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Exchange Rate Mechanism Crisis 1992-1993

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Abstract

The Exchange Rate Mechanism (ERM) Crisis of 1992-1993 marked a significant turning point in the economic history of the European Monetary System (EMS). This crisis, centered on the inability of several member currencies to maintain their fixed exchange rates against the German mark within the prescribed ERM bands, exposed the fragility of EMS and its ERM. The crisis was precipitated by a combination of factors, including divergent economic policies among member states, the strengthening of the German mark, and speculative attacks on weaker currencies. As the crisis unfolded, several governments were forced to devalue their currencies or withdraw from the ERM, causing widespread financial turmoil and eroding confidence in the EMS. The failure of the ERM highlighted the need for deeper economic integration and stronger institutional arrangements to support a more stable currency union. It laid the groundwork for the creation of the European Union and the eventual introduction of the single European currency, the euro, in 1999. The ERM Crisis also underscored the importance of macroeconomic policy coordination and the role of expectations in shaping currency markets. It remains a case study in international economics, providing insights into the challenges and complexities of managing exchange rates in a multi currency union. In conclusion, this paper studies the causes of ERM Crisis of 1992-1993 and shows the history of creation of the European Union. This paper also explains why government macroeconomic policy might be a failure.

Keywords

Exchange Rate Mechanism Crisis, European Monetary System, European Union, Speculators Attack, Maastricht Treaty

1. Introduction

On the morning of August 26, 1992, the British Chancellor of the exchequer, Norman Lamont stood in front of the financial building. He faced a television camera and said, "we will not devalue the pound and leave the European Monetary System." "We absolutely support the European Monetary System." As the voice began to fall, the crowd of reporters lifted up the microphone. Lamont simply ignored reporters' question and added, "We are taking action." Then he left in a hurry.

This is what happened during the exchange rate mechanism crisis in Europe from year 1992 to 1993. Lamont's talk is undoubtedly aimed at stabilizing the market. Reporters and psychological experts have captured and interpreted the uneasiness from his body language. "The man was very restless, and most people blinked six to eight times a minute, but Lamont blinked 64 times in 45 seconds," said an expert in a video analysis sector for the Daily Mail.

This episode took place on the eve of the European monetary crisis in 1992. In order to ascertain the cause of his nervousness during the interview, we need to discuss European Monetary System and Exchange Rate Mechanism.

2. European Monetary System and Exchange Rate Mechanism

European Monetary System, EMS, created in 1979, was an arrangement between several European states, which links their currencies in an attempt to achieve exchange rate stability through the convergence of economic performance. It's operating mechanism contained two basic elements: the European Currency Unit, ECU; and the Exchange Rate Mechanism, ERM.

2.1. European Monetary System

ECU is a basket of currencies which was made up of a certain proportion of the member states' currencies. The composition of the monetary proportion of member states was determined by the gross national product of the country and its share in the internal trade within the community. In order to adjust the exchange rate according to the economic development of various countries, the European Monetary System stipulates that the weight of member currencies should be revised every five years (Derosa, 2008).

2.2. Exchange Rate Mechanism

Let us now talk about the Exchange Rate Mechanism, ERM. ECU keeps a free floating rate within certain range with other currencies, such as the US dollar. ECU set a central exchange rate, and then established a Grid Parity System or Semi-Pegged System.

West Germany was the largest economy in the European Community at that time, its trade with the surrounding countries also accounted for a major share, which led to the decisive role of German Mark when deciding the central rate. The exchange rates of other member countries tend to float within a certain range following the German mark. German's policy will also affect other states heavily. After the establishment of the European Monetary System, although the international financial market was unrest, the member states participated in the Exchange Rate Mechanism have gradually formed a relatively stable currency area for the following decades.

During the period from 1979 to 1987, 11 times realignments of Exchange Rate Mechanism. However, during the period from 1987 to 1992, there's only one realignment and it was positive realignment: Italian Lira is now changed from the wider band of ± 6% to narrower band of ±2.25%, same with other member states. Because of the decisive role of German Mark system, Germany monetary policy had great influence on the other member states' monetary policy as well (Derosa, 2008). In other words, under the European Monetary System, the autonomy of monetary policy of some member states was reduced.

2.3. How Does Exchange Rate Mechanism Work?

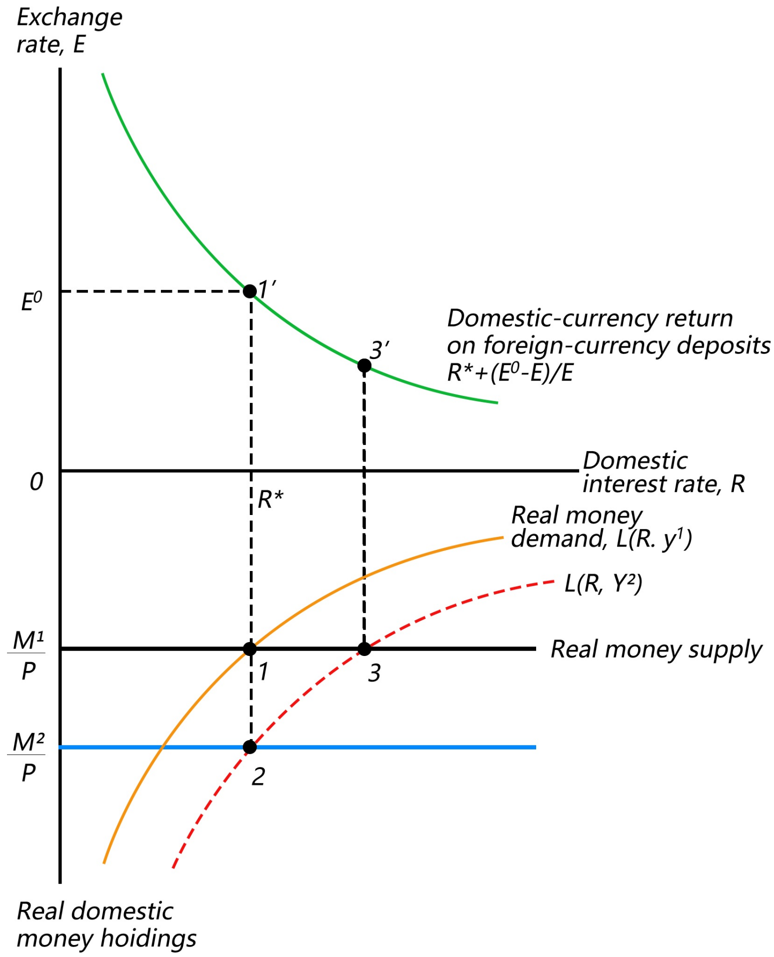

Figure 1. Change of the exchange rate between two countries with the change of one country's income.

As can be seen in Figure 1, for example, we assume that there are two states, German and Italy. If income in Italy increases, that raises the demand for real money holdings at every interest rate, thereby shifting the aggregate money demand curve downward. However, money supply in Italy real money asset market don't change, this will raise Italian interest rate which will make Italian Lira more attractive in the foreign exchange market. Given that the expected exchange rate doesn't change, which means the curve in the foreign exchange rate market doesn't move. Appreciation of Lira and exchange rate decrease to point 3' and new equilibrium in real money asset market is point 3. In order to restore the Semi-pegged exchange rate system, Italian government could increase money supply by purchasing back the government bond or purchasing the foreign assets. A new money market equilibrium would be at point 2. The foreign exchange rate market equilibrium would be back to point 1.

3. Exchange Rate Mechanism Crisis Overview

Due to the massive capital outflows in Britain, Italy, and Spain, they decided to exit the Exchange Rate Mechanism of the EMS in the fall of 1992. Besides, there was a second wave of attack in the summer of 1993, which result in the decision to widen the exchange rate bands for member states' currencies including French franc.

3.1. The Causes—From International Perspective

What's more, from an international perspective, the monetary policies of the United States and Germany are at opposite ends. The US economy has been in recession since 1991. To stimulate the economy, US has to cut interest rates continuously, while Germany has kept interest rates high for the purpose of restraining inflation. This made the interest rate spread between US and German as high as 6.5 per cent (Guo, 2017). In this case, investors dumped dollars to get the Mark. The appreciation of Mark will leave pressure on the other member states as well.

3.2. The Causes—Reunification of Germany

Economic development asymmetry can be observed in Europe during that time. After the unification of German, the government sector and private sector transfer significant savings to East German. Despite other European states that suffered from recessions, German experience dramatic economic growth after the unification during the same period. After the reunification of Germany, West German and East German was under different political and economic system before the reunification. They had different productivity and standards of living. After reunification, a highly controversial monetary-fiscal policy mix had been applied. The aftermath of reunification soon generated a noticeable increase in investment demand. Unless much of the increase in consumer demand from the east could be directed toward foreign goods, the German reunification scenario would lead to domestic overheating and inflationary pressures in the western part of the country. Also, huge budget deficit happened in German during that time. Huge budget deficit was also an indicator of inflation. As a result of the history of Pentium inflation (1919-1924), the Deutsche Bundesbank is very inflation-averse. Therefore, it quickly adopted a contraction monetary policy, the Bundesbank raised the interest rate on Treasury bond repurchase agreements to 9.7% to curb inflation (Derosa, 2008). The impact of Germany on the rest of Europe was obvious. In the early 90s, most European states like British and Italy, their economic performance have been sluggish and the unemployment rate is rising. They need expansionary monetary policy to introduce low interest rate to reduce the cost of borrowing, reduce corporations' borrowing cost, increase investment, expand employment, increase production, stimulate consumption, and stimulate the economy. In isolation, the UK would have resorted to expansionary monetary policy to get out of slump but this idea was hindered by the exchange rate system and interest parity conditions. UK had to raise interest rate as well.

Overall, in the early 90s, the economy of German suffers from high inflation rate after the reunification; however, states like UK and Italy were suffered from recession. Therefore, states like UK should apply expansionary policy but they have to follow Germany step to apply contraction monetary policy as well.

3.3. The Causes—Speculators Attack vs. United Kingdom

There was conflict for the UK of staying in the ERS and the development of own economics. Some speculators realized that the UK will not stay in the system for long. Therefore, they started to attack the Pound. Speculators borrow Pound and then purchase Mark. This lead to the devaluation of Pound, capital fight happened. In order to stabilize the system, UK use foreign reserve to sell Mark and buy Pound. Finally, UK government's action appeared to be a failure. UK withdrew from the Exchange Rate Mechanism and let the Pound to float freely. The Pound depreciates by 10% against the Mark after this action (China Urban-Rural Financial News, 2006). Speculators use Mark to repurchase Pound by the price lower than borrow cost and then repay the money they borrowed before.

3.4. The Unification of Germany—Impact on United Kingdom

In this research paper, it will mainly focus on UK during the ERM crisis.

According to **Figure 2**, ssuppose that E zero was the current exchange rate. R equals to R*. But, high interest rate in German made Mark appreciated and resulted in people's expectations on the devaluation of Pound. Therefore, the curve in the upper panel will shift upward as expected exchange rate rise to E one. But, in order to maintain the Exchange Rate System, the Bank of England took three actions.

First of all, UK government negotiate with Germany and want Germany government to reduce their interest rate. Again, because of the nightmare Germany had on the high inflation rate, Germany government refuse to do so by three times. Secondly, in order to make Pound more attractive, UK raised the interest twice to 10% and 15% respectively, but this doesn't work well (China Urban-Rural Financial News, 2006). Finally, the Bank of England use international reserve to sell Mark and buy Pound. By doing so, money supply in UK decrease and no change in aggregated demand. Therefore, money market equilibrium changed from point one to point two and exchange rate market equilibrium changed from point 1' to point 2'. Market expectations prove to be self-fulfilling. People anticipated the devaluation of Pound as they believe the UK government wouldn't stay for long, so they sell Pound and buy Mark. Capital fight came into place and the crisis took place.

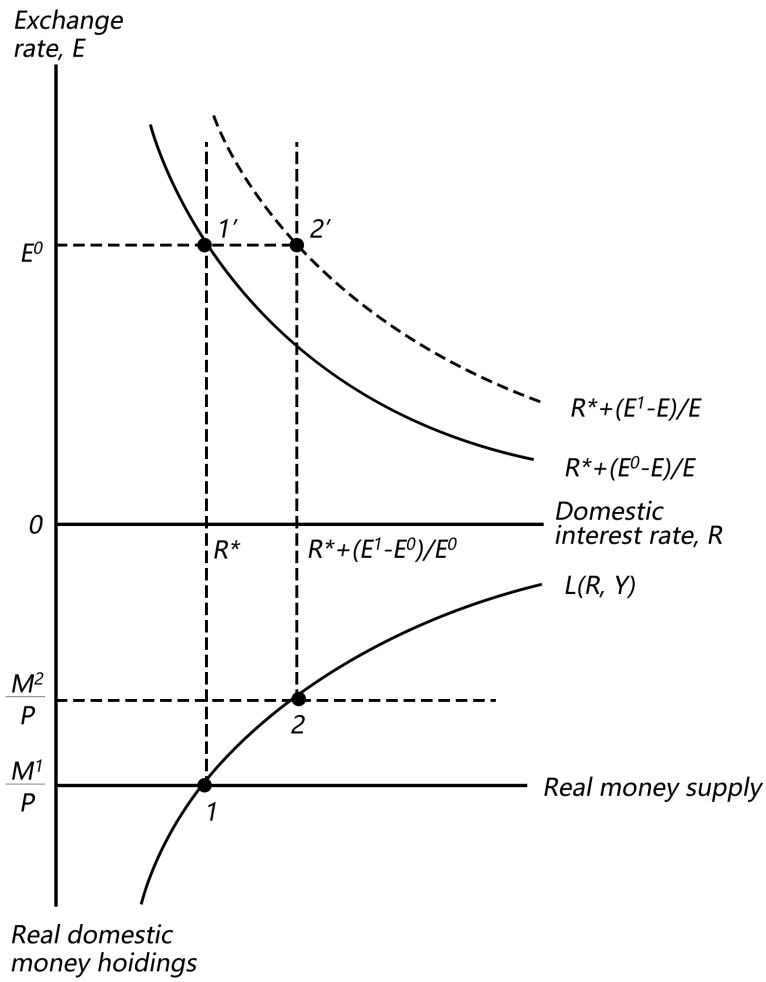

Figure 2. High interest rate in German made Mark appreciated and resulted in people's expectations on devaluation of Pound.

Black Wednesday was the extremely significant event happened to the UK. In 2005, documents released under the Freedom of Information Act indicated that the actual cost may have been slightly less, £3.3 billion. Black Wednesday occurred in the UK on 16th. September 1992 and the UK government had to give up the exchange rate mechanism because of the inability to keep the pound above the lower limit required by the system. After the UK withdraw from the ERM and begin to let it currency to free float, the pound depreciated by 10% against the Mark (China Urban-Rural Financial News, 2006).

4. Consequences

The Exchange Rate Mechanism Crisis of 1992-1993 had many consequences, and I will list a few of the main ones.

4.1. Direct Consequences

First of all, UK, Italy and Spain withdrew from ERM. Secondly, the remaining states in the ERM, were following a weaker scheme, almost free floating could be observed: the ERM bands around the central exchange were widened up to 15 percent in either direction (Derosa, 2008).

Also, the belief, popular throughout the 1980s, that the exchange rate is an effective nominal anchor and countries can import credibility for their disinflation strategies by pegging their currencies to a price-stabilizing center country, was suffered from widespread skepticism.

4.2. Creation of the Maastricht Treaty, European Union and Euro

Three main events happened after the crisis. First of all, signing of the Maastricht Treaty. Secondly, the formation of European Union. Last but not least, the creation of euro.

The Maastricht Treaty, or formally, the Treaty on European Union or TEU, created three pillars structure of the European Union: Community integration method, intergovernmental cooperation method and Intergovernmental cooperation method. It also helps the creation of single currency in Europe, euro.

The Treaty of Maastricht aims to establish the European Monetary Union, EMU, and enforce a number of economic convergence criteria. These criteria were about the inflation rate, public finances, interest rates and exchange rate stability. Besides, there was also a criteria focus on member states' currency stability. Member states must have been a member of the ERM for at least two consecutive years without having devalued its currency during this period.

The euro was created because a single currency offers many advantages and benefits as can be supported by the ERM crisis. Single currency could eliminate the fluctuation risk and exchange rate risk; it could also mean the strengthened cooperation among member states for a stable currency and economy. But the loss of the right of autonomy should also be considered. The European Monetary System was not appropriate for the member states, especially after German reunification situation.

Nowadays, the euro becomes to the second largest reserve currency as well as the second most traded currency in the world after the US dollars.

5. Lessons from Exchange Rate Mechanism Crisis

First of all, the spill-over effect should be considered when applying the monetary policy. ERM crisis shows the fact that because of the spillover effect, one state's economic policy will also have influence on other states' economic performance. Therefore, member states may take integrated and cooperated policy in order to seek development together.

Secondly, government intervention might be a failure. "Black Wednesday" is a classic example of failed government policy, the UK government has no choice but to withdraw the system and let exchange rate to float freely.

Thirdly, speculators will normally choose to attack the market when there's a rising domestic-foreign interest differentials, which reflects the rising expectations of depreciation.

Fourthly, the same economic fundamental, but with different expectations, it can be good equilibrium, it can be bad equilibrium. In ERM crisis case, investors start to questioning the ability for government to maintain the exchange rate arrangement, then they would like to take out the money out of the UK economy. Everyone starts to doing that which induce the capital flight, the government has to use foreign reserve to defend.

Fifth, in economic fundamentals, there is a "zone of vulnerability". In a country, the zone of vulnerability may depend on its economic development or the cyclical state of the economy. From ERM crisis, the zone of vulnerability is depended on the cyclical state of the economy. The tight monetary policies UK and Italy used to defend their currency are politically more costly as they were experiencing recession.

Sixth, there are two approaches to get rid of balance of payment crisis. One is adopting floating exchange rate and another one is giving up the national currency. The creation of the Euro shows the idea of giving up national currency. No national currency, there's no balance of payment crisis. But this might result in the situation that balance of payment crisis is replaced by the sovereign debt crisis. Again, the zone of vulnerability matters. In order to avoid the financial crisis, it is important for government to save the economy from the zone of vulnerability by giving out the good signal to the global capital market.

Finally, the crisis is self-fulfilling expectations. Not because the bad economic fundamental but simply because of enough investors start to questioning the government' ability to maintain the commitment of fixed exchange rate. Therefore, some triggers can change investors' expectations and triggers can be random. In theories, triggers can be anything, as long as the majority of the investors change their expectations, crisis can happen.

6. Conclusion

This paper first describes the operating mechanism of the European monetary system and explains the causes of the crisis which includes the opposite monetary policies adopted by The United States and Germany, the reunification of Germany and speculators' attacks. At the same time, this paper also lists some major events after the crisis, which includes the signing of the Maastricht Treaty, and the establishment of the European Union and Euro. Last but not least, the final part of the paper summarizes the experience learn from this crisis, which includes the spillover effect that should be considered while applying macroeconomic policy, the key role that expectations play in the money market, government intervention that might be a failure, two approaches to get rid of balance of payment crisis, the existence of "zone of vulnerability" in economic fundamentals, and finally, speculators will normally choose to attack the market when there's a rising domestic-foreign interest differentials, which reflects the rising expectations of depreciation.

In summary, the research significance of this paper is paramount in its profound analysis of the European monetary crisis and the invaluable lessons derived from it. This analysis not only sheds light on the intricate causes and far-reaching consequences of such a crisis, but also offers crucial insights to policymakers on how to avert similar situations in the future. By gaining a deeper understanding of the crisis's genesis and implications, policymakers are better equipped to formulate preventative measures and devise effective strategies to address any potential economic challenges that may arise.

Conflicts of Interest

The author declares no conflicts of interest regarding the publication of this paper.

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