Leaving the ERM, 1992
Transcript

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Leaving the European Monetary System in 1992

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Today's lecture is about Europe. It is about Britain's departure from the European Exchange Rate Mechanism, the ERM, less than two years after joining it, on September 16th 1992, a day that came rapidly to be known as Black Wednesday, though Euro-sceptics called it White Wednesday since they regarded it as a day of liberation rather than one of failure. But whether you regard departure from the ERM as a failure or liberation, you cannot, I think, deny its major significance in the European debate, and in particular, it legitimised Euroscepticism in the Conservative Party and delegitimised the pro-Europeans, to the extent that it became difficult for a pro-European Conservative to secure the leadership of the Party or even nomination for a winnable constituency. The leading pro-Europeans in the Conservative Party are now confined to the older generation, people like Kenneth Clarke and Michael Heseltine. It is difficult to think of any younger successors of that stature.

Our departure from the ERM was a further episode in the long and difficult saga of Britain's relations with Europe, a saga which is coming to its climax, if a saga can climax, in the forthcoming Referendum, and it does show the capacity the European issue has of dividing parties and destroying Prime Ministers. Europe, of course, excites very strong passions, but I will regard this lecture as successful if you in the audience cannot tell from it which way I am going to vote in the Referendum.

The Exchange Rate Mechanism was intended by its designers as a step towards European monetary union. Now, monetary union was not mentioned as an aim in the Treaty of Rome signed in 1957, which provided for the founding of the European Communities, as the European Union used to be called, but it was agreed by the original six founding members, which of course excluded Britain, at a summit meeting of heads of government at The Hague in 1969, four years before we joined, because the six founding members said exchange rate stability was necessary for the common price system of the Common Agricultural Policy, to encourage trade between member states, and above all, to give Europe more weight in a world economy dominated by the volatile American dollar. The Prime Minister of Luxembourg was commissioned to produce a report on the subject, and he proposed that monetary union should be achieved by 1980. This was agreed by the six at a summit in Paris in 1972, and endorsed by Edward Heath's pro-European Conservative Government, and a precursor to the ERM was set up, called the snake, by which members agreed to peg their currencies to each other, but the snake soon ran into trouble because of the instability of the dollar during the final stages of the Vietnam War and then the problems caused by the huge rise in oil prices which followed the Yom Kippur War in the Middle East in 1973, and the snake was abandoned in 1979. Now, we joined the snake in 1972, but remained in it for just eight weeks, before speculative pressures against the currency forced exit, and in the process, we lost $2.5 billion of foreign exchange reserves in six days, a precursor perhaps of what was to happen with the ERM, and upon leaving the snake, we reverted to a floating currency.

Still, this does show how false it is, I think, to say that people were misled at the time of the 1975 Referendum, to the effect that the European Communities were nothing more than a free-trade area. The idea of monetary union was clearly on the table well before the Referendum. Now, admittedly, at the time of that Referendum, monetary union seemed no longer on the immediate agenda and it was not mentioned in the Government's pamphlet recommending a "yes" vote, but nevertheless, it should have been clear that most of the member states had aims which went well beyond those of a free-trade area.

The idea of monetary union was soon to be resurrected, and in 1979, the ERM was introduced. The main influences behind that were Roy Jenkins, who became President of the European Commission when he left the British Cabinet in 1976, and the French President, Giscard d'Estaing, and Helmut Schmidt, the German Chancellor. Like the snake, the ERM involved the pegging of currencies to a central European exchange rate.

The ERM was established in the final days of James Callaghan's Labour Government, and Callaghan decided not to participate. For this, ironically, he was roundly condemned by Margaret Thatcher, as leader of the opposition. She said, "This is a sad day for Europe." "Labour," she said was, "content to have Britain openly classified among the poorest and least influential members of the European Communities." The Conservative Election Manifesto of 1979 made positive noises about the ERM, saying "We support the objectives of the new system, which is bringing currency stability in Europe" and the Conservatives at that time were more pro-European than Labour, but they made no attempt, nevertheless, to join the ERM after they won the Election of 1979.

But the ERM had a particularly powerful supporter in the new Thatcher Government, and that was Sir Geoffrey Howe, the Chancellor of the Exchequer, and later Foreign Secretary, who was a committed European, and he was strongly in favour of Britain joining. He believed in a united Europe and did not want to rule out a British commitment to monetary union and a common currency, that is the Euro.

Howe was to be joined in the mid-1980s in his support for the ERM by his successor as Chancellor, Nigel Lawson. Lawson was less of a committed European than Howe, and indeed is now to be found in the Brexit camp, and some of you may have read a very trenchant letter in the Times that he wrote today criticising the

Treasury's projections of the future for Britain if we left the European Union. Now, at that time, Nigel Lawson was in favour of Britain remaining in the European Union, but he was not in favour of monetary union or a common currency. He favoured British membership of the ERM for slightly different reasons from Geoffrey Howe. He saw it as an end in itself and as a means to conquer inflation. Lawson distinguished carefully between monetary union, on the one hand, with a common currency, and the ERM, which was an agreement between independent and sovereign states and, in his view, did not cede control of the economy to a European Central Bank, which of course the common currency does.

Lawson wanted to control inflation, and when the Conservatives came to power in 1979, they had believed that inflation could be controlled by controlling the money supply, but it gradually became unclear precisely what definition of money was to be used in the control of inflation and unclear how precisely it could be controlled. Monetarism gradually broke down as the supply of credit in the economy became more and more diverse with deregulation and the ending of exchange controls, and it proved impossible to control all the organisations which were pursuing credit. All this fuelled an exuberant consumer boom, which Lawson failed to control, and perhaps a "get rich quick" mentality, which also Lawson failed to control. With no controls on credit, it became impossible, effectively, to control the money supply, and I think there was a basic conflict between monetarism and the idea of the free-market which the Conservatives supported. In 1985, in his annual Mansion House speech, Lawson formally abandoned monetarism. He said there was no monetary aggregate with a clear and predictable causal connection with inflation. How then was Britain to control inflation? Lawson said by joining the ERM, and that would tie the weak British Pound to the strong German Deutsche Mark, the dominant currency in the ERM, and so provide a framework for financial discipline. British anti-inflation policy would, as it were, gain in credibility from its link with the Bundesbank, and the easy option of depreciation of the currency would be made more difficult since realignment, while allowed, was difficult to achieve because it required agreement of all the members in the ERM. So, it was hoped this would put employers and employees under pressure to restrain costs and improve efficiency, whereas, under a floating currency, so Lawson argued, industrial inefficiencies or excessive wage demands could always be met by a downward floating Pound. So, Lawson's argument was not that he favoured European Union, but as an anti-inflationary weapon, he wanted to join the ERM.

