14

Britain's Last Currency Crisis

The 1992 ERM crisis was the last currency crisis in the history of the pound under fixed exchange rates.[1] It marked the end of British intervention on the foreign exchange market. After 1992, the Bank started to target inflation instead of exchange rates. It was a case of market forces overpowering state intervention. Global foreign exchange markets had just become too big and the Bank of England could not follow.[2] The size of global foreign exchange transactions (all currencies included) had reached \$880 billion a day.[3] That is thirty-nine times as much as the United Kingdom spent on Black Wednesday. In 1952 the Bank of England was still able to overpower the market, as shown in Chapter 3. This was no longer the case in 1992.

The crisis showed the limits of fixed exchange rates. Without clear commitment to restrictive domestic monetary policy, an exchange rate peg could not work. The British government was willing to join the ERM, but not keen enough to make the country suffer through higher mortgage rates and potential unemployment because of higher interest rates. Speculators became aware of these shortcomings. They started to bet

1 Some of the text in this chapter draws on a joint paper with Barry Eichengreen: Eichengreen and Naef, 'Imported or Home Grown?'

2 Advanced economies' central banks still intervening today usually only do it to depreciate their currency. And this often leads to the accumulation of massive foreign exchange reserves, see for example Alain Naef, 'The Investment Portfolio of the Swiss National Bank and Its Carbon Footprint', *Applied Economics Letters* (10 December 2020), 1–6, https://doi.org/10.1080/13504851.2020.1854436.

3 Tobias Straumann, *Fixed Ideas of Money: Small States and Exchange Rate Regimes in Twentieth-Century Europe*, 1st ed. (New York: Cambridge University Press, 2010), 312, quoting BIS, Annual Report, 1993, 196.

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against the Bank of England. At the same time, pressure was mounting on other European countries.

The United Kingdom joined the ERM to try to subdue inflation, not as a Europhile project. Thatcher saw it as a 'spine' to structure inflation in the United Kingdom.[4] Just like the gold standard in its time, the ERM would be an external force to manage British inflation. But the commitment of Britain faded once it was faced with an increase in interest rates. Higher rates would have threatened mortgage owners with higher mortgage costs. This went against one of the main electoral promises of the Conservative party.[5] Britain's economy was also in recession. The government hesitated to hike rates on the morning of Black Wednesday, even after the pound had already broken the ERM peg overnight.[6] Markets took this hesitation and ran. This left no chance to the Bank of England, which had to sell over \$22 billion in reserves in a few hours.[7] The crisis then spread to France, which just survived it, thanks to a less hesitant government, heavy foreign exchange interventions and more support from Germany.

In this chapter, I present new evidence of Bank of England operations during the crisis.[8] The British press made a request under the Freedom of Information Act, trying to understand more about the losses of the Bank of England. But not all information was disclosed. Thanks to the new disclosure policy of the Bank of England, moving from thirty to twenty years, the full archives are now available.

A EUROPEAN CRISIS

The 1992 ERM crisis is one of the most severe currency crises of the pound in the twentieth century. While it is a key event in British monetary

[4] James, *Making a Modern Central Bank*, 268–9.

[5] Wolf Hassdorf, 'Contested Credibility: The Use of Symbolic Power in British Exchange-Rate Politics', in *Power in World Politics*, ed. Felix Berenskoetter and Michael J. Williams, 1st ed. (London: Routledge, 2007), 141–61.

[6] 'Sterling had traded below its ERM floor overnight', Archives of the Bank of England, Dealers' report, 16 September 1992, reference C8.

[7] It is important to note that while the United Kingdom spent \$22 billion in reserves, the net loss for the United Kingdom was only around \$4.91 billion, see James, *Making a Modern Central Bank*, 306.

[8] Some of the data presented here is also used in the following two papers Eichengreen and Naef, 'Imported or Home Grown?'; Alain Naef, 'Blowing against the Wind? A Narrative Approach to Central Bank Foreign Exchange Intervention', Working Paper (European Historical Economics Society (EHES), June 2020), https://econpapers.repec.org/paper/heswpaper/0188.htm.

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history, it has its roots in the European context. It all starts with the Maastricht Treaty. The treaty presented a roadmap for European integration, based on economic convergence criteria. It was negotiated in December 1991 and then took two years to be ratified by all members. The ratification process was painful and led to many currency crises for member countries, including Britain.

The ERM crisis started around 2 June 1992, when Denmark rejected the Maastricht Treaty in a referendum.[9] The outcome had not been forecast by opinion polls. It cast into doubt the transition to the Single Currency.

While the Danish crisis was important, pressure on European exchange rates had already started before the Danish referendum.[10] Still, the referendum reminded investors that the future monetary union was not guaranteed. This led to pressure on the exchange rates of most European currencies. The referendum caused the Italian lira to fall to its lower limit and forced the Bank of Italy to intervene. Italy's weaknesses were macroeconomic in nature, something that the Maastricht Treaty's convergence criteria were tailored to address. Pressure on the Portuguese escudo and Irish punt also appeared around the time of the Danish referendum.

In contrast, the pound was overvalued coming into the summer of 1992. Yet it does not appear to have experienced significant exchange-market pressure at this point. This would remain the case until shortly before the crisis, as we will see.

Next, the Irish punt came under pressure. Ireland was the next place where a referendum was scheduled. There were fears that if the Irish voted no, the punt would come untethered from the ERM.[11] On 18 June, more than two-thirds of Irish voters backed the treaty.

While both the Danish and Irish currencies survived their respective referenda (this despite the Danish no), Italy seemed to systematically be a collateral victim. This stands out when looking at Bank of Italy interventions, interest rates and exchange rates.[12] Italy was also in a constitutional

[9] Denmark was one of two countries, along with Ireland, required to hold a referendum on the Maastricht Treaty. France also held a referendum, although it had the option of treaty ratification by parliamentary vote, which would have required a three-fifths majority in both the Assembly and Senate.

[10] Eichengreen and Naef, 'Imported or Home Grown?', place the start of the crisis earlier in 1992.

[11] There were also worries about the systematic implications: the *Financial Times* wrote that if 'the Irish follow the Danes and vote "no", there would seem little alternative to scrapping the treaty'. 'One in Four Irish Voters Undecided about Maastricht', *Financial Times*, 18 June 1992, 1.

