

*Finance Basics*

# Black Wednesday



Hélène Dury

# EXECUTIVE SUMMARY

<i>Introduction</i> .....	3
<b>PRELUDE</b> .....	4
<b>THE CRISIS</b> .....	5
<b>THE AFTERMATH</b> .....	6
<b>ANALYSIS</b> .....	8
<i>Conclusion</i> .....	10
<i>References</i> .....	11

## **INTRODUCTION**

The settlement of a unique currency in Europe was not done in a day. Shortly after WWII, the major European forces were convinced that a Union should bring harmony back on the old continent, thus going through the creation of a common currency to achieve monetary stability.

But September 16, 1992 also known as Black Wednesday made optimistic review their theories. It was even more shocking because of its suddenness. As speculators broke the pound, the United Kingdom's (UK) economy was wrecked in just a few hours.

Only five years later, the UK Treasury estimated that the loss of Black Wednesday was around £3.14 billion.

In this paper, we will first introduce Europe's and UK's economic situation at the time. Then, we will move on to the economic crisis and its aftermath and we will finally conclude on the effects of the crisis and why it is still an important lesson to keep in mind in all common economic areas.

# I. Prelude

---

Introduced by the European Economic Community (EEC) in March 1979, the European Exchange Rate Mechanism (ERM) was a system created in order to reduce exchange rate variability and achieve monetary stability in Europe. As part of the European Monetary System (EMS), it is now considered as one of the ancestor of the Economic and Monetary Union and a former institution responsible for the introduction of a single currency, the Euro, which took place on January 1<sup>st</sup> of 1999.

## Britain's entrance in the ERM:

Let's recall that before succeeding to Margaret Thatcher, John Major had been Chancellor of the Exchequer<sup>1</sup> from October 1989 to November 1990. He was thus well aware of the actual monetary policy when he became as Prime Minister.

Within the ERM, the pound had fixed exchange rates compared to all other participating currencies and would comply with these pegs in a permitted fluctuation band of around 6%. To take an example, the British government had chosen a fixed exchange rate of 2.95 German marks. This meant that Britain wanted to keep its currency above 2.95 German marks (in reality keeping its currency between 2.78 marks and 3.13 marks.)

The stated purpose of this policy was to bring an internal monetary stability and, in other words, to control inflation through a disciplinary policy imposed by the British government's membership in the ERM. Indeed, to meet the terms with ERM rules, the UK government was required to keep the pound in a trading band within 6 percent of the parity rate.

Indeed, the ERM's policy showed that if each currency should remain stable with respect to each other in practice, the state members would normally focus on stabilizing their own currencies according to the German mark. This currency had been tacitly and unanimously chosen as the anchor currency because of its strength and because of the Bundesbank's independence. Therefore, in order to stabilize their currencies against the mark, State Members had no lasting solution than to try to follow the monetary policy of the German Central Bank. Furthermore, since the crisis of 1922-1923, the German's Bundesbank had been following a very restrictive policy of inflation control. Thus required by imitation, State Members of the ERM were more or less obliged to follow the German Central Bank's monetary policy. And, as British inflation had rose to 10.9% (three times higher than that of Germany) in October 1990, the UK was in dire need of another anti-inflation disciplinary plan, which served good to John Major to justify the full British participation in the EMS.

---

<sup>1</sup> *The Chancellor of the Exchequer*: the Minister of Finance and Treasury of the UK, the head of Her Majesty's Treasury (*HM Treasury*)

## II. The Crisis:

---

From the early nineties, the high German interest rates set by the Bundesbank to counter inflationary effects related to the expenditure on German reunification caused significant stress across the ERM Member States. The first currencies in trouble were the Finnish mark, as well as the Swedish and Norwegian crone, all three outside the ERM. But the trigger of the crisis was the unexpected depreciation of the dollar as the German mark appreciated. For a currency that served of back up currency and in which many British exports were priced, it was too much for the European countries.

By the end of the 1992 fall, the phenomenon of the currency crisis went far beyond the British case. In September, the Italian lira that had devalued by 7% was temporarily suspended in the ERM and the following month, both of the Spanish peseta and the Portuguese escudo were devalued by 6%. The ERM State Members were actually paying the price of an underestimation of the magnitude of the consequences of the German reunification.

To this economic situation was added the political uncertainty about the future of the European Union with the Danish rejection of the Maastricht Treaty and the announcement of a French referendum. On currency markets, speculators took advantage of uncertainty and disparity rose.

On 16<sup>th</sup> of September 1992, Britain upped its interest rates to attract people to the pound but speculators began heavy shorting<sup>2</sup> of the currency. As the sterling/mark exchange rate approached the lower end of the trading band, traders increasingly sold pounds against deutsche marks, forcing the Bank of England to intervene and buy an unlimited amount of pounds in accordance with ERM rules. Fears of a larger currency devaluation sent British companies scrambling to hedge their currency exposure by selling pounds, further compounding pressures on the system.

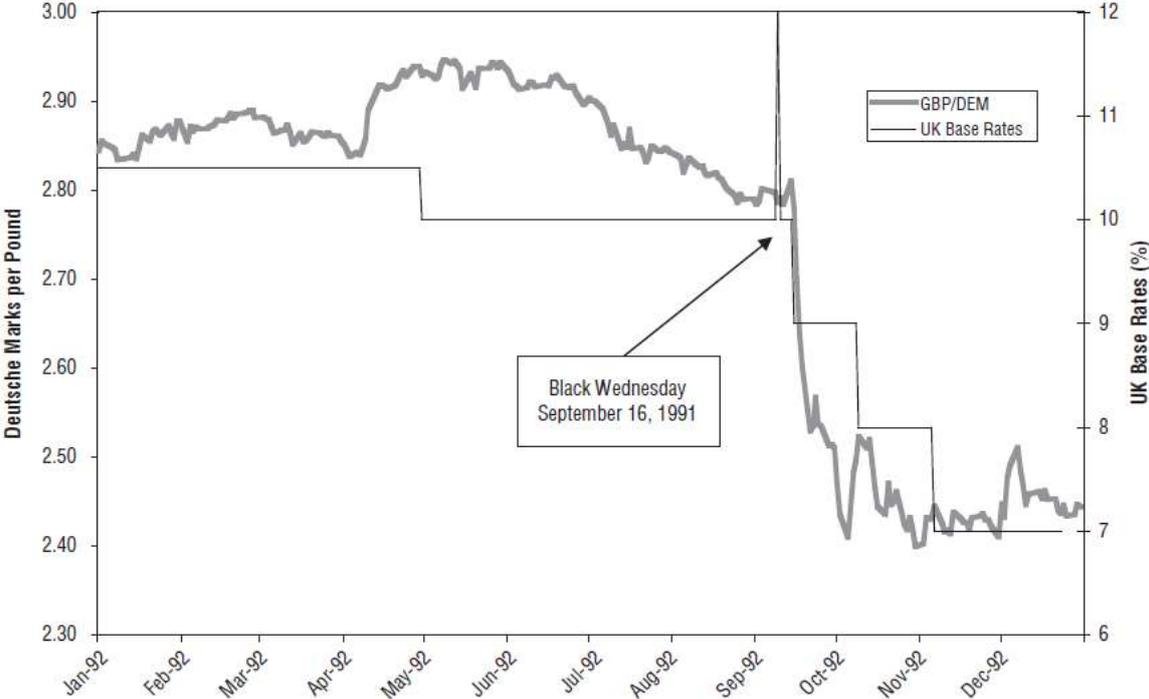
The British government announced a rise in the base interest rate from an already high 10 to 12% in order to tempt speculators to buy pounds. Despite this and a promise later the same day to raise base rates again to 15 percent, dealers kept selling pounds, convinced that the government would not stick with its promise. By 7:00 PM that same day, the British government announced it would no longer defend the trading band and withdrew from the ERM as it became clear that it was losing billions. The pound came back stronger because the excess interest and the high inflation were forced out of the British economy following the beating.

Speculators pocketed a lot on the deal, they sold billions of pounds hoping to buy them back at a depreciated rate and pocket the difference. Among them was famous Georges Soros who won around \$ 1.1 billion and cemented his reputation as the premier currency speculator in the world.

---

<sup>2</sup> *Shorting*: the sale (also known as "writing") of an options contract.

Yet, UK's monetary policy finally emerged from the tunnel. After two decades of testing various policies that had always proved to be defective in the long term, the government finally settled for Major's foundations for an effective monetary policy, sustainable and universally acclaimed and still preserved to this day, that of direct inflation targeting.



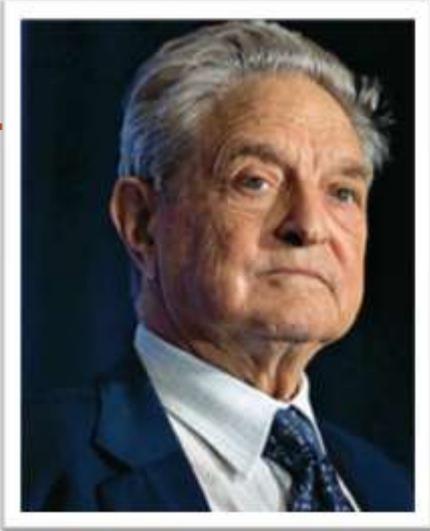
**FIGURE 1** Sterling/Mark and UK Base Rates, 1992  
 Source: Bloomberg.

**Georges Soros:**

Also known as “The Man Who Broke the Bank of England,” Georges Soros is one of the important characters of the Black Wednesday crisis.

Hungarian-American investor, philosopher and philanthropist, Soros took advantage of the withdrawal of the UK from the ERM, and, as the pound devalued, he earned an estimated \$1.1 billion as the UK Treasury estimated the entire cost of Black Wednesday to £3.4 billion.

However, he was certainly not alone in betting against the pound. While he may have borne a disproportionate amount of the criticism because of his significant gains, the government’s own policies are believed by many to have been the root cause of the problem, the speculators merely being an indicative presence.



### III. The Aftermath

---

#### Getting out of the tunnel:

In September 1992, the withdrawal of the pound in the ERM system resonated as a personal failure to the Prime Minister of that time, so much that the name of his Chancellor, Norman Lamont, was somewhat forgotten. However, he was certainly the one who got Britain out of the tunnel thanks to his ultimate goal: The direct inflation targeting policy.

In order to understand the concept of direct inflation targeting, it is useful to return to policies that had been previously applied in the UK. In the monetarist policies seen in the Thatcher former government, as well as in the politics of exchange rates applied from 1990 to 1992, the ultimate goal was always to reduce inflation.

Here, as its name suggests it, the goal is to reach a certain inflation rate. This technique, also known as *Forward looking*, implies to act immediately on the basis of inflation forecasts in order to achieve a certain level in the future.

Basing himself on Europe's most powerful inflation rates from which he wanted UK's inflation rate to get closer, Lamont decided to target an inflation rate of 2% maximum in the long term.

Thus, in order to achieve this long-term rate, the Chancellor proposed to give an immediate objective: to keep inflation within a range from 1% to 4% maximum, which was already considered as an improvement as the inflation rate of the ten previous years had been within a range of 3% to 7%.

Yet, despite this innovative policy and some notable economic recovery in September 1992, Lamont was dismissed in May 1993 and replaced by Kenneth Clarke. Clarke kept Lamont's policy in the first time and refined it a bit in 1995. Noting the deceleration of inflation, he reduced the target range of 1.4% to 2.5%.

Other ERM countries such as Italy, whose currencies had breached their bands during the day, returned to the system with broadened bands or with adjusted central parities. Even in this relaxed form, ERM-I proved vulnerable, and ten months later the rules were relaxed further to the point of imposing very little constraint on the domestic monetary policies of member states.

Furthermore, the effect of the high German interest rates, and high British interest rates, had been arguably to put Britain into recession as large numbers of businesses failed and the housing market crashed. Some commentators, following Norman Tebbit, took to referring to ERM as an "Eternal Recession Mechanism" after the UK fell into recession during the early 1990s.

In 1997 the UK Treasury estimated the cost of Black Wednesday at £3.4 billion, with the actual cost being £3.3 billion which was revealed in 2005 under the Freedom of Information Act<sup>3</sup> (FoI).

Therefore, if the 16<sup>th</sup> of September 1992 is world-widely known as “Black Wednesday” and as a national disaster on the British point of view, some conservatives claim that the forced ejection from the ERM turned this day into a “Golden Wednesday.” Indeed, it brought Britain to an economic revival with the creation of an innovation economic policy. It led to the re-establishment of economic growth with the falling of unemployment and inflation rates.

## IV. Analysis

---

With a high inflation rate, an unemployment rate peaking and the background economic history of Margaret Thatcher’s politics, the United Kingdom was certainly not fulfilling the right conditions to enter in the ERM. Furthermore, as every State Member had to follow the German example, it is hard to understand how John Major did not analyze it through. Stabilizing the pound Sterling against the mark was doomed to a certain pessimistic faith as the growth rate of UK was stable, if not considered as “bad”, while the German economy was booming in late 1990.

The trading losses in August and September were estimated at £800 million, but the main loss to taxpayers arose because the devaluation could have made them a profit. The papers shows that if the government had maintained \$24 billion foreign currency reserves and the pound had fallen by the same amount, the UK would have made a £2.4 billion profit on sterling's devaluation. Newspapers also revealed that the Treasury spent £27 billion of reserves in propping up the pound.

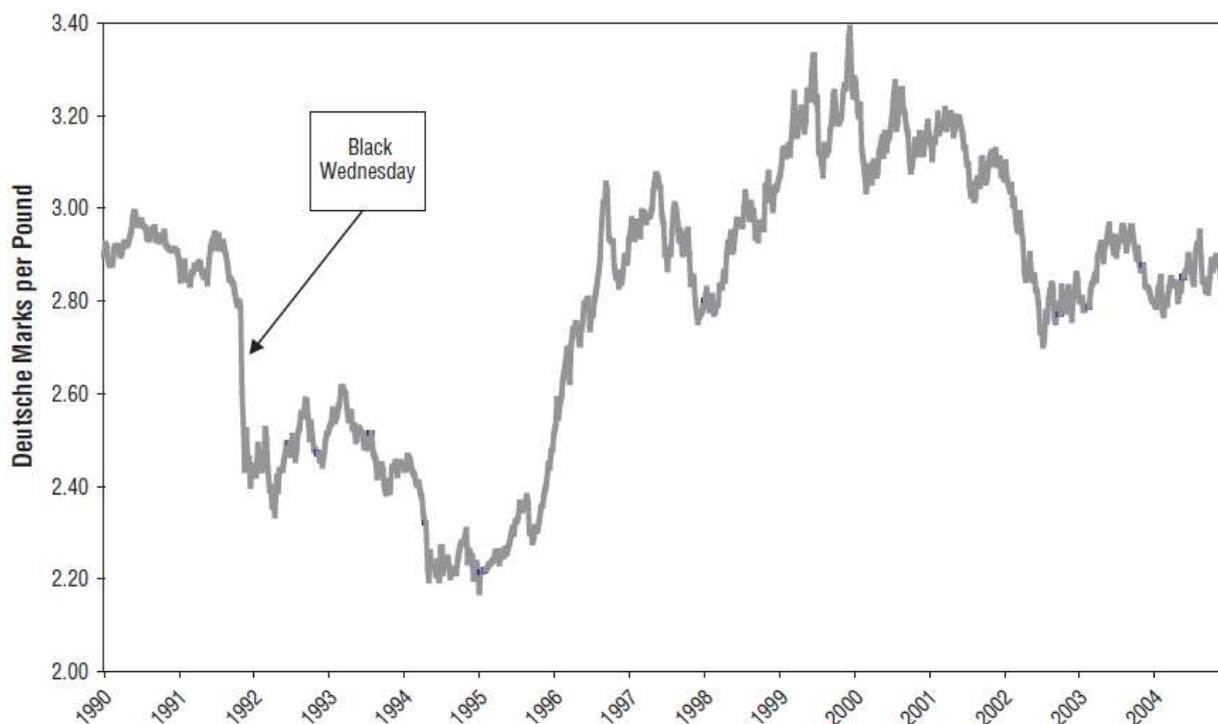
In 1995, the pound eventually traded as low as 2.16 deutsche marks but then rose as high as 3.44 in 2000 as the British economy recovered from recession and Germany suffered from the negative effects of euro integration.

Some assert that today’s main strength in the British economy is its interest rate and the currency flexibility afforded by its position outside of the euro system. (*See Figure 2*)

This is especially striking when the United Kingdom’s economic growth over the last decade is compared to the growth rates of formerly strong euro area countries such as Germany and France. “Non-Euro” partisans amusingly claim that Great Britain should erect a statue of George Soros in Trafalgar Square as an expression of gratitude for taking the pound out of the ERM. “UK’s Chancellor Norman Lamont and Prime Minister John Major suffered from short-term humiliation for long-term good. Look at the muddle France and Germany are still in.”

---

<sup>3</sup> *The Freedom of Information Act*: Act of Parliament of the Parliament of the United Kingdom that creates a public "right of access" to information held by public authorities.



**FIGURE 2** Sterling/Mark, 1990-2005

Source: Bloomberg.

A lot of conclusions have to be made from these mistakes.

First, we can say that the Free Market Forces that drive exchange rates are indeed “Free.” Traders of that time continued relentlessly shorting the Pound despite the government measures because they knew that at the end of the day, market forces would prevail. Once these Market Forces push a currency one way it is almost impossible to intervene via the Central Bank mechanisms, the government directives or otherwise.

Another lesson to conclude from this drastic event is that if you make yourself vulnerable by borrowing too much or trying to maintain too high a price, there are people out there that will get richer by pushing you over the edge, using leverage for instance. In 1992, British Chancellor Lamont found no defense in time against the hedge fund.

Although the ERM the ERM may have helped set a low-inflation foundation for the subsequent decade, it did prolong the British slump, by preventing UK rates from being cut to the levels justified by the UK economy.

It has generally made the UK a bit more skeptical about hitching itself to external currency systems. Pro-and anti-euro campaigners agree the ERM was a mistake, they do not agree on which route we should now follow, with those opposed in the "no" camp using it as a reason why the UK should not join the euro.

Today, if Britain would adopt the Euro, they might know again the nightmare of 1992. This, because Euro, “as our actual exchange rate mechanism, would force us to accept interest rates that are not good for us”, “anti-euro” supporters predict.

“The reason why Britain has recovered so quickly after 1992, it is precisely because we were free to have an independent economic policy and a declining exchange rate,” says this pressure group. But Jacques Cailloux, economist at Barclays Capital, affirms today that ‘if the` Black Wednesday 'is psychologically important, it remains limited in terms of real economic significance.'

For Norman Lamont, Chancellor of the Exchequer at the time, ‘the events of September 16, 1992 showed that a single monetary policy could not work for both Britain and the rest of Europe.’

## **CONCLUSION**

Black Wednesday is nowadays considered as the day the British government was forced to withdraw the pound sterling from the ERM only two years after joining this monetary system, and thus sending the currency into a free fall.

As today’s European Monetary Union is facing various difficulties, like the Greece example for instance, the Black Wednesday episode shows us how to avoid making too many mistakes while entering an inter-countries common monetary union.

## References

### Books

*Inside the House of Money: Top Hedge Fund Traders on Profiting in the Global Markets*,  
by Steven Drobny

### Internet

*The European Exchange Rate Mechanism (ERM)*

ERM definition

[http://en.wikipedia.org/wiki/European\\_Exchange\\_Rate\\_Mechanism](http://en.wikipedia.org/wiki/European_Exchange_Rate_Mechanism)

*The Monetary politics of UK in the nineties*

Going out of the tunnel

<http://osb.revues.org/746>

*Georges Soros*

How did George Soros "break the Bank of England"?

<http://www.investopedia.com/ask/answers/08/george-soros-bank-of-england.asp#axzz1f7a7kUIV>

The man who made killed the Pound

<http://www.next-finance.net/George-Soros-l-homme-qui-a-fait>

*Black Wednesday sources:*

Investopedia

<http://www.investopedia.com/terms/b/black-wednesday.asp#axzz1f7a7kUIV>

Trade Forex

<http://fxacademy.net/black-wednesday/>

Q&A : ERM and Black Wednesday

<http://news.bbc.co.uk/2/hi/business/4249425.stm>

Youtube video footage

<http://www.youtube.com/watch?v=AHDsO7gvXHQ>

The day the Pound died

<http://www.economicsuk.com/blog/000182.html>