A Complete Disaster or a Relative Success?
Reconsidering Britain's Membership of the ERM, 1990-1992

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Abstract

Britain's membership of the ERM from 1990 to 1992 is almost universally regarded as one of its worst policy disasters of the post-war period. The mistaken overvaluation of sterling and high interest rates compounded the effects of an already severe recession, while the events of Black Wednesday destroyed the governing credibility, and with it the political fortunes, of the Conservative Party. Analyses of this episode to date, however, have interpreted these events in an overly narrow manner, focusing primarily on the economic, as opposed to the political motivations behind ERM membership. Considering these motivations in terms of the 'depoliticisation thesis' enables a different interpretation of events in which ERM membership can be seen as a relative success.

Introduction

Britain's membership of the European Exchange Rate Mechanism (ERM) was one of its most tumultuous experiences of the postwar era. Almost universally, the decision to join the regime is regarded as having been a complete and unmitigated policy disaster. According to received wisdom, sterling entered the system at a mistakenly overvalued exchange rate, compelling the Conservative government to maintain onerously tight credit conditions at a time of steep recession, compounding the severity of the downturn and dealing a fatal blow to the governing credibility of the Conservative party – epitomised in the events of Black Wednesday – from which it has still to fully recover. This conventional narrative, deeply entrenched within the British national psyche, while not without elements of truth, is nevertheless problematic. The principal reason for this is that the motivations behind Britain's participation in the ERM are posed in overly narrow terms. Typically construed as an 'economic' policy to which 'political' considerations were largely adjunctive, it is scarcely surprising that, when assessed against such criteria, Britain's period of ERM membership should be held in such low regard.

One challenge to this conventional view, however, comes from proponents of the 'depoliticisation thesis'. This argues that a key goal of the policy was to insulate state officials from the adverse political consequences of the recession by shifting the responsibility for economic policy-making onto an externally constituted regime. While these alternative accounts are themselves not unproblematic, their focus on the political motivations involved in Britain's membership of the ERM offers the potential for a broader and rather different interpretation of events. Building on this approach, this paper contends that Britain's ERM policy should be seen not as a disaster, but as having been a relative success. Albeit transiently, ERM membership provided the Conservatives with a credible framework for economic management and an effective means of displacing political pressures and responsibilities for economic affairs, enabling them to deal with a range of governing problems with fewer difficulties than would otherwise have been the case.

Anatomy of a disaster?

The ERM was the key component of the European Monetary System, which was established in 1979 as a means of securing monetary stability within the European Community. Joining the mechanism committed participating states to maintain their exchange rates within certain predefined limits, determined by target bandwidths of either two-and-a-half or six percent around a central parity fixed in relation to the ecu (a notional unit composed of weighted amounts of all ERM currencies). Procedures to preclude unilateral devaluations and oblige central bank intervention in defence of exchange rate parities (along with the provision of credits in support of this end) helped to ensure credibility in the system, as did the nominal anchor role played by the German deutsche-mark (DM), which, backed by the long-standing and highly successful anti-inflationary policies of the constitutionally independent Bundesbank, formed the ERM's strongest currency (Gros and Thygesen, 1992; Tsoukalis, 1997).

For the overwhelming majority of commentators, the Conservative government's decision to join the ERM in October 1990 is thought to have been driven by a narrow range of concerns. In the main, entry into the ERM is interpreted as having been an economic policy, designed with the overriding goal of providing a stable macroeconomic platform and for establishing a sound monetary framework for lowering inflation. According to Johnson (1994: 89), for example, the reduction of inflation was, for officials, 'the main priority at the time of entry', while Cobham (1997: 218) contends that 'the authorities regarded ERM membership as conferring benefits in the form of greater exchange rate stability and a contribution to counter-inflationary policy' (for this view also see Barrell *et al*, 1984; Brittan, 1992; Eichengreen, 1996; Smith. 1992; Stephens, 1996). While political factors are generally absent from the analysis, they too, where permitted to intrude, are dealt with in a constrained fashion; typically coalescing around the issue of Britain's wider relationship to Europe, with ERM membership seen as a means of uniting the Conservative party on the question of European integration and of enhancing Britain's influence within the European Community (for the former view see for example Howe, 1994; for the latter see Thompson, 1995, 1996). Assessed against these criteria, then, it is scarcely surprising that the ERM policy should be thought of as a dramatic failure. The conventional view is that Britain joined both at the wrong time, namely on the verge of an impending recession, and at the wrong exchange rate, with the pound, by most estimates, deemed to have been around 10% overvalued. This, so it is argued, required onerously high levels of interest rates in order to keep sterling within its ERM bandwidths, severely exacerbated the effects of the recession, and ultimately undermined the credibility of the government's commitment to the regime, leading to sterling's ejection from it on 'Black Wednesday' in September 1992. In sum, for all its noble aims, membership of the ERM is emblazoned across Britain's twentieth century experience as one of its most inglorious policy episodes. As Budd (2005: 15) explains: ‘The commonly held view is that our membership of the ERM was a disaster and was always doomed to fail'. Or, as Thompson (1995: 248), puts it, joining the ERM 'brought no benefits to the UK at all. The story of policy-making on ERM is thus one of missed opportunities, chronic misperception by British policy-makers and huge welfare losses for the British economy....unequivocally a policy disaster'.