[12] This is measured in Eichengreen and Naef, 'Imported or Home Grown?'

crisis, with a new government to be formed on 19 June. And things started to get worse in the following month. In August 1992, pressure on the lira, but also on the peseta and escudo, mounted further. On 3–4 September, Germany stepped in with its largest intervention of the crisis, spending over $4 billion to support the lira. The Bank of Italy increased its interest rate by 1.75 percentage points, the largest increase in eleven years.

While this European drama was unfolding, the pound still seemed somewhat shielded against pressure. In the dealers' room at the Bank of England, the mood was still optimistic. Only thirteen days before the biggest currency crisis in the history of the pound, the dealers noted that 'sentiment is a good deal more positive than earlier in the week'.[13] The positive outlook of the dealers shows that they were not expecting such a large shock.

AN UNEXPECTED AND BRUTAL SHOCK

While the ERM crisis affected many European countries, the shock in the United Kingdom was several orders of magnitude greater than that of other countries. The British crisis was unparalleled because of its sudden nature. As hinted at the beginning of this book, the Bank of England spent in a few hours what two other European countries took a year to accumulate.[14] The Bank spent $22 billion on Black Wednesday to defend sterling before the government decided to throw in the towel.

To understand the exceptional nature of the crisis, I rely on an Exchange Market Pressure index for all European countries. Here the index uses daily intervention data from the Bank of England archives, interest rates from various central banks and spot exchange rates.[15] The EMP index is constructed following Aizenman and Binici and the formula is as follows:[16]

[13] Archives of the Bank of England, Dealers' report, 4 September 1992, reference C8.
[14] That is Bulgaria with a GDP of $10.18 billion and Croatia with a GDP of $12.16 billion, a total of $22.34 billion or roughly the interventions of Black Wednesday.
[15] The data is from previous work with Barry Eichengreen but the country data presented here has not been shown elsewhere: Eichengreen and Naef, 'Imported or Home Grown?'
[16] Joshua Aizenman and Mahir Binici, 'Exchange Market Pressure in OECD and Emerging Economies: Domestic vs. External Factors and Capital Flows in the Old and New Normal', *Journal of International Money and Finance*, The New Normal in the Post-Crisis Era, 66 (1 September 2016), 65–87, https://doi.org/10.1016/j.jimonfin.2015.12.008. This is also what we did in Eichengreen and Naef, 'Imported or Home Grown?'

$$EMP = \frac{\Delta e_t - \mu_e}{\sigma_e} - \frac{\nabla r_t - \mu_r}{\sigma_r} - \frac{int - \mu_{int}}{\sigma_{int}}$$

where Δe_t is the change in a country's exchange rate; Δr_t the differential between the interest rate in a given country and that in Germany; *int* is a daily measure of intervention; π and σ are the means and standard deviations of the variables in question. The dataset for this index spans 1986–95.

The uniqueness of the British crisis in the European context is apparent in Figure 14.1. It plots the EMP index for twelve European countries (note that Germany is not shown as it is the core country in this approach). Among the approximately 3,200 trading days shown in Figure 14.1, Black Wednesday is the day with the most pressure on any exchange rate. The day lies 35 standard deviations away from the average day on the market.[17] Intervention amounts unimaginable to any central banker at the time and a double interest rate hike on the same day (more on this double hike later) explain this exorbitant pressure index figure.

While tensions among European currencies were somewhat palpable in the wake of the Danish referendum, they were not yet completely out in the open. Things changed in Bath. The town held the Economic and Financial Affairs Council (ECOFIN) meeting on 4–5 September. During

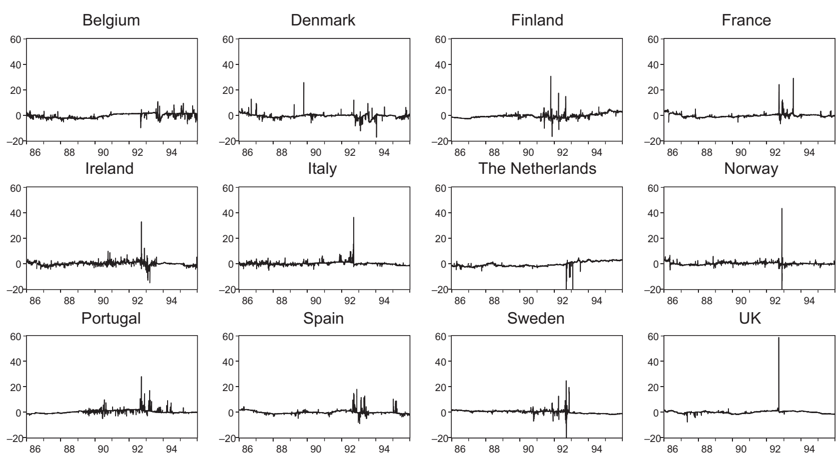

Figure 14.1. The Exchange Market Pressure indices for twelve ERM countries.
Data and methodology from Eichengreen and Naef, 'Imported or Home Grown?'

[17] The other peak in Figure 14.1 is on 20 November 1992, when the Norges Bank was forced to abandon its Ecu peg

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this meeting, Chancellor Norman Lamont harangued the Bundesbank president Helmut Schlesinger for further reductions in German rates. The most Schlesinger was prepared to concede was that there was no immediate need for German rates to increase.[18] Lamont, in his post-meeting press briefing, characterised the German position as a firm promise not to raise rates. This assertion reassured investors about ERM currencies, such as the lira. But it also marked a period of tension between Lamont and Schlesinger. This would later become damaging for the pound and is at the heart of the British crisis.

Despite the events in Bath, it was still smooth sailing on Threadneedle Street. According to the dealers, the Monday after the Bath meeting, the week opened 'on a quiet note'.[19] The Bundesbank's 'commitment on interest rates [not to raise rates] at the weekend meeting in Bath was seen as constructive for the dollar'.[20] It is not certain if the dealers were aware that the German 'commitment' had more to do with the British Chancellor than with the true position of the Bundesbank. The *Financial Times*, in retrospect, had a reading closer to reality. Its front page read, 'Doubts emerge over effectiveness of efforts by EC to stabilize financial markets'.[21] The newspaper noticed that Schlesinger 'declined to give explicit support to the statement issued by Mr Norman Lamont' that ERM currencies would not have to align.

On 8 September, European central bank governors met at the BIS in Basel in their monthly meeting. Banque de France governor Jacques de Larosière suggested that the European central bankers 'strongly reaffirm[ed]' the commitments made after the Bath meeting.[22] The Bundesbank president said not to mention the Bath statement. He argued that 'the Deutsche Bundesbank had not been a party to the agreement to which it referred, nor could it be'. Schlesinger did not want to commit Germany to not raising rates in the future. This would have limited the Bundesbank's independence. He saw the solution in a realignment, a solution which he advocated indirectly to German media (more on this later). On the fringe

18 Harold James, *Making the European Monetary Union* (Cambridge, MA: Belknap Press, 2012), 352.

19 Archives of the Bank of England, Dealers' report, 7 September 1992, reference C8.

20 Ibid.

21 'Doubts Emerge over Effectiveness of Efforts by EC to Stabilize Financial Markets', *Financial Times*, 7 September 1992, 1

22 Minutes of the 269th meeting of the Committee of Governors of the Central Banks of the Member States of the European Economic Community, held in Basel on Tuesday, 8 September 1992 at 9.30 am.

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of the meeting in Basel, Schlesinger also met with George Soros. The meeting convinced Soros that the lira and the pound would fall soon.[23]

Meanwhile, the crisis kept on going elsewhere in Europe. Finland abandoned its unilateral markka peg the following day, 8 September. And once more, Italy was collateral damage. Germany, the Netherlands and Belgium all intervened to prevent the lira from breaking through its bilateral fluctuation bands. Sweden then followed with pressure on its currency in the midst of a banking crisis. On Friday, 11 September, the lira felt unprecedented levels of pressure. On Saturday, the German Finance Ministry and the Bundesbank agreed that the German central bank would refrain from further intervention on behalf of the lira, invoking its authority under the Emminger letter.[24] The Bundesbank immediately conveyed the news to a shocked Bank of Italy governor, Carlo Ciampi.[25]

Despite all this pressure on other European currencies, the United Kingdom still seemed to be in a safe place. On 8 September, the Bank of England dealers thought that things were under control. They wrote: 'Sterling was uncomfortable but not under great pressure.'[26] Even discounting for the usual British phlegm, this statement seemed a genuine expression of confidence. The following day, despite being 'rather soft', the dealers still saw 'no real pressure on sterling'.[27] On Thursday, 10 September, dealers still witnessed some 'good two way demand all day' for sterling.[28] And on the Friday, the last week of over 150 years of sterling fixed exchange rates, the dealers still thought that all was well. They reported that sterling 'was helped by Mr Major's speech'.[29] But they did note that 'demand was deterred by realignment fears'. Was this British composure by dealers before a catastrophic currency crisis just a living

23 Sebastian Mallaby, *More Money than God: Hedge Funds and the Making of a New Elite*, Illustrated ed. (New York: Penguin Books, 2011), 156–7; James, *Making a Modern Central Bank*, 294.

24 The Emminger letter is discussed in Barry Eichengreen and Charles Wyplosz, 'The Unstable EMS', *Brookings Papers on Economic Activity* 1 (1993), 51–143, https://doi.org/10.2307/2534603. See more in William Keegan, David Marsh and Richard Roberts, *Six Days in September: Black Wednesday, Brexit and the Making of Europe* (London: OMFIF Press, 2017), 103. See also Otmar Emminger, *The D-Mark in the Conflict between Internal and External Equilibrium, 1948–75* (International Finance Section, Department of Economics, Princeton University, 1977).

25 James, *Making the European Monetary Union*, 356.

26 Archives of the Bank of England, Dealers' report, 8 September 1992, reference C8.

27 Archives of the Bank of England, Dealers' report, 9 September 1992, reference C8.

28 Archives of the Bank of England, Dealers' report, 10 September 1992, reference C8.

29 Archives of the Bank of England, Dealers' report, 11 September 1992, reference C8.

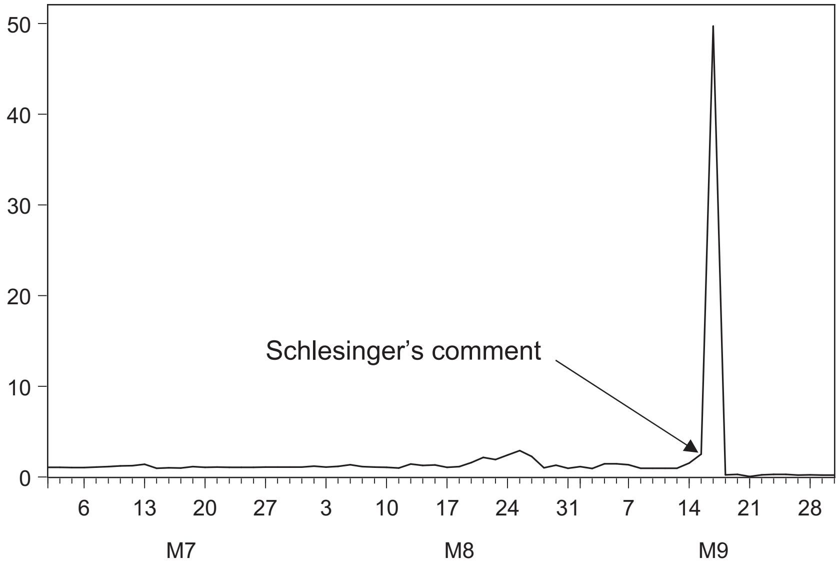

Figure 14.2. The British EMP index

expression of the adage 'keep calm and carry on', or is there more to it? When looking at this problem with numbers, the dealers had no reason to worry.

Figure 14.2 is an explanation of the dealers' calm in the form of a graph. It shows values for the EMP pressure index presented for the United Kingdom in the three months leading to Black Wednesday. Up to Friday 11 September (or three working days before the crisis), there was no pressure on sterling, as measured by the EMP. If the internal reports at the Bank showed nothing but relative calm, it is because sterling was calm. And this is even more marked when compared with other countries that also faced currency crises around the same time as the United Kingdom. Looking at Figure 14.3, one could predict that Italy, Portugal and Spain were under a lot of pressure and likely to experience a currency crisis. The same cannot be said for the United Kingdom. The British EMP index is higher than usual but stable. It explodes on Black Wednesday, the worst day for any European currency over that seven-year period.

The weekend before the week of Black Wednesday, things got tougher for Italy. On Sunday, European policymakers announced a 3.5 per cent devaluation of the lira and 3.5 per cent revaluation of other ERM currencies. This was a cosmetic way of devaluing the lira by 7 per cent. Normally, currency realignment decisions would consist of a Saturday meeting of the

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	Average	FRANCE	IRELAND	ITALY	PORTUGAL	SPAIN	UK
August 20, 1992	1.1	0.9	0.2	1.0	1.9	0.7	2.1
August 21, 1992	2.0	0.6	0.7	0.9	8.0	-0.3	1.9
August 24, 1992	2.6	1.3	1.0	1.5	8.8	0.8	2.4
August 25, 1992	2.9	0.7	2.5	5.6	2.6	3.3	2.9
August 26, 1992	2.5	0.7	-1.0	5.1	6.4	1.3	2.2
August 27, 1992	2.9	0.8	1.2	3.8	3.1	7.9	1.0
August 28, 1992	2.7	0.7	4.1	6.5	1.8	2.0	1.3
August 31, 1992	1.1	0.7	1.2	1.0	1.8	1.2	1.0
September 1, 1992	1.6	0.7	1.2	1.0	4.5	1.2	1.1
September 2, 1992	1.5	0.7	3.2	1.0	2.2	1.2	0.9
September 3, 1992	1.7	0.8	1.2	3.5	2.4	0.7	1.4
September 4, 1992	3.0	0.9	1.2	9.4	4.4	0.9	1.4
September 7, 1992	1.1	0.8	1.9	0.3	1.8	0.7	1.3
September 8, 1992	2.6	0.8	2.8	0.8	7.9	2.1	0.9
September 9, 1992	1.0	0.8	1.2	0.3	1.8	0.7	0.9
September 10, 1992	4.8	0.7	1.3	10.7	8.4	6.5	0.9
September 11, 1992	3.3	0.8	1.3	13.2	2.9	0.7	0.9
September 14, 1992	0.7	1.6	0.7	-2.1	1.8	0.8	1.5
September 15, 1992	5.5	0.6	1.1	8.3	8.7	11.7	2.5
September 16, 1992	18.6	0.4	2.3	30.6	22.9	5.6	49.7
Black Wednesday				Black Wednesday			
September 17, 1992	7.9	10.1	28.0	-0.6	8.5	1.1	0.2
September 18, 1992	2.3	10.8	-3.3	-0.6	5.0	1.6	0.3
September 21, 1992	1.1	3.3	0.9	-0.5	0.7	1.9	0.1
September 22, 1992	5.1	14.2	5.0	-0.6	0.8	10.8	0.2
September 23, 1992	2.6	7.6	6.7	-0.5	1.2	0.0	0.3
September 24, 1992	0.9	0.5	4.0	-0.5	1.5	-0.1	0.3

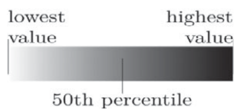

Figure 14.3. The EMP index around Black Wednesday for selected European countries

EU Monetary Committee. Their decision could then be ratified by the ECOFIN committee on Sunday. And early on Monday, Ministers would announce a new parity grid, including all currencies in the ERM. On this occasion, the procedure was not followed. There was a risk that a meeting of the Committee would lead to discussions about a potential change of the parity of the French franc. So there was no meeting of the Monetary Committee. But the Italian devaluation was announced. Eyes turned to the United Kingdom and other weaker ERM countries.

In a show of good faith, the Bundesbank cut interest rates. It cut the discount rate by 50 basis points and the Lombard rate by 25. Markets considered the package inadequate for the small size of the German interest rate cut and the fact that no other countries accompanied Italy in realigning. At the same time, the *Financial Times* headline read 'Bundesbank Bows to External Pressure'.[30] This likely created anxiety among Bundesbank officials. Their nightmare was to appear committed

[30] 'Bundesbank Bows to External Pressure', *Financial Times*, 14 September 1992.

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to anything else but low inflation. The *Financial Times* wrote that it was 'the biggest concession made in the history' of the Bundesbank. It was 'admitting the limitations of its independence'. It is understandable that faced with such criticism, senior Bundesbank officials wanted to change the view of the press. The press also became aware that Chancellor Helmut Kohl had paid the Bundesbank a secret visit the Friday before the rate cut.

The day after the German rate cut announcement, the press really focused on Schlesinger as a person. He was asked about his resignation. The *Financial Times* ran an article titled 'Schlesinger Puts on a Brave Face'.[31] The article read: 'If Mr Helmut Schlesinger felt any embarrassment yesterday, he hid it well'. The paper also referred to Mr Issing doing 'his best not to look like someone forced to eat his words'. This press conference was clearly a humiliating exercise for the Bundesbank management. The press singled them out personally. This set the stage for retaliation.

BLACK WEDNESDAY

Black Wednesday was an unexpected crisis. But what explains the magnitude of the shock? The Monday after the Italian devaluation (day minus two), the pressure mounted in the United Kingdom. Yet it was still in line with the previous weeks. The EMP index reached 1.5 on the Monday, a value in line with the average of the previous twenty days (see Figure 14.3). On Tuesday, the day before the crisis, the index jumped to 2.5, indicative of pressure, but still less than a few days earlier on 25 August. The day before Black Wednesday, still nothing indicated the crisis to follow.

On Monday 14 (day minus two), dealers started to get worried. 'The market eyed it [sterling] as the next devaluation candidate', they wrote.[32] On the Tuesday (day minus one), they noted that 'investors began to position themselves ahead of the French referendum'.[33] The French referendum on the Maastricht Treaty was looming on 20 September. Opinion polls suggested that the outcome would be razor thin.[34] Pressure on currency markets in Europe was palpable ahead of the French deadline. At the same time, Downing Street confirmed to the press that the

31 'Schlesinger Puts on a Brave Face', *Financial Times*, 15 September 1992.
32 Archives of the Bank of England, Dealers' report, 14 September 1992, reference C8.
33 Archives of the Bank of England, Dealers' report, 15 September 1992, reference C8.
34 Michael S. Lewis-Beck and Daniel S. Morey, 'The French "Petit Oui": The Maastricht Treaty and the French Voting Agenda', *Journal of Interdisciplinary History* 38, 1 (23 May 2007), 65–87, https://doi.org/10.1162/jinh.2007.38.1.65.

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probability of an ERM realignment was 'zero'.[35] These types of announcements have in the past been indicative of risks of crises. Sterling also went through a fall of 1.16 per cent during that day, and the Bank intervened with $788 million to support the pound. Italy, Portugal, Spain and Sweden also intervened heavily on foreign exchange markets to support their currencies.

And then the irreversible happened on Tuesday, 15 September, after the London market closed. Schlesinger told reporters from the *Handelsblatt* and the *Wall Street Journal* that a more comprehensive realignment would have been more effective and that further exchange market pressure could not be ruled out. The remarks were published the following day but had already hit markets overnight. Schlesinger's comments planted doubts in the minds of investors. It was now unclear whether the Bundesbank was prepared to engage in unlimited interventions to prevent the Deutschmark from breaching its bilateral limits against other currencies.

Sterling had already broken the ERM floor before the market opening in London on Black Wednesday (16 September).[36] In overnight trading, either at the end of the day in New York or during trading in Asia, the market showed doubts about maintaining sterling's peg. The *Handelsblatt* had sent a summary of its story to the news agencies before publication. So, by 8 pm on Tuesday the story was 'humming on the wires'.[37] As soon as the Bank saw it, it contacted the Bundesbank and was told that the story was 'unauthorised'.[38] The Bundesbank had stories checked by its press department before authorising them. Authorised or not, the story had hit the markets.

There is some dispute about the intent and impact of the Schlesinger interview.[39] Some have argued that Schlesinger may have been unaware

[35] 'German Rate Cut May Stave Off UK Increase', *Financial Times*, 15 September 1992, 1.

[36] Archives of the Bank of England, Dealers' report, 16 September 1992, reference C8.

[37] 'Inflexibility Meets Naievety', *Financial Times*, 17 September 1992, 25.

[38] Schlesinger later wrote that the reporter from the *Handelsblatt* 'released an unauthorised text to the news agencies' and he 'could not deny what I had actually said'. Quote from Philip Stephens, *Politics and the Pound: The Tories, the Economy and Europe*, 3rd ed. (London: Trans-Atlantic Pubns, 1997), 248, found in Keegan, Marsh and Roberts, *Six Days in September*, 113.

[39] For different views on the question, read the preface by Schlesinger himself in Keegan, Marsh and Roberts, *Six Days in September*; James, *Making the European Monetary Union*; James, *Making a Modern Central Bank*. Press articles at the time include Quentin Peel and Andrew Fisher, 'Inflexibility Meets Naivety', *Financial Times*, 17 September 1992, 25; and Craig Whitney, 'Bundesbank Chief Is at Eye of Currency Storm', *New York Times*, 8 October 1992, D1.

that he would be quoted. Or he may have been responding to Lamont's earlier provocation. Other commentators downplay the remarks. They argue that the remarks were disclosing nothing that investors did not already know. The subsequent crisis came from macroeconomic and financial imbalances, not from the statements of the Bundesbank president.

Evidence presented in Figure 14.2 is consistent with the view that a shock of an unexpected nature took markets by surprise after Schlesinger's statements. This happened somewhere between London market close and the overnight trading. The timing matches with the release of the interview. While sterling had been in the news for weeks, pressure on the currency was still moderate as measured by the EMP index. On the first two days following the Italian realignment, sterling and the French franc were under limited pressure (Figure 14.3). The pressure exploded with the news of Schlesinger's interview. If another event did cause the crisis within this narrow time frame of a few hours, it did not leave any written trace. It was most likely the interview.

This was not Schlesinger's first time. Harold James reports conversations in June 1992 when the British Government told the Bank about Schlesinger's 'deeply unhelpful' comments in the *Herald Tribune*.[40] The Bank did bring the issue to Schlesinger in July 1992 in Basel. But Schlesinger denied it and said that 'he had never made any reference about devaluing any of the EMS currencies', the minutes read.[41] Later in the same meeting, Robin Leigh-Pemberton, governor of the Bank, stressed that the German attitude was not helpful: '[T]he situation was made more difficult when the media reported on statements which appeared to have been made by the Deutsche Bundesbank concerning a realignment of the ERM currencies.'[42] The minutes do not record any reply by Schlesinger to Leigh-Pemberton's accusations.

There seemed to be a pattern on Schlesinger's side of sharing his opinion with German and foreign media, more or less directly. Later he would deny it in official arenas. James notes that the Bank 'began to suspect that the Bundesbank was playing a double game'.[43] After Black Wednesday, Chancellor Lamont blamed the Bundesbank. Lamont detailed 'at least five

[40] James, *Making a Modern Central Bank*, 290.
[41] Minutes of the 268th meeting of the Committee of Governors of the Central Banks of the Member States of the European Economic Community, held in Basel on Tuesday, 14 July 1992 at 9.30 am.
[42] Ibid. [43] James, *Making a Modern Central Bank*, 290.

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occasions on which senior Bundesbank board members or bank sources had used language that had undermined the pound'.[44] The Bundesbank was an easy target for the undermined British government on the evening of defeat. But the fact remained that the Bundesbank obtained its realignment by playing the press against the pound. And this was probably not a decision for the Bundesbank to make alone.

Schlesinger himself has apologised for his remarks in a recent book on the topic. He wrote: 'I regret to this day – without being able to assess the effect – that a general remark by myself, not focused especially on the pound, should have played a role in aggravating sterling's position.'[45] Schlesinger then goes on to say that Soros had 'already geared himself to the pound's depreciation'. Yet Schlesinger forgot that he had talked to the hedge fund manager a few days earlier, likely shaping his view on the question.[46]

Regardless of the intention of the remarks, the damage was done. During Black Wednesday, William Allen was in charge of foreign exchange intervention operations. He wrote a detailed summary of the event a few days later.[47] The following paragraphs draw on this narrative from 1992 and the dealers' reports.

The Bank of England most often intervened in secret, without communicating its intervention. On Black Wednesday, the Bank ran 'several rounds of overt intervention' which had 'momentary success', according to the dealers.[48] Allen reported that the Bank bought '£325mn publicly between 8–8.30 AM' and then 'a further £300mn publicly shortly afterwards'. By 9 am, the Bank had spent over £1 billion (around $1.8 billion), or 8 per cent of what it was about to spend during the course of the day.

On that day, the government announced two interest rate hikes (one at 11 am and another at 2:15 pm), an exceptional event in British monetary history. The timing of the first announcement played an important role in the chaos that followed. Normally, the Bank announced rate hikes at 9:45 am. On 16 September, the announcement was delayed until 11:00, indicative of internal debate. The government feared going against mortgage owners, having made housing access a core political promise. First there was an interest rate increase to 12 per cent, but it 'failed to stem'

[44] 'Britain Blames the Bundesbank', *Financial Times*, 17 September 1992, 1.
[45] Keegan, Marsh and Roberts, *Six Days in September*, v.
[46] On the meeting with Soros, see Mallaby, *More Money than God*, 156–7; James, *Making a Modern Central Bank*, 294.
[47] Allen's remark dates from 20 September 1992, or four days after the event, and bears the note 'written from memory'.
[48] Archives of the Bank of England, Dealers' report, 16 September 1992, reference C8.

interventions.[49] The second hike, to 15 per cent, 'reduced the scale of intervention' but did not manage to lift sterling from the ERM floor.

Communication at the governor level seemed to be difficult between the Bank and the Bundesbank.[50] Keegan et al. report that Leigh-Pemberton tried to reach Schlesinger during the day, but he was unavailable. At the operational level, cooperation was still functioning. Allen noted that 'Bundesbank and the Bank of France were extremely helpful' to buy '£100 million and £50 million respectively'.[51] These operations funded by the Bank of England were done without 'making clear to the press that they were dealing for our [the BoE's] account'.[52] The French and German central banks were making it look like genuine operations, a sign of faith in the pound. Allen also noted that the Bank had advised the government to leave the ERM. But the advice was not followed during the day.

Throughout concerted interventions among European Community central banks, the Bundesbank 'insisted on sticking to the rules obliging central banks to intervene'.[53] This behaviour led to heavy losses for the United Kingdom. The whole day, European Community governments were in contact to try to find a solution. The United Kingdom wanted a temporary suspension of the ERM to avoid a devaluation, which a few days earlier in Italy had done little to solve problems. This was an issue for the French. They needed to stick to the ERM before the vote on the Maastricht Treaty a few days later.

Keegan et al. report that John Mayor was taking his time to decide and kept to his scheduled agenda to give an impression of normality.[54] However, on the market it was anything but a normal day. At 4 pm the Bank announced to other central banks that Britain was temporarily leaving the ERM. At 7:30 pm Lamont officially announced to the public that Britain was throwing in the towel. And the second rate hike was rescinded as it was supposed to take effect the following day.

James quotes a letter to Schlesinger after the crisis, where Leigh-Pemberton wrote: 'As you will be aware, the Bundesbank bought sterling only for our own account, and we were given the very clear signal that you were not willing to do so for your own account.'[55] The Bundesbank could have supported sterling with its own reserves. To the credit of the

[49] Ibid. [50] Keegan, Marsh and Roberts, *Six Days in September*, 120.
[51] Allen's note, 20 September 1992. [52] Ibid.
[53] James, *Making a Modern Central Bank*, 302.
[54] Keegan, Marsh and Roberts, *Six Days in September*, 119.
[55] James, *Making a Modern Central Bank*, 304.

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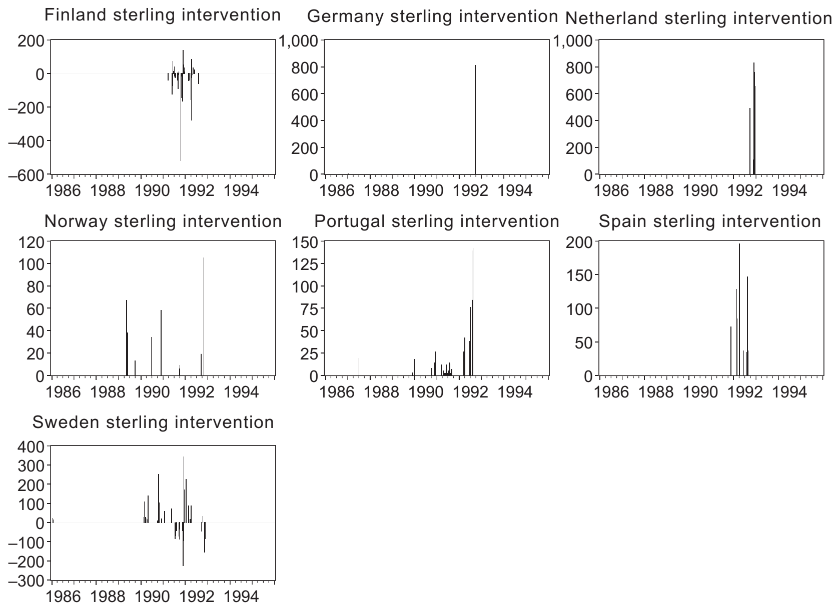

Figure 14.4. Interventions in sterling by other ERM and ERM-pegged countries. Positive numbers mean support for the pound, negative numbers usually mean support for the domestic currency against the pound.

Bundesbank, it did disguise its support as Germany's own account operations (even if operations were financed by Britain).[56] This point is also clear when looking at Figure 14.4, showing sterling intervention by ERM countries. The Bundesbank only supported sterling once for £809 million on Black Wednesday. It never supported the pound outside of its ERM obligations, only intervening at the margins as was required.

WHAT IF?

Black Wednesday was the result of Schlesinger's attacks and British hesitancy to raise rates in time, in the context of the French referendum moving European priorities far from Britain. While the pound was already under pressure, it was not the most exposed currency, as Figure 14.3 makes clear. The pressure on the pound might have receded after the French yes to Maastricht. This would have cleared the way for a completely different path for Britain in the ERM.

[56] Allen's note, 20 September 1992.

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While counterfactuals are always imperfect, can we measure the pressure on the British exchange rate, absent Schlesinger's remarks? The model proposed here is based on a few assumptions, which might not be perfect, but provide an idea. Pressure on the pound was dependent on several variables: First, I use the differential with German monetary policy. Higher German rates likely led to more pressure on the pound. Second, I use the Deutschmark–dollar exchange rate with the assumption that a stronger Deutschmark led to more pressure.[57] And finally, I use the pressure in other ERM countries. The link with other countries might not be causal. More pressure in France probably does not cause more pressure in the United Kingdom, but they are correlated. So I assume that if Italy, Portugal, France and Spain were under more pressure, it would be likely that the United Kingdom was as well.[58]

I forecast the pressure on sterling after 15 September, absent Schlesinger's comments. I run the model as a Vector Autoregression (VAR). I delete existing data for the British EMP (but only that variable) after 15 September 1992. The model then forecasts the data for the British EMP. It uses the observations of all the variables presented above during the year 1992. I only use the model to forecast twelve days after Schlesinger's remarks, as forecasts tend to lose explanatory power over time. The model is as follows:

$$EMP_{UK} = \mathrm{FX}_{USD-GER} + \nabla r_t + EMP_{FR} + EMP_{IT} + EMP_{PT} + EMP_{SP} + \varepsilon$$

where EMP_{UK} is the EMP index for the United Kingdom which we want to forecast, $Fx_{USD-GER}$ is the dollar–Deutschmark rate, ∇r_t the difference between the British and German rate and finally EMP_n is the EMP indices for country n, namely France, Italy, Portugal and Spain respectively. The forecast is shown in Figure 14.5.

The counterfactual in Figure 14.5 shows (again with the caution linked to such exercises) that without Schlesinger's remarks, the United Kingdom would still have been under substantial pressure after Black Wednesday, but nowhere near as much. This is visible in Figure 14.5 when comparing the dashed with the full line after 17 September. Once the United Kingdom left the ERM, it was under much less pressure as the country stopped intervening (remember interventions are one of our three EMP variables). Caution is needed with this counterfactual. Yet it seems to show that

57 On the role of the dollar, see the main argument in Eichengreen and Naef, 'Imported or Home Grown?'

58 Including Nordic countries in this list could be problematic as they went to crises linked to their banking systems, in part independent from EMS-related events.

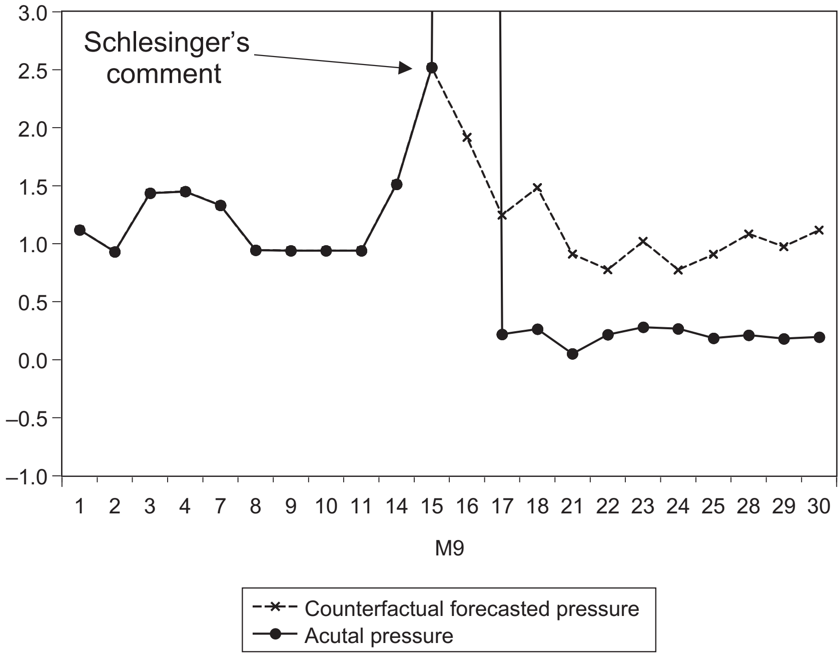

Figure 14.5. Actual vs counterfactual EMP index
Note: The actual index reaches a value of just 50 but this is not shown on this graph to improve readability (for the full picture, see Figure 14.3).

nothing outside the Bundesbank president's remarks would have led the United Kingdom to leave the ERM at that point.

MORE LUCK ACROSS THE CHANNEL

As the crisis transmitted from the United Kingdom to France following Black Wednesday (Figure 14.3), the reactions of the two countries were diametrically different. Both France and the United Kingdom sold over $20 billion to the market in September 1992. France managed to recoup all its losses within a month, making a profit. The United Kingdom, on the other hand, lost almost everything on one day. The Bank could not compensate its interventions without great exchange rate losses. These were estimated as just short of $5 billion.[59] The British crisis also became the focus of national criticism (or possibly fascination). The French intervention

[59] James, *Making a Modern Central Bank*, 306.

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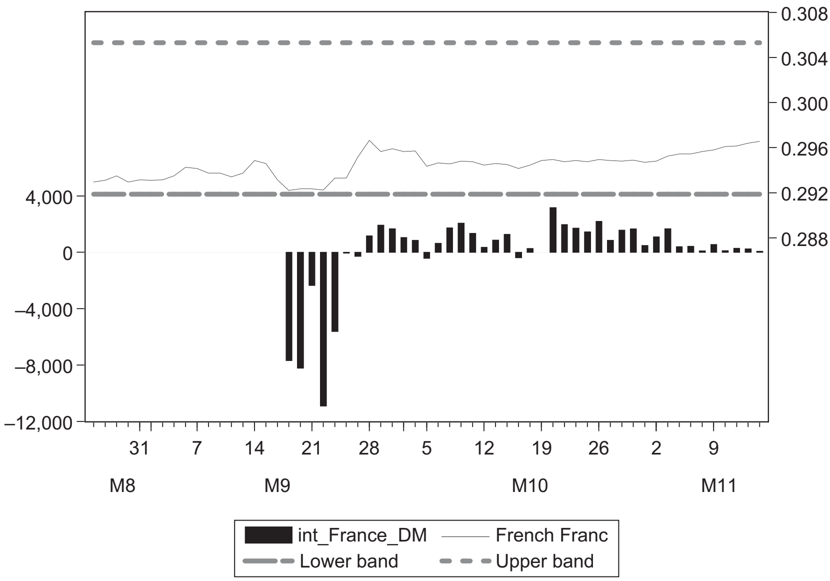

Figure 14.6. Banque de France intervention and franc/DM exchange rate (millions of $US left-hand scale, francs per DM right-hand scale). The upper and lower band are the ERM limits of the exchange rate.

record, however, has barely been mentioned in scholarly accounts or otherwise. The French data are presented here in detail for the first time. They also come from the publicly available archives of the Bank of England. They were collected in a process called the concertation.[60]

The central position of France played a role in its more successful path within the ERM. But also its commitment to the peg and Europe was much stronger than the United Kingdom's.[61] Figure 14.6 shows both French interventions on the foreign exchange market to support the franc and the franc–Deutschmark exchange rate. Between 17 and 25 September, the Banque de France spent $35 billion, according to the concertation data. This is 50 per cent more than the United Kingdom spent. But after 25 September, a few days after the Maastricht 'oui', the wind changed

[60] The concertation was a process of intervention information exchange between central banks in advanced economies. This exchange was a way for central banks to monitor use of their currency by other members. It may have also discouraged offsetting interventions and avoided introducing volatility into the market.

[61] On the fact that the United Kingdom felt it was treated unfairly in comparison with France, see James, *Making a Modern Central Bank*, 304.

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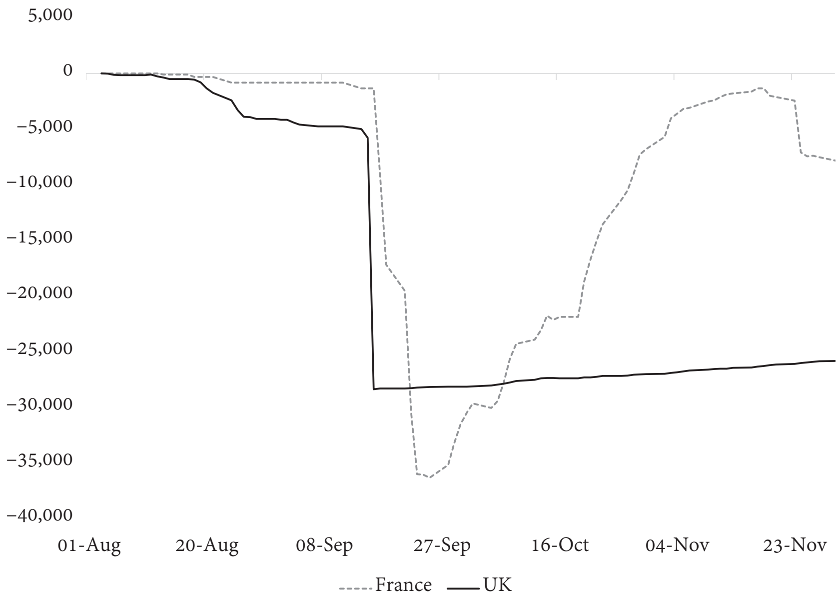

Figure 14.7. Cumulative French and British interventions (in USD)

direction. Over the next twenty-three trading days, the Banque de France bought back $35 billion of reserves.[62]

Figure 14.7 shows the parallel trajectories of intervention between France and the United Kingdom. The size of French losses is similar to British ones. Around Black Wednesday, France experienced a V-shaped reserve loss and recovery. The United Kingdom experienced a definitive reserve loss with no recovery. The French equivalent of Black Wednesday does not have a name, as it was quickly forgotten. Black Wednesday, on the other hand, shaped the future of the United Kingdom.

Around the Maastricht referendum crisis, the Banque de France bought French francs with DM for a value of FF –71.7 billion. Over the next three weeks, the Banque bought back the same amount of DM, paying only FF70.6 billion (Figures 14.6 and 14.7). The Banque de France made a profit of over FF1 billion in the operations.[63] The Banque de France bought

62 The exact numbers almost perfectly match up, with losses of $35,036 million and $35,029 million recouped.

63 The exact numbers adjusted at each day's closing price are FF71,686.3 million and FF70,583.1 million. Note that this calculation might be wrong if the transaction happened at another price than the closing price, which is likely.

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cheap French francs against DM and managed to resell these francs at a higher price over the next few weeks. It is striking to contrast the $214.7 million (= FF1 billion) French gain with the $5 billion British loss. An older strand of literature on foreign exchange intervention links central bank profit with successful interventions.[64] This is a great case in point.

These differences in performance were not only due to poorly managed interest rate announcements on the British side. They also reflect the position of both countries in the ERM. Germans needed the French to be in the ERM while the same cannot be said for Britain. And the French government really wanted to join the European monetary project. The British government only joined it as an effective way to manage inflation.

The consequences of Black Wednesday remained important for the United Kingdom. It stopped foreign exchange interventions after the event, bar a few instances for international cooperation. It marked a new era of inflation targeting by the Bank. The episode was also one among many showing British independence from the European institutions, forecasting a future of more distance between British and European interests.

64 See Milton Friedman and Marilyn Friedman, *Essays in Positive Economics* (Chicago, IL: University of Chicago Press, 1953), for the original idea, and a more modern take on the idea in Francesco Chiacchio, Gregory Claeys and Francesco Papadia, 'Should We Care about Central Bank Profits?', Research Report (Bruegel Policy Contribution, 2018), www.econstor.eu/handle/10419/208020. See also Christopher Neely, 'Technical Analysis and the Profitability of U.S. Foreign Exchange Intervention', *Review* 80 (July 1998), 3–17; Friedman and Friedman, *Essays in Positive Economics*.

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