Britain's 'most stupid decision'

'Six Days in September' OMFIF Press book launch

by OMFIF analysis

Tue 19 Sep 2017

Britain's doomed attempt to stay in Europe's exchange rate mechanism on 'Black Wednesday' 25 years ago was 'the most stupid decision I have seen in 40 years of public life', according to Lord (Andrew) Turnbull, former UK cabinet secretary.

However, Turnbull – during Britain's 1990-92 ERM adherence Prime Minister Margaret Thatcher's principal private secretary and then head of the Treasury's monetary department – said Britain's eventual ERM exit on 16 September 1992 was positive for the economy. It ushered in an improved monetary policy, leading eventually to Bank of England interest rate-setting independence, and a long period of above-average growth.

Turnbull's bittersweet judgement was among multiple postscripts to Britain's 23-month membership of the ERM, the forerunner of economic and monetary union, at the 15 September London launch of OMFIF's Six Days in September: Black Wednesday, Brexit and the making of Europe .

Turnbull's verdict referred to the decision – midway through the 16 September 1992 trading day – by Prime Minister John Major, Thatcher's successor, to stay in the ERM despite overwhelming sterling pressure and raise interest rates by 3 percentage points. (The rise was never actually enacted.)

Turnbull, who was Treasury permanent secretary before becoming cabinet secretary, told an audience at the British Academy that Black Wednesday was 'another episode in our civil war about our relationship with Europe... The mood became staunchly anti-European, with europhiles heckled by their peers in government.'

Several participants in last Friday's launch discussed why Britain could not suspend membership of the system on 16 September 1992 under contingency plans already elaborated by the Treasury in 1985 – although these plans were laid above all to allow the UK to 'opt out' of the ERM during defined periods such as election campaigns.

Questions were raised, too, why the UK could not deploy a clandestine suspension mechanism secured by the Bundesbank in November 1978 under an agreement between Chancellor Helmut Schmidt and Otmar Emminger, then Bundesbank president, subsequently known as the 'Emminger letter'.

The existence of the letter – even though it was revealed in a German newspaper article in 1978 – was not communicated to the British, French or Italian governments. Turnbull confessed last Friday that he had not heard about the letter until that day.

Financial historian Richard Roberts, a co-author with William Keegan of The Observer and OMFIF Managing Director David Marsh, described the link between the 1992 crisis and Britain's 2016 referendum to leave the European Union.

Sir Ivan Rogers, Britain's permanent representative at the EU until he resigned in January over a disagreement with the UK government's negotiating policies, underlined the continuity. Rogers said the British had always 'hated' what he called the 'teleology' of the European project. 'We wanted to stop at the single market. We negotiated the opt-out of the single currency and out of the Schengen agreement. Then we negotiated opt-outs for justice and home affairs. Over the past 20-25 years, the UK has successfully cherry-picked everything it liked about the union while insulating itself from the faults. The UK then tried to negotiate further opt-outs and then pulled out of the single market project, which was essentially its idea in the first place.'

Sir Tom Scholar, present-day Treasury permanent secretary, said: 'Everyone involved in policy-making cannot make sense of the current situation without an understanding of the historical context, and we are immensely grateful to Bill, David and Richard for writing this book.'

Jacques de Larosière, governor of the Banque de France in September 1992, said, 'It is a book of vision. The reader, after finishing Six Days , continues to ask questions. That is the litmus test for a great book.'

Zeti Aziz, governor of Bank Negara Malaysia in 2000-16 and a reserve manager in the Malaysian central bank's London office in 1992, described how the experience of the ERM crisis helped her and other Asian central bankers contend with the Asian financial crisis five years later. She commended Keegan, Marsh and Roberts for their 'impressive and riveting account', adding that ' Six Days in September will be of great value to policy-makers in other parts of the world, particularly in Asia, where deeper economic and monetary integration is being considered.'

Julia Leung, an executive director at the Hong Kong Securities and Futures Commission, said the 1992 upheavals – particularly the role of hedge funds – were a crucial part of the build-up to the 1997-98 Asia financial crisis. As an official at the Hong Kong Monetary Authority, during the latter upset, Leung played an important role withstanding a run on the Hong Kong dollar. Leung has related her experiences in another OMFIF Press book, The Tides of Capital , reissued last week in a second edition.

There was much discussion of the UK's motivations for joining the ERM in 1990. Lord (Terry) Burns, Treasury permanent secretary in 1992, said, 'This was a short-term issue of monetary policy. The UK wanted to bring down a high rate of inflation. It was a tactical decision.' Burns said Thatcher had never been a 'convert' to the ERM as she had never wanted to join. He declared that UK policy-makers 25 years ago underestimated both Britain's need for much lower interest rates to beat recession and the Bundesbank's intention to raise rates to quell inflation caused by German unification. The combination proved fatal to Britain's ERM ambitions.

Sir Stephen Wall, private secretary to Major in 1992, related how Thatcher told Alan Greenspan, US Federal Reserve chairman, 'We are [joining the ERM] so that we can borrow some of the Germans' spine.'

De Larosière, a former International Monetary Fund managing director, said, 'It's not because [the UK] liked Europe. It's because they wanted to lower inflation. And, two years later, they didn't feel any attachment to the project… The British treat the EU and the European Community as an open, free market thing, a commercial thing… you are not interested in the European idea of "shaping our destiny". You are, fundamentally, not attached.'

De Larosière said Britain joined at too high an exchange rate. But it had a more flexible economic system than France and could 'capitalise' on its ERM exit. 'Leaving the ERM gave the UK a positive future – they didn't need to be under the strictures of the European Monetary System.' De Larosière affirmed: 'The pound's exit from the ERM strengthened the project for monetary union.' But he pointed to the 'paradox' of France's 1992-93 decision to resist devaluation and remain in the ERM 'They thought it would help convergence with Germany. But it didn't really happen.'

De Larosière said the episode showed the importance of the 'fundamentals' determining the exchange rate between the D-mark and the French franc, which protected the French currency from devaluation. French inflation was somewhat lower than in Germany. The budgetary position in France was close to balance while Germany was about to embark on massive deficits due to reunification. 'No French firms were asking me for a devaluation.'

Elaborating on sterling's alleged overvaluation, de Larosière said. 'I have never understood why the UK had insisted on such a high rate of entry. Everyone knew that German monetary policy was going to be tightened because of re-unification… The combination of an overvalued rate coupled with the prospect of high interest rates on the D-mark was lethal.'

De Larosière made clear the Banque de France's escape from the storm had been 'painful'. France was ready to keep higher interest rates than in Germany and, if needed, to increase the differential during the crisis. 'As Governor, I insisted on interest rate hikes. That was the French “contribution” to the joint effort. A painful contribution for a low growing, non-inflationary country. But it was the manifestation of a joint effort and also a cost imposed on speculation.'

As a result of 'practically unlimited' financial support from the Bundesbank to the Banque de France, speculators eventually realised 'they were not attacking the franc but, in fact, the D-mark'.

Like Britain. French monetary reserves turned negative during the crisis because of massive borrowing from the Bundesbank, hitting a low of minus $15bn on 23 September. But later bouts of franc strength – above all after the August 1993 widening of ERM fluctuation band to 15% each side of a central rate – allowed 'extremely rapid' unwinding of the unfavourable reserve position, de Larosière said.

Participants discussed the confused communications between the Bundesbank and Bank of England during the crisis in September 1992. Sir Paul Tucker, private secretary to Bank of England Governor Robin Leigh-Pemberton, who went on to become a deputy governor, voiced scepticism over the contrition of

Helmut Schlesinger, then Bundesbank president, who apologised in the OMFIF book for his role in provoking the upsurge in speculation that culminated in the UK's 16 September ERM departure.

Tucker recounted how he and Robin Leigh-Pemberton, Bank of England governor, had spoken to Schlesinger on the evening of 15 September asking him to withdraw a reported remark questioning sterling's ERM parity. Schlesinger said he was unable to do this, though the Bank offered to help with technical assistance, showing, according to Tucker, that Schlesinger intended all along to draw attention to what the Bundesbank considered to be the pound's ERM overvaluation.

Tucker said the 1992 turbulence carried a warning for the UK government over the challenges it faces in 2017. 'If you embark on a major policy shift, and you're not clear in government about what your goal is, and you're not clear with the public, then you are likely to fail. I am not convinced that our nation has learnt those lessons that the 1992 ERM crisis could teach us.'

To purchase a copy of Six Days in September , please click here . A gallery of photographs from the launch can be viewed here .