In contrast to this attenuated view of the motivations behind Britain's ERM membership, a small number of less conventional commentaries have sought to explain this as a policy of 'depoliticisation'. This refers to a process in which officials directly relinquish overt control over a particular policy area, typically delegating management and responsibility to a system of rules or an ostensibly non-political institution, with a view to displacing it from the public sphere, or at least of reducing its political salience. This, in Burnham's oft-cited dictum, offers a means of 'placing at one remove the political character of decision-making' (Burnham, 2001: 128). If deployed successfully, such an approach offers distinct advantages for state managers, transforming potentially or actually contentious issues into technical, apolitical matters, and enabling officials to disclaim responsibility for any unpopular consequences that may subsequently arise (also see Hay, 2007).

One problem with this alternative approach, however, is that proponents of the 'depoliticisation thesis' are divided on how successful this policy actually was. According to Buller (2003), governmental hopes that the policy 'would shield the Major leadership from the unpopular consequences of ERM membership did not materialise' (also see Buller and Flinders, 2005), though for Bonefeld and Burnham (1996: 5) the policy is considered to have been a success 'at least initially', since it allowed the government 'to distance itself politically from the consequences of austerity by arguing that its hand was forced by international commitments'. More serious than this lack of agreement, though, is the limited nature of the evidence on offer in support of these claims. Buller and Flinders (2005) offer little empirical material beyond the events of Black Wednesday to substantiate the assertion that depoliticisation failed; while Bonefeld and Burnham (1996), by focusing (paradoxically) on the economic effects of the regime, similarly fail to demonstrate that a displacement of political responsibility onto international commitments actually took place (also see Bonefeld and Burnham, 1998; Bonefeld *et al*, 1995).

With both conventional and alternative conceptions of Britain's ERM membership having failed to fully address the political factors involved, the result, almost two decades after the event, is that key aspects of this policy episode remain unexplored. In what follows, the rest of this paper seeks to address this through an empirical analysis of the politics of ERM membership from the perspective of depoliticisation. This begins, with the background to Britain's entry into the regime.

Out and in

Conservative party statecraft throughout the 1980s was characterised by the search for a stable and credible framework for economic policy-making. Having proclaimed itself to be in favour of joining the ERM ‘when the time was right’, the cornerstone of the Conservatives' initial governing strategy was instead based on the tenets of monetarism. This took the form of a public commitment to contain the growth of the money supply in line with pre-specified targets in order to deal with the legacy of the 'politicised' mode of statecraft that had prevailed throughout the postwar period. In short, monetarism was thought to offer a credible framework for reducing inflation, raising productivity, curtailing wage demands and reducing the direct involvement of the state in economic affairs. The aim, as Nigel Lawson, the Chancellor from 1983 to 1989, explained, was to expose the economy to an anti-inflationary ‘shock-treatment’, to ‘adjust expectations to reality’, and to avoid ‘politicising the wage bargaining process’ (Lawson, 1992: chapters 5-7).

In practice, though, the monetarist turn was far from successful, and by the mid-1980s the idea that economic policy could be managed with narrow reference to monetary variables had been fatally undermined. The introduction of tight economic policies had contributed to the onset of a sharp recession and a huge rise in unemployment, a series of runs on sterling had exerted a destabilising impact on the domestic economy, monetary targets had been persistently overshot, and while inflation had fallen (from a high-point in excess of twenty percent in 1980 to less than five percent by 1983) the money supply, by any measure, had actually increased (Keegan, 1984). Against this backdrop, senior government figures, most notably Lawson and Geoffrey Howe (the Chancellor from 1979 to 1983 and now the Foreign and Commonwealth Secretary), began to highlight the role of the exchange rate as a key determinant of inflation. Maintaining that the fall in the price level had been primarily due to the deflationary effects of a large appreciation of sterling during the early part of the decade, it was argued that fixing the value of the pound within the ERM would offer a firmer and more effective base for economic management (Howe, 1994; Lawson, 1992).

But while such a prospect was welcomed by the majority of the Cabinet, the City, the Confederation of British Industry (CBI), the Trades Union Congress (TUC), the Labour Party, the Bank of England and senior Treasury officials, a major Cabinet discussion on the issue in November 1985 ended with the Prime Minister effectively vetoing the proposal. According to Margaret Thatcher, ERM membership would constitute a damaging admