuated preexisting competitiveness problems. Creeping protectionism in the West reinforces the problem, as French President de Gaulle—oops, I meant to write French President Sarkozy—tells the nation’s auto makers to bring their assembly operations back home.

The Eastern European economies have no easy choices. They cannot allow their currencies to weaken further, much less use monetary policy to support demand, because doing so will bankrupt corporations and households with bank loans and mortgages denominated in euros and Swiss francs. They cannot apply fiscal stimulus because most of them entered the crisis with large budget deficits. They cannot impose capital controls or adopt the euro unilaterally if they are already in the EU, since existing treaty obligations preclude this. And they cannot do so if, like Croatia, they are not yet members, since this will dim their chances of eventually being accepted into the club.

The only countries with a choice under these circumstances are the incumbent members of the EU and of the euro zone in particular. They can announce an accelerated timeline for euro adoption by EU members that have not yet adopted the euro. Given the gravity of the financial crisis, tomorrow would not be too early for adoption. They can indicate to aspiring EU members like Croatia that unilateral euroization will not damage the prospects for accession.

And they can instruct the ECB to extend euro swap and credit lines. The ECB has done this for existing euro area members since the second half of 2007. More recently it has done so for EU member states like Hungary that have not yet adopted the single currency. It is now time for it to do the same for non-EU European economies like Croatia. The Fed has provided \$120 billion of dollar swaps for Mexico, Brazil, Singapore and Korea. Where are the ECB’s euro swaps for Southeast Europe?

Or the ECB can adopt the holier-than-thou attitude of President de Gaulle in 1967. In that case it had better be ready for the blowback.

Now it is not simply EU membership to which they aspire—some of them already have it, after all—but

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