So, by the mid-1980s, the two most powerful figures in the Government, after the Prime Minister, Nigel Lawson and Sir Geoffrey Howe, both favoured ERM membership. So did much of the City and the business community, and much of the quality press. There was a consensus growing that this was the right thing to do, but, sadly, this consensus no longer included the Prime Minister, Margaret Thatcher, who, after a period in which she had at first seemed to be in sympathy with the ERM, and then at least open to persuasion, came out strongly against it. Now, her motives were mixed, I think. There was partly a political motive, if you like, of low-level politics. She said the British economy would be at the mercy of speculators and what would happen if, during a pre-Election period, it appeared that Labour was challenging for power? Then, she said, speculators would sell Sterling, and to stem the flow, the Conservatives would have to raise interest rates to provide an incentive to hold Sterling, but that could generate an impression of poor economic management, swing the economy into a recession, and, ironically, make it more likely that Labour would be returned. So, that was a political objective, but there were much deeper economic objections in Margaret Thatcher's mind. In her view, the ERM was an attempt to control the market and so went against economic rationality, and this was especially so as it attempted to yoke two very different economies together, the British and the German, and what was right for the one might not be right for the other, and given Germany's powerful economic position, the danger was that British economic policy might be determined not by what was in Britain's interests, by what was in Germany's interests or by an economic standard that Britain could not match. One of Margaret Thatcher's favourite aphorisms was that if you try to buck the market, the market will buck you. Then she said that to tie British monetary policy to that of the Bundesbank was a form of defeatism, a confession that Britain lacked the ability to control inflation by herself, by her abilities.

Nigel Lawson took a different view, and he was to argue in his resignation speech in 1989 that the exchange rate was not itself an aspect of market freedom or market economics but part of the financial discipline needed to suppress inflation. So, here, you have a clear and fundamental difference between the Prime Minister and her Chancellor.

In November 1985, there was a meeting of Ministers outside the Cabinet to discuss the issue. Margaret Thatcher found herself almost isolated. All but one Minister, John Biffen, a junior Minister at the time, thought Britain should join the ERM. Even Norman Tebbit, later a keen Eurosceptic, also thought then that Britain should join the ERM. Margaret Thatcher responding, according to Nigel Lawson, "If you want to join, you will have to do so without me." Now, Ministers could have brought the matter to the Cabinet, where there might have been a majority against Margaret Thatcher, but they did not do so, no doubt because they did not want to contemplate her resignation, so Margaret Thatcher had her way, and that was a clear example of Prime Ministerial Government. In general, I am rather sceptical of those who say the British Prime Minister has presidential powers or that the powers of the Prime Minister have become more presidential over time, but this was undoubtedly one example of it, and of course, one has to remember Margaret Thatcher had enormous prestige at that time. She had led the Conservatives to two Election victories, the most recent one, in 1983, a landslide, so her position was strong.

Nigel Lawson thought briefly of resigning. He felt either the Prime Minister should take the advice of the Minister responsible for economic policy, that is himself, or, if she had no confidence in him, move or dismiss him, but he decided to stay on. However, relations between him and the Prime Minister never really recovered. Lawson was, and indeed is, an intellectually self-confident man, his critics would say arrogant, and he believed he had won the argument but lost the battle. One consequence of the strained relations between the two was it was difficult, almost impossible, for them to discuss the subject again, but for the moment, the squabble was patched up. The official record of the meeting summed it up in the best Civil Service style. It said: "The policy was to maintain rigidly the line which had been taken so far, that Britain would join when the time was right." Margaret Thatcher was to take refuge in that formula whenever asked, that Britain would join when the time was right, but many in the Cabinet felt that, for her, the time would never be right.

In any case, Nigel Lawson did his best to ignore the Prime Minister and began to follow very much the same kind of policy he would have followed if Britain had in fact joined the ERM. He ensured that the Bank of England, which was not then independent, that the Bank followed a policy of using its reserves to shadow the Deutsche Mark. This was his personal policy and not that of the Government. In her memoirs, Margaret Thatcher asked, quite reasonably perhaps, "How could I possibly trust him again?" Relations between her and Lawson deteriorated further, leading eventually, in 1989, to Lawson's resignation.

But meanwhile, on the Continent, things were moving, much more rapidly than Britain expected, towards monetary union. In 1986, a major and radical amendment to the Treaty of Rome was passed, called the Single European Act, in my view, the most radical of all the amendments to the Treaty of Rome and much more important than the Maastricht Treaty. This was a further stage in European integration, which in effect abolished unanimity for many issues and, in its place, instituted qualified majority voting. Margaret Thatcher supported this very radical degree of integration because she believed, rightly in my view, that the completion of the internal market, that is the removal of non-tariff barriers to trade, would be a particular benefit to Britain and that you could not remove them if every country had a veto on their removal, so Margaret Thatcher supported that. But the other leaders of Europe believed that, if it was to be effective, the internal market required a common currency so as to remove the transaction costs inevitable if each member state retained its own national currency. So, if you were serious about a single internal market, you needed to remove the currency barriers to trade, just as, for example, in the United States, which is a federal state, there is a common currency, Canada, Germany and so on. So, the Europeans believed, unlike Margaret Thatcher, that a single market implied, if it did not require, a single currency, and that meant restrictions on monetary sovereignty. The preamble to the Single European Act therefore committed members of the European Communities to economic and monetary cooperation, and that was though to imply a common currency.

To pursue this, the European Communities agreed to set up a committee, which was composed primarily of Central Bank Governors, but chaired by the activist President of the European Commission, Jacques Delors, who became one of Margaret Thatcher's bêtes noires, to consider the move towards a currency. In 1989, the Delors Committee reported, proposing a timetable for monetary union in three stages, beginning with membership of the ERM, which all of the member states would be required to join, and the final stage would be the common currency. Now, the committee agreed unanimously to this, and the Governor of the Bank of England, Robin Leigh-Pemberton, was, to Margaret Thatcher's fury, one of the signatories of the report, so this was unanimous.

The Delors report had far-reaching implications for the ERM. Before Delors, there had been a number of realignments, or if you like devaluations, within the system, though they had become less and less frequent. But if the ERM was to lead to monetary union, currencies had to be stabilised, so the ERM altered from being a fixed but adjustable system of currencies to a more rigid one, a staging post to full monetary union, and in that staging post, of course realignments would be severely frowned upon. But at the same time, the abolition of capital controls had made it more difficult to maintain currency levels before monetary union was achieved since money could more easily be moved from one country to another, so assisting the speculators.

The Delors report came at a convenient time for the French and German Governments because this was the time of German reunification. The French said they would only support it if they could be assured that Germany was fully integrated into Europe so that German nationalism would not rear its ugly head again, and one precondition of that was monetary union. The Germans were worried about that, they thought it could be inflationary, but they said it is perhaps a price worth paying. However, it was the failure to accommodate the economic impact of German reunification which was effectively to destroy the ERM.

Lawson's position on this was that he remained opposed to monetary union, but nevertheless, he supported membership of the ERM for Britain, for reasons I have already given, and he now added another reason, which you may think is rather curious. He said it would give Britain more influence in Europe and therefore enable her to put a break on the full Delors project of monetary union. Margaret Thatcher was also of course strongly opposed to monetary union, which she said would be "entering a federal Europe through the back-Delors". Lawson hoped that Margaret Thatcher's fervent opposition to monetary union might persuade her to support ERM membership and so detach monetary union from the ERM, but she did not, and when he tried to raise the subject with her, she said, according to Lawson's memoirs: "I do not want you to raise this subject ever again. I must prevail."

Lawson then began to coordinate his activities with Howe, to whom he had previously not been close, and they drew up a joint memorandum for the forthcoming summit at Madrid in June 1989, saying that Britain must play an active part in stage one of monetary union, that is joining the ERM, and then seek to detach it from the further stages leading to the single currency. In June 1989, Howe and Lawson told Margaret Thatcher they would resign if she did not commit to joining the ERM as part of stage one of monetary union and also set a timetable for doing so. Margaret Thatcher, as you can imagine, was furious, but she had no alternative but to concede. At the Madrid summit, she said, "I can reaffirm today the UK's intention to join the ERM," though she still did not give a timetable, a definite timetable. The formula remained the Government would join when the time was right, some people said "when the time was ripe" – it was not clear which.

Nevertheless, Margaret Thatcher had made a commitment of principle from which she could not back down, and she says in her memoirs, "I was of course opposed root and branch to the whole approach of the Delors report, but I was not in a position to prevent some kind of action being taken on it." But, as you can imagine, Margaret Thatcher was not the sort of person who took defeat lying down, and one senior Foreign Office official was heard to warn, before the Madrid summit, that if Howe and Lawson did not take care, "They will both be gone by the end of the year," and that proved not a bad prediction.

One month after the Madrid summit, Howe was demoted from the Foreign Office to become Leader of the House of Commons, with a notional title of Deputy Prime Minister, really a non-position. Then, in October, three months afterwards, Nigel Lawson resigned. His resignation came about in the following way.

Margaret Thatcher had increasingly felt the need for independent advice on economic affairs so that she could hold her own with her economically-literate Chancellor, and she used for this purpose Alan Walters, an Economics Professor who had emigrated to America but who she persuaded, in May 1989, to return as her economic advisor, and it was known that Walters was opposed to British membership of the ERM. Nigel Lawson was taunted in the House of Commons by John Smith, Labour's Shadow Chancellor, who said that Lawson was the nominal Chancellor and that his views were overruled by a mere advisor, and that was difficult for a proud man to bear.

Walters held the view that the ERM was, as he put it, "a half-baked idea, betwixt and between" and that a system of fixed and adjustable exchange rates would always be open to speculative attack, especially after the abolition of exchange controls. He said either you had to have a single European currency, the Euro, or the Pound should float. Similar advice was given by another economist, Brian Griffiths, the head of Margaret Thatcher's Policy Unit. The advice of these two economists was based less perhaps on their attitudes towards Europe than on professional economic knowledge, which Margaret Thatcher respected. Another member of the Policy Unit, David Willetts, later Tory Minister, said this, and this was apparently circulated quite widely around the Treasury at the time. He said: "If God had intended us to join the Exchange Rate Mechanism, we would be as productive and as moderate in our wage demands as the Germans. Will the average home owner happily accept a rise in his mortgage rate once he knows its purpose is to maintain the Pound's value against the German Mark?" A prescient comment…

Now, by a stroke of ill-luck - or it may not have been ill-luck, we do not know – the Financial Times, in October 1989, published an article that Walters had written a year before, in which he wrote the following words: "My advice has always been for Britain to retain its system of flexible exchange rates and stay out. So far, Mrs Thatcher has concurred." That appeared in the Financial Times in October 1989, perhaps as a matter of luck, perhaps planned – we do not know. What we do know is that Lawson was outraged. He told Margaret Thatcher she must sack Walters or he would resign. Margaret Thatcher, understandably perhaps, refused to sack her advisor, and Lawson went, but after that, Walters felt obliged to resign as well, and that was crucial because it eroded Margaret Thatcher's opposition to the ERM. She remained instinctively opposed to it, but no longer had the arguments to counter her senior Ministers or officials in the Treasury or Foreign Office who so strongly favoured entry.

Within three months, Margaret Thatcher had demoted one senior figure in the Government and lost another, both on the European issue – it shows how toxic it has been and for how long. Their replacements were John Major, who went for three months to the Foreign Office and then, after Lawson's resignation, to the Exchequer, and in the Foreign Office, Douglas Hurd. Hurd and Major were obviously in a strong position because Margaret Thatcher could hardly afford to lose two more senior Ministers, and by 1990, she was gravely weakened politically. The Poll Tax was damaging the Conservatives electorally – that was shown in by-election losses, and opinion poll evidence seemed to show that Labour would win the next Election. And, in July 1990, Margaret Thatcher suffered another blow when one of her few remaining supporters in the Cabinet, Nicholas Ridley, was forced to resign after giving an incautious interview to the Spectator, which he thought was off-the-record, in which he called monetary union, and I quote, "a German racket designed to take over Europe" and compared the surrender of sovereignty to Helmut Cole's Germany to a surrender of sovereignty to Adolf Hitler. Some believed that Margaret Thatcher was not wholly in disagreement with that view.

Perhaps Margaret Thatcher hoped that John Major, whom she saw then as very much her protégé, though things were to change, that he would support her on the ERM, but he did not. He came to be a supporter of ERM entry himself, less on European than on practical grounds, that membership would be the best way to control inflation, and he showed his great political abilities by handling Margaret Thatcher rather more tactfully than Howe or Lawson had done, and he and Hurd eventually succeeded in persuading her, no doubt against her instincts, that Britain should join in October 1990.

Britain joined at a rate of 2.95 Deutsche Marks to the Pound, and within the broader 6% range of the ERM, rather than the 2.5% range, to give added flexibility. The decision was supported by the Labour Party, which said it had taken too long to reach; the Liberal Democrats said the same, and the CBI and the TUC. Just 11 Conservative MPs voted against joining. They did not include the prominent later-Eurosceptic Norman Tebbit, who confesses himself at the time, and I quote, “an agnostic about the ERM” but said that “On balance, I believe that, at the moment, our entry is probably more likely to be helpful than unhelpful. A few on the Labour left were also sceptical. An otherwise unknown Labour MP called Ron Leighton said, “It is always dangerous to prophesy, but I guarantee that the policy will fail. It will not be possible to sustain the exchange rate of the Pound at 2.95 to the Deutsche Mark.” It was actually an accurate prophesy.

Entry into the ERM was one of the few occasions when Margaret Thatcher was pushed into making a decision she did not want to make. Some years later, her ally, Nicholas Ridley, said: “When Margaret Thatcher is dead and opened, it will be those three letters, ERM, that will be lying on her heart,” just as it was said about Queen Mary that Calais would lie on her heart. But joining the ERM was one of the last significant decisions made by Margaret Thatcher. Six weeks afterwards, she was forced into resignation, following the resignation from the Government of Geoffrey Howe, again on a European, and in this film of her final speech in the House of Commons as Prime Minister, we can see how she dealt with the issue of monetary union.

[Video plays]

“I am most grateful to the Prime Minister. Will she tell us whether she intends to continue her own personal fight against the single currency and an independent Central Bank when she leaves office?

No, she is going to be the Governor!

[Laughter – House called to order]

MT: What a good idea! I had not thought of it, but if I were, there would be no European Central Bank accountable to no one, least of all to national parliaments, [because a point] of that kind of European Central Bank is no democracy, taking powers away from every single parliament, and being able to have a single currency and a monetary policy and an interest rate, which takes all political power away from us. As my Right Honourable Friend said in his first speech after the proposal of a single currency, a single currency is about the politics of Europe. It is about a federal Europe by the back door. So, I will consider the Honourable Gentleman’s proposal. Now, where were we?! I am enjoying this!

[Laughter – House called to order]

You can wipe the floor with these people!

MT: I was talking about Europe.”

It was on this occasion that the Sun produced its famous headline “Up Yours, Delors!” and called on, and I quote, “patriotic family of readers to tell Delors where to put his single currency”, and they could do this by facing France at midday on Friday 2nd of November 1990 and shouting “Up yours, Delors!” across the Channel. I do not know how many people followed that advice.

Margaret Thatcher’s successor after a leadership contest was John Major, who chose as his new Chancellor Norman Lamont, a Eurosceptic. Had Lamont had a free choice, he probably would not have himself chosen to join the ERM, but as Chancellor, he had no choice to accept the decision had been made and loyally did his best to make it work, but in the end, his best proved not good enough and he became very unpopular, perhaps somewhat unfairly.

When Lamont was appointed Chancellor, his Permanent Secretary had told him, “You do realise you are about to become the most unpopular person in the country?” Lamont wrote in his memoirs, “I think, in my entire time as Chancellor, it was the only forecast which proved to be correct!”

We entered the ERM at a rate of 2.95 Deutsche Marks to the Pound. Some said that we joined at too high a rate and argued for a lower rate, just as they had said when we joined the Gold Standard in 1925. It was said, rather unkindly, of Delors that he did not care what the rate was as long as it was not the one that Britain wanted. But the British Government ignored, I think foolishly, the requirement to consult the German Government and the

Bundesbank about the rate, and this caused problems later on because the Germans felt under no obligation to defend the parity that Margaret Thatcher and John Major had unilaterally chosen.

The Keynesians wanted a lower rate to stimulate recovery, but this had two problems: firstly, would the other member states have allowed Britain to gain a competitive advantage in that way; and secondly, would not devaluation have been inflationary by raising import prices and was not that an odd thing to do when entry to the ERM was intended to impose an anti-inflationary discipline and a rise in import prices could easily stimulate wage claims because of course it would increase the cost of living? Now, that argument about devaluation, in my view, masked a larger problem which was much stressed by supporters of the floating rates: the ERM would work if national currencies were fixed at the rate which reflected the competitive power of the country concerned, but how could politicians divine what that rate actually was and how were adjustments to be made when circumstances changed? Because, even if the rate was right at one particular time, it would not necessarily be right when economic conditions changed, and if that happened, the adjustment would have to be made not by the exchange rate but by the domestic economy, but the adjustments might not suit the domestic economy. For example, you might have to raise interest rates at a time when the domestic economy was in recession, and that would worsen the recession. So the danger would be that, instead of gradual adjustments which you could get with a floating Pound, you would have a huge economic and political upheaval when a country devalued. That, as I said, was Margaret Thatcher's view, that the euro was an attempt to buck the market and the ERM an attempt to buck the market, and if you try to do that, the market will buck you.

We remained in the ERM for just two years, and from the beginning, there were problems, two in particular. The first was German reunification and that was inflationary since wages and social benefits in East Germany had to be raised to the level in the West, and Helmut Cole, the German Chancellor, chose a rate of exchange of 1:1 between the Deutsche Mark and the East German Ostmark, though obviously the Ostmark was worth much less than the Deutsche Mark. Cole chose to finance reunification not by raising taxation but by borrowing, so to deal with inflation, the Bundesbank had to raise interest rates, and that meant that Britain would have to follow. Now, that might have been right for Britain in 1990. By 1992, Britain was in recession and needed to lower interest rates. So the ERM was leading not to a convergence of economies but divergence since the immediate interests of Britain and Germany were quite different, and that is what Alan Walters had predicted, and some might say the same is happening between Germany and Greece with the Euro.

Second, there was a Maastricht Treaty signed in 1991 which extended European integration and made provision for the common currency, from which Britain had an opt-out, and that required ratification by the member states. Now, what might have been a smooth process was derailed when, in June 1992, the Danes unexpectedly rejected Maastricht in a referendum. The French Socialist President Francois Mitterrand then announced that France would have a referendum on the Maastricht Treaty on 20th September. He assumed ratification would be easily achieved and this would strengthen his domestic political position and divide the conservative opposition, but he had underestimated the hostility to Maastricht in France and the polls seemed to show it could be defeated. In the event, it was ratified but by a very narrow majority, but for much of the time, it seemed as if it would be defeated, and therefore, Mitterrand had injected uncertainty into the system and this led to speculation against weak currencies, not only the Pound but the Italian Lira, which was devalued by 7% a week before the French referendum, on 13th September 1990, but devaluation proved insufficient and Italy was forced out of the ERM shortly after Britain.

During the summer of 1992, during this period of uncertainty, the markets were coming to the view that the British Government lacked the resolve to implement the necessary measures of economic and financial discipline needed to sustain the ERM. The Conservatives were unwilling to raise interest rates in line with Germany, understandably, as it was in the middle of a recession, and they did not raise interest rates until it was too late, so market predictions proved self-fulfilling. John Major did his best to hold the line. He told the European Policy Forum, a pro-European think-tank, in July 1992, that the ERM, and I quote, "…is not an optional extra, an add-on to be jettisoned at the first hint of trouble. It is, and will remain, at the very centre of our macroeconomic strategy." He said he would pay any price to keep Britain in the ERM.

On 8th September, just eight days before Black Wednesday, he told the Scottish CBI that a realignment of currencies was, and I quote, "the soft option". It would, he said, be, and I quote, "…the betrayal of our future and of our children's future". Now, of course, no Prime Minister can admit that devaluation or leaving the ERM is a possible option, so it may be that fixed exchange rates force all politicians to be liars, but Major did actually seem to believe what he said. John Maynard Keynes once said the trouble with politicians was that they said the same private as they did in public. Certainly, Major gave hostages to fortune. He told Andrew Neal, the then Editor of the Sunday Times, in August, that his ambition was for the Pound to replace the Deutsche Mark as the strongest currency in Europe. Neal, disbelieving, nevertheless, the headline of the Sunday Times on 2nd August, seven weeks before we left the ERM, was "Major Aims to Make Sterling Best in Europe". This was at a time when there was tremendous speculation against the currency. Now, this was absurd hubris given the speculation because the Pound was a weak currency, not a strong one.

We have seen that, in earlier crises, such as Suez and the IMF Crisis of 1976, Britain sought help from the United States, and was surprised to find that the American Congress was not in fact a charitable institution. Now, it sought help from Germany, and was equally surprised to find that the Bundesbank also was not a charity. Britain wanted help from Germany to resist the speculation. It said either Germany should revalue her currency or she should lower interest rates, and John Major begged Cole to follow one of those policies. The Bundesbank was an independent bank and could not be ordered by the German Government, but the President of the Bundesbank said that Germany would revalue as part of a general realignment. The French refused that policy, in line with Mitterrand's policy of the Franc Fort, the strong Franc, and France was enabled to stay in the ERM, partly because it had better relations with Germany. The Germans refused to lower interest rates until quite late, when there was a token reduction of 0.25%, which was less than Britain needed. They said it wasn't right for their economy to lower interest rates. In addition, to be equally helpful, the day before Black Wednesday, the President of the Bundesbank declared that currencies other than the Italian Lira might also have to be devalued. He did not want the Bundesbank to be tied to a weak Pound and he developed hostility towards Norman Lamont, who had, it appeared, tried to bully him.

Germany was much-criticised by British Ministers, but the German bank had the odd idea that its responsibility was to work for the German national interest and not the British, but it's fair to say Germany had become a hegemon within the system and had responsibilities which went along with that role. The Germans said they favoured European solutions, but by happy coincidence, those European solutions always seemed to be those which suited German national interests. So, there was a conflict between the role of the hegemon and the role of German national interests. The Bundesbank chose the latter. Now, it had, in any case, never been especially sympathetic to the ERM or to monetary union because it believed the danger was it would lose control over inflation and that Germany would be subject to the indiscipline of other European countries. At a conference shortly before Black Wednesday, when Lamont was trying to persuade the Germans to alter their policy, the President of Bundesbank was heard saying to the German Finance Minister: "In 1948, remember, we had nothing, and look at what we have now. We achieved it by pursuing our own line of policy. We must not weaken now." So, Britain did not get much help from Germany.

At the time, the head of John Major's Policy Unit, Sarah Hogg, wanted to get in touch with Major to discuss the German attitude, but she was on a walking tour of Scotland and this was before the days of mobile phones, and she had to find a police phone, with two police constables listening to the conversation, so she had to be careful, and what she said was: "Prime Minister, I don't think we can rely on the Germans." The two police constables standing nearby said, "Dead right!"

However, Major, in his memoirs, said that the Germans knew what was what in world affairs. The Germans, they played a convenient role because, like the Americans at the time of Suez and 1976, the Germans could be convenient scapegoats for misjudgements in British economic policy and the failure to make the British economy more competitive. It always helps if you can blame a foreign country for those things.

The question is whether German aid would in fact have helped or would it not be pouring out its own money to sustain a weak currency which could not be sustained? The Germans believed Britain should adopt German methods of financial discipline if she wanted a strong currency. The Germans said a strong currency would not be the victim of speculation. Now, the Government was not completely free to devalue the Pound since any realignment within the ERM had to be mutually agreed, but in any case, the Government took the view a devaluation would not be helpful because it would require a rise in the rate of interest to keep money into Britain, and what then would become of the argument that inflation could be controlled through linking the Pound to a sound anchor currency such as the Deutsche Mark? In any case, it was by no means obvious that a devalued currency would not also be open to further speculative attack.

Britain had hoped to hold out till after the French referendum on 20th September because then either Maastricht would be rejected, in which case it would be dead, or it would be accepted and the Treaty would go ahead, but either way, uncertainty would end and the hope was speculation against the Pound would end, but the speculation was too great and, on Wednesday 16th, Britain left the ERM and floated the Pound, but not before interest rates had been temporarily raised to 15% and then lowered to 12%. There was a huge loss of reserves and gains for speculators. The Hungarian financier, George Soros, claimed he made a billion Pounds from selling Sterling that he did not own. Release of Treasury papers in 2005 showed a loss of £3.3 billion to the reserves.

In a moment, you will see Norman Lamont announcing suspension, the ending in effect, of Britain's membership of the ERM. His Special Advisor at that time was a young man called David Cameron, though he does not I think appear on the film, but you may speculate how David Cameron's experience of Black Wednesday may have affected his approach to European issues. Let us see this film now…the announcement and the reaction…

[Video plays]

A unique day in London's financial markets ended with the Chancellor announcing that the Pound was being suspended from the ERM and that the second of two dramatic interest rate rises during the day was after all cancelled.

NL: Today has been an extremely difficult and turbulent day. Massive speculative flows continued to disrupt the functioning of the Exchange Rate Mechanism. As Chairman of the Council of European Finance Ministers, I have called a meeting of the Monetary Committee in Brussels urgently tonight to consider how stability can be restored to the foreign exchange markets. In the meantime, the Government has concluded that Britain's best *interests are served by suspending our membership of the Exchange Rate Mechanism. As a result, the second of the two interest rate increases that I sanctioned today will not take place tomorrow, and minimum lending rate will be at 12% until conditions become calmer. I will be reporting to Cabinet, discussing the situation with colleagues tomorrow, and may make further statements then, but until then, I have nothing further to say. Thank you very much.*

The most dramatic U-turn in Government economic strategy for 25 years was forced on the Prime Minister and Chancellor by the overwhelming pressure of billions upon billions of Pounds being sold in the foreign exchange markets. The Pound will now be left to find its own level in the markets, inevitably, below the ERM floor which the Government was pledged to defend.

Well, the Pound is really floating free at the moment and it doesn't look as though it will be re-established at a new parity until the French referendum is out of the way and until the markets have settled down, so basically, the Pound is free to go where it wants to go, and at the moment, that seems downwards.

Only last Thursday, the Prime Minister reaffirmed in Glasgow the Government's absolute rejection of any departure from the two Deutsche Mark 95 parity enshrined in the Pound's membership of the ERM.

All my adult life, I have seen British Governments driven off their virtuous pursuit of low inflation by market problems or political pressures. I was under no illusions when I took Britain into the Exchange Rate Mechanism. I said at the time that membership was no soft option, the soft option, the devaluers' option, the inflationary option – in my judgement, that would be a betrayal of our future at this moment and I tell you categorically that is not the Government's policy.

Earlier, in a day of high drama, as the Governor of the Bank of England, [plied] between Whitehall and the City, the Treasury and the Bank of England fired off one after another of their biggest guns, in a final effort to live up to the Government's pledges to do whatever was necessary to keep the Pound in the ERM. First, the Bank of England and other Central Banks spent several billion Pounds' worth of foreign currencies, buying the Pounds others wanted to sell. Then, the Bank of England raised interest rates 2% to try to persuade speculators to stop selling. When that failed, it raised them another 3%, but still the enemy kept coming. By the end of the day, the Pound had fallen several [finings] below its supposed ERM floor. The Government had to act. Following the Chancellor's statement, the European Community's Monetary Committee meets in Brussels in the next half-hour. The Committee has power to approve currency realignments within the ERM.

The Government now has two deeply unappetising options: it can put its Europe policy first, formalise the devaluation of the Pound at a new rate against the Deutsche Mark and re-enter the ERM, thus putting the Pound back in the possible firing line; or it can decide that today has proved that Mrs Thatcher was right after all, that you can't buck the market, and that the Pound had better float outside the ERM for the time being. That might hasten recovery from recession, but it would also wreck the Government's strategy for zero inflation later this decade. The decision will be fateful."

Well, the Government, in fact, took the second option of floating the Pound. Now, Black Wednesday proved part of a wider crisis for the ERM. Eight other countries floated their currencies before 1993, and in that year, the ERM bands were widened to 15%, the equivalent of floating and in effect the end of the system. So the ERM was discredited as anything other than a staging post on the way to irrevocably fixed exchange rates, that is a single currency, the Euro, and that of course was very different from Nigel Lawson's view of the ERM.

The consequences of departure were, I think, massive and radical. First, the effect on John Major and other Conservatives... They said the rhetoric about international solidarity means little – countries will always put their own interests first and Britain should do the same. So, it legitimised Euroscepticism in the Conservative Party and delegitimised the Europhiles. It made it more difficult for Major to ratify the Maastricht Treaty, which provided for monetary union, including a single currency, and in the end, he could do so only by calling a vote of confidence and threatening a General Election.

The Pound floated and the economy recovered. Eurosceptics said it was because we were now free of constraints of the ERM, but the Europhiles had a good argument: they said that ERM membership, though brief, had given us the discipline which enabled us to conquer inflation – it had brought inflation down, that inflation was 11% when we joined, but 3.5% when we left, and it's remained low ever since, and that's the Europhile argument. The question is: was it the ERM which squeezed inflation out of the system or high interest rates, but then, would we have imposed those high interest rates if we had not been in the ERM? Could we have squeezed inflation out of the system by our own? Could we have done it without joining the ERM? Did we have the discipline to do it? That is a question on which you will have different views, but what is not in doubt is that we recovered from the recession more rapidly than those countries which remained in the ERM, and with inflation squeezed out of the system, new methods of economic management were adopted, primarily inflation-targeting. We had an inflation target of 2.5%. Inflation-targeting was put in place first by New Zealand, and then adopted in Britain by Norman Lamont, perhaps an undervalued Chancellor.

The Conservatives did an outstanding job in improving the economy after 1992, ironically, their period of greatest unpopularity. By the time of the 1997 Election, the budget deficit had been eradicated, inflation was under 3% and growth in GDP was 3%. But of course, the opprobrium which the Conservatives got from this setback of the ERM meant they got no credit for the improvement, and the credit went instead to Tony Blair, Leader of the Labour Party from 1994, and Tony Blair's New Labour ideas. Blair also made the Bank of England independent and gave it responsibility for interest rates, so insulating it against political interference and strengthening the battle against inflation. Bank independence was in fact a logical corollary of inflation-targeting and it was a step that two Conservative Chancellors, Nigel Lawson and Norman Lamont, wanted to take but had not been able to. The economic consequences are arguable and no doubt you will have different views about that, but I think the political consequence is not arguable: it was disastrous for the Conservative Party.

At the time we left the ERM, unemployment was 10%. It had increased by a million since 1990, and by contrast with previous recessions, it was high even in the normally prosperous South of England. During the first nine months of 1992, there were nearly 36,000 bankruptcies and nearly 25,000 company liquidations. Over 68,000 properties were repossessed and 205,000 property owners found themselves in mortgage payment arrears. GDP growth was negative, -2.2% in 1991 and -0.6% in 1992, and this hardship was felt particularly strongly amongst the poor Conservative, or if you like Thatcherite, constituencies – small businesses and the self-employed. Conservative supporters were devastated by the economic collapse. The repossessions and the mortgage arrears seemed to put an end to the Tory dream of a property-owning democracy.

One Conservative backbencher said he'd been told by many of his constituents that departure from the ERM was the biggest humiliation for Britain since Suez.

Major's defence of his policy was feeble. He first said there were fault lines in the ERM, but the obvious response was: why did you not foresee that when you took Britain in? Why did you join, or why at least did you not seek to reform it so as to eliminate the fault lines? His second defence was that the markets were irrational, but the Conservatives were believers in a market economy, and in truth, you may argue the markets were rational, sensing deep-seated weaknesses in the British economy. Speculators do not make a profit by speculating against a strong currency, but a strong currency requires a strong economy, and after 13 years of Conservative Government, the speculators did not think that Britain had a strong economy or a strong currency. Major seriously thought of resigning as Prime Minister since the central pillar of Conservative policy had collapsed. The 1992 Manifesto declared, and I quote: "Membership of the ERM is now central to our counter-inflation strategy." But he did not resign, and he dissuaded his Chancellor, Norman Lamont, from resigning as well. In the event, Lamont was given no more than a nine-month stay of execution – he was sacked nine months later. But, after all, the policy of joining the ERM was primarily John Major's policy, not Lamont's, but Lamont, for the moment, could remain as a lightning conductor, draining away some of the hostility that would otherwise be directed against Major.

In the debate on the departure from the ERM, John Smith, the new Labour Leader, made his first speech in the House of Commons, and he called Major "the devalued Prime Minister of a devalued Government", even though John Smith and Labour Party as a whole had been strong supporters of entry to the ERM.

Conservative support plummeted in opinion polls and was never to recover. It was the longest electoral nightmare for any post-War British Prime Minister and there's an argument for saying the 1997 Election was lost on Black Wednesday.

The pro-Europeans said, for the reason I have given, that inflation was squeezed out of the system, that we were right to enter, and right to leave when we did. The Chief Economic Advisor to the Treasury, Sir Alan Budd, said later it had squeezed inflation out of the system. He said, "We went into the ERM in despair and left in disgrace. Nevertheless, we are still enjoying the benefits of it." Now, that may have been a sound economic judgement, but politically, it was odd to say that a policy which had been right for Britain in August 1992 had suddenly become bad for Britain in September 1992, and that a policy which Major had denounced as a betrayal had suddenly become the remedy. The anti-Europeans said we should never have joined and it's easy to see why the latter argument gained more political credence than Alan Budd's argument. Whoever was right in terms of the economic argument, it is not in doubt the Conservatives had lost their reputation for economic competence, which traditionally had been their strongest claim for support of the voters. It was Labour, under Blair, who became Leader in 1994, Labour gained the reputation of being more economically competent, perhaps unfairly, since Labour was equally committed to the ERM, but of course politics often is unfair. In 2005, in the Election, Blair said: "The Conservatives used to run on the economy; now, they run away from it." It was to take the Conservatives until 2010, 18 years, to recover their reputation for economic competence.

All this began a civil war in the Conservative Party which continues to this day. In the 1992 Conference, held shortly after we left the ERM, about three weeks afterwards - it coincided with the debate on Maastricht – Douglas Hurd, the Foreign Secretary, reminded the Conservatives of the disastrous effects of the splits on the Corn Laws and tariff reform. The first had kept the Tories out of a majority government for 28 years, the second for 17 years. He said, "Let us decide to give that madness a miss," but his plea fell on deaf ears, and Europe was to keep the Conservatives out for 13 years. John Major accepts, in his autobiography, that Black Wednesday was, I quote, "…a political and economic calamity. It unleashed havoc in the Conservative Party and it changed the political landscape of Britain. On that day, a fifth Conservative victory, which always looked unlikely unless the opposition were to self-destruct, became remote if not impossible." It is difficult to improve on that verdict.

The Eurosceptics, as I said earlier, talked not about Black Wednesday but White Wednesday, and the pro-Europeans were correspondingly weakened. Now, you could, as the pro-Europeans did, like Kenneth Clarke and Michael Heseltine, you could produce a perfectly logical argument to say that joining the Euro would eliminate the problems of the ERM because, with a single currency, there would be no exchange rate risk or risk of devaluation, and that also was the view of the French, who, unlike the British, had stayed in the ERM. Their resolve was hardened that monetary policy should be put in European hands, hence French support for the Euro. But it is understandable if that argument did not get very far in the Conservative Party, and the Conservative view of the Euro was perhaps best summarised later by William Hague, when he said it was "like a building on fire with no exit". The pro-Europeans, no doubt, were logically consistent in saying that a single market required restrictions on national sovereignty, perhaps even joining a single currency. The anti-Europeans were equally consistent in saying we prefer to retain national sovereignty, even perhaps at the cost of some economic benefit, and that's part of the argument in the coming Referendum, that what was not possible was a qualified allegiance to the single market and to national sovereignty, as proposed by the ERM, and in a sense, the ERM reflected a British preference for practicality for not pushing principles to their logical conclusion, but perhaps it was an unstable equilibrium.

At the Conservative Conference in 1992, the opposition was led by Norman Tebbit, though he had, as we have seen, favoured entry, but he now called the ERM "the eternal recession mechanism" and he put a number of questions to the delegates. He said: "Do you want to be citizens of the European Union? Do you want to see a single currency? Do you want to let other countries decide Britain's immigration policy?" You won't be surprised that the response from the audience was a loud and overwhelming "No!" after each of these questions, and a standing ovation at the end of his speech. If we look at this film, you can see what happened at the Conference…

[Video plays]

"Barely three weeks after Black Wednesday, John Major faced the Party at the Annual Conference in Brighton. The crisis had dealt a terrible blow to the Conservatives' reputation. Ten months earlier, John Major had been hailed by his Party for his skill in negotiating the Maastricht Treaty on the future of the European Union and getting Britain key opt-outs, but now, many Party activists had had enough of all things European."

"The 1992 Party Conference was unlike any Party Conference I have been to before or since. It was, firstly, within just a few months of winning a General Election, yet, [from] the attitude, we might never have won it. We might even have lost it. There was no post-Election feeling of euphoria [when] everyone had thought we would lose. The issue was Europe, Europe, Europe, Europe…"

"Two days into the Conference, Norman Tebbit, the Thatcher loyalist and former Party Chairman, made a speech from the floor in which he lambasted John Major's European [policy, a] devastating attack."

"And I hope, Prime Minister, that you will stand by your Chancellor. After all, it was not Norman Lamont's decision to enter the ERM."

"I was astonished at Norman's speech. He of all people, as a former Party Chairman, knew exactly what he was doing by making that speech, in that manner, at that time. It was immensely damaging, and he spoke in absolutely demonic mode, and it was a total parody of the policy that he knew we had."

"Do you want to be citizens of a European Union?!"

"No!"

"I sat there and I thought to myself, you were Party Chairman – how would you have reacted if one of your predecessors as Party Chairmen had come to the Party Conference and attacked your policy in this way, in this fashion, knowing as you do that you are misrepresenting it in the way that you were?"

"I cannot say whether anyone else would have [thought that] my speech was demonic. Those who were there at the Party Conference, the Party faithful, clearly felt that it was a speech which was pitched at just the right level. I am sorry I had to do it in the way that I did, but he did not take any notice of me when I did it in private."

"Lady Thatcher, newly a noble, also used the opportunity to unleash a broadside against John Major's European policy. In an article in the European newspaper, written to coincide with her own triumphal entry to the Conference, she accused John Major of damaging Britain's constitutional freedom by signing up to the Maastricht Treaty. It was, in the view of one commentator, "a double-barrelled gunshot blast at an already open wound"."

"This combination of an ex-Prime Minister, Margaret Thatcher, and a former Party Chairman, Norman Tebbit, was of course lethal. It was quite unprecedented in modern-day politics, and it inflamed the debate and it carried it forward and encouraged people to pitch in on either side of the debate. Their subsequent opposition to the Government on European policy was absolutely relentless. It went on and on. It was not just a short-term opposition. It was continuous, right up to the next General Election, and of course, divisions like this in any Party have a very profound effect, and it had a very profound effect on us: we lost, very heavily, the 1997 Election."

The years 1990 to 1992 were the years when we were in the ERM and signed the Maastricht Treaty and which began with the resignation of Margaret Thatcher. These years are the source of the fundamental divisions which remain in the Conservative Party today. But they also affected one leading Labour politician, the new Shadow Chancellor, Gordon Brown. Brown had been a strong supporter of joining the ERM and berated the Government not for having joined but for having been forced out of it. Instead, he said the Government should have taken stronger measures to stay in. His judgement seemed flawed, and that is perhaps one of the reasons he did not succeed John Smith when Smith died in 1994, and perhaps also the reason why he became so hostile to the Euro as Chancellor, when his Prime Minister, Tony Blair, was in favour of joining, and I think Eurosceptics would say that a statue to Gordon Brown should be erected in Parliament Square for keeping us out of the Euro.

But perhaps the most important change was in public opinion. Until 1992, there had been a slow but steady rise in acceptance of British membership of the European Communities. There was what one might call a permissive consensus on Europe. Indeed, in 1990, the occasion, though not perhaps the cause, of Margaret Thatcher's departure had been that she seemed obstructive on Europe, but after departure from the ERM and a crisis over the Maastricht Treaty, that consensus collapsed and support for Europe fell. Many economists, as we have seen, took the view that membership of the ERM had been beneficial, but it is understandable if the popular view was we were forced out of the system and we've been better off since we left. Therefore, many people said Margaret Thatcher was right and the pro-Europeans were wrong, and that, I will leave you to judge.

But what is clear, I think, is the previous crises I have discussed, the 1951 Health Service crisis, Suez, the 1976 IMF crisis, and the Falklands War, they are now perhaps primarily of historical interest, but the ERM crisis clearly has many echoes today, and just how strong these echoes are, we shall discover on 23rd June.