
Black Wednesday - the controversy continues

We present a two part special feature on Black Wednesday. In the first part, Norman Lamont (now Lord Lamont), the chancellor of the exchequer at the time of the crisis, replies to the article by Stephen Frowen in the last issue of the journal. The second part features an analysis by John Chown of the contrasting accounts of Black Wednesday contained in the autobiographies of John Major, the ex-prime minister, and Norman Lamont.

There was a time when I held academics in awe. But when academics descend to what Keynes called “discovering what average opinion believes average opinion to be”, they seem little different from journalists.

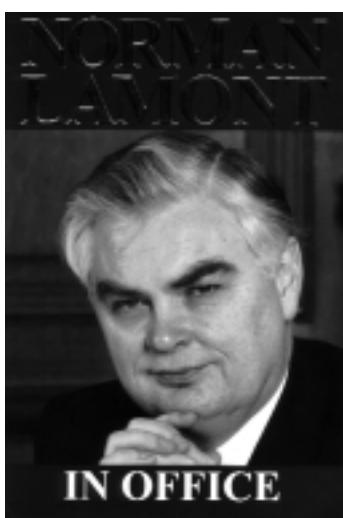
Central Banking has asked me to reply to Stephen Frowen’s article “The UK and the ERM - unjustified British critique of the Bundesbank”. Frankly I am not sure that his article merits a reply and I am a little surprised that *Central Banking* printed it.

Professor Frowen spends considerable time pointing out some elementary facts about the Bundesbank he thinks are unknown to the wider world. He points out that the Bundesbank is independent and therefore argues that in 1992 it was a mistake to attempt to influence the Bundesbank to reduce German interest rates.

Strange as it may seem news that the Bundesbank was independent had reached me. Were Frowen more familiar with the statutes of the Bundesbank he would know that exchange rate policy was a matter for the Government, and in 1992 when the ERM was being hardened to become the euro, exchange rate policy and interest rate policy were two sides of the same coin. One could not change interest rates without affecting exchange rate policy. The interest rate policy of the Bundesbank was threatening to undermine the exchange rate regime, the preservation of which was one of the central political objectives of Chancellor Kohl’s government.

Frowen takes exception to my observation in my book that “the Bundesbank is a strangely parochial institution. Its federal constitution makes it in a literal sense, provincial, and it has often proved indifferent to the international consequences of its action”. What I wonder does he make of the comment of Jean-Claude Trichet, governor of the Banque de France, who said, “It is absurd for the Bundesbank’s stance to be fixed by the representatives of the German Laender, who only care about local preoccupations and do not take account of the greater interests of Europe...”

Frowen’s working methods are curious. He makes some selective quotations from my book (“In Office”) with precise page references, and then counterbalances these with various assertions whose source remains anonymous. He made no attempt to talk to me but many of his sources are clear to me. I would not be a little shocked if Frowen has been getting an EU grant for Europropaganda.



Norman Lamont in office

Frowen is a little naive and his views of Bundesbank independence are somewhat facile. It was Horst Koehler, state secretary at the ministry of finance, who on February 1 1993 in an interview in *Der Spiegel* said that the exchange rate mechanism made it impossible for Germany to ignore the situation in other countries in making economic policy and that the Bundesbank could not escape this reality. He went on to make a plea for lower interest rates from the Bundesbank and gave a clear warning that Bundesbank independence was neither absolute nor irrevocable. He observed that the mandate of the Bundesbank “does not contain the obligation that stability he achieved through a deep depression”. If a German minister felt that the Bundesbank should take into account the wider interests of Europe, it is hardly surprising that other European finance ministers, including myself, held this view.

The anxieties I expressed at the Ecofin meeting in September 1992 were shared by Spain, Ireland, Portugal, Italy and France. Indeed French ministers, several times, openly criticised Bundesbank policy. On June 24 1993 Edmond Alphandery said that German interest rates had an importance going far beyond Germany’s borders. He went on to say that there were millions of unemployed in France and the hope of reducing unemployment depended on cuts in the German interest rates. It is difficult to see why Frowen finds it surprising that I also held that view.

But I never went as far as Jacques Delors, the president of the commission, who was more colourful. On Thursday July 29 1993, referring to the Bundesbank, he asked, “Why have they declared war on us?”!!

Repeating the old canard

Stephen Frowen refers to numerous “facts” which are alleged to be incorrect in both my book and John Major’s. He says he will deal with “two” in my book, but in fact he refers only to one which turns out to be his version of a conversation between John Major and the prime minister of Italy, Giuliano Amato, on September 13 1992. Frowen was not present at No. 10 so I do not know how he can claim his version to be correct. I was not present either but I did read the official note and I have spoken several times to John Major. As he has confirmed Amato did not press him for a wider realignment during that telephone call.

Clumsy and unprofessional

Frowen repeats the old canard that I failed to observe the conventions of chairmanship during the Bath meeting on Saturday September 5 1992. As chairman it would have been a dereliction of my duty if I had not put forward the views that other countries like Italy, France and Ireland had asked me to express on their behalf. It was indeed a difficult meeting, but the degree of acrimony was overstated in the press.

Frowen attempts to defend Dr. Schlesinger's comments in the Handelsblatt article in which he suggested an alteration in ERM parities beyond the Italian lira would be a good thing. Frowen claims that Handelsblatt misreported Dr. Schlesinger. I am quite prepared to believe that. But it is hardly a reason for the governor of a central bank to refuse to correct them. I was informed that the quotations in Handelsblatt came from what the Germans called an "unauthorised version of the interview". Dr. Schlesinger refused to issue an immediate denial but said he would issue an appropriate statement the next day. He behaved in a clumsy, unprofessional way. Whatever his private opinions he should have kept them to himself. After his remarks it was inevitable that there would be immense pressure on sterling the next day, as indeed there was.

The straw that broke the camel's back

Dr. Schlesinger's words were not the fundamental problem and I have never suggested they were. But it is undeniable that they were the straw that broke the camel's back. We were very near to getting through the crisis. It was only three days away from the French referendum and if we had survived until Sunday, the crisis would have been over.

The fundamental problem in 1992 was the conflicting needs of the German and UK economies. Germany needed high interest rates to restrain inflation and Britain low ones to end recession, as did other European countries. The ERM was thus subject to huge strains. The experience of 1992 is a powerful argument against the single currency, which, unlike the ERM, is not irreversible.

But is Britain only a region?

Frowen says in the modern world there is "no room" for "nationalistic thinking". "Regional monetary authorities are forced to cooperate closely." Of course, but is Britain only a "region"? Are we not entitled to have a British policy for British needs? Frowen apparently thinks not.

His arguments remind me of the howls when I stated, in October 1992, that from now on British policy would be in the interests of Britain. It was said it was impossible for

Britain to have interest rates lower than those of continental Europe. This was complete nonsense. We cut British interest rates sharply below those of Germany and the British economy recovered. Continental Europe remained in recession and was joined there by Germany.

***Large parts of my book
have not been read***

Frowen writes, "Why Lamont believes that a broader realignment would not have worked under any circumstances is difficult to understand." There are apparently large parts of my book that Frowen has not read. Of course, my opinions may be wrong, but there is no mystery about them and they are clearly set out, at length.

There are two aspects to the argument:

1. Was such the option of a wider alignment available? The answer is no. The French in the person of M. Beregevoy ruled it out at an early stage for the obvious reason that it would have wrecked their referendum on Maastricht.
2. Would a wider realignment have worked? Our problem was not an exchange rate problem but an interest rate one. The recession was largely domestic. What Britain needed was lower interest rates.

***Disaster if interest rates
had to go up***

Surely even Frowen can see that you cannot get lower interest rates in a fixed exchange rate system by devaluing. In 1992 and 1993 the peseta, the punt and the escudo remained within the ERM after they had devalued. In all three countries interest rates had to be raised for a considerable length of time. It would have been a disaster if British interest rates had had to go up after September 1992.

Even in Italy, which both devalued and left the ERM, interest rates had to be raised. The Italian experience illustrates precisely Frowen's naivety. The Italians devalued the first time. They were then forced to do so a second time and then to leave the ERM. So much for his assertion "the markets would have quickly settled down."!

Not serious journalism

After these implausible arguments, Frowen suggests that I deliberately sabotaged British policy because of "my (sic) secret desire to take Britain out of the ERM." This observation is on the same level as his other apparently serious suggestion that I should have thanked the Bundesbank for forcing Britain out of the ERM, again because of my dislike of the

ERM. His comments are more suited to The Sun newspaper than to a serious journal.

Strong eurosceptism

Frowen portrays me as inherently hostile to Germany. I am quite sure my friend Theo Waigel or the German ambassador would readily confirm that is not so, and that despite my strong eurosceptism, I have never hidden my admiration for modern Germany. Whatever policy disagreements there were in 1992, they were not personal and were no different in degree from the disagreements between the French and German governments at the same time.

Note from Professor Stephen Frowen:

Norman Lamont's reply to my article "Unjustified British Critique of the Bundesbank" (Volume X, No. 3) could not be more polemical. It reflects the aggressiveness of his time in office, of which there is also ample evidence in his autobiography. I do not intend to step down to the tone and level of his argument. Instead, I prefer to provide an objective answer to his criticism, pointing out where he is going wrong again, in a forthcoming issue of Central Banking.

What really happened on September 16 1992?

***By John Chown,
John Chown & Co.***

These are two interesting long autobiographies by two respected and able former ministers, but I have been specifically asked to comment on their different accounts of how we left the ERM. John Major had been responsible for British entry in 1990, the final outcome of a long political battle which he describes in detail. When he became prime minister, Norman Lamont who succeeded him as chancellor accepted what "was not my preferred policy but I had no reason to think it would become unworkable" (page 208).

The seeds of ERM's partial demise had in fact been sown in July of that year when the German politicians botched the terms at which the currencies of East and West Germany had a "politically driven and unrealistic rate" (Major page 159)¹. My then colleague, Ian Marsh, and I had been analysing the implications of various scenarios but the ultimate decision to unite the currencies at par was totally outside the range of possibilities we considered. It was then clear to us (and I would guess to most other monetary economists) that either Germany would have a serious problem with inflation and risked the DM falling out of bed or (as indeed happened) the Bundesbank would regain the initiative, rescue the situation

1. For further information, see Hans Tietmeyer "Recollections of the German treaty negotiations of 1990" and Nobert Klotten "German Unification: A Personal View" in S.F. Frowen and R.Pringle (eds), *Inside the Bundesbank* pp. 68-109 and 110-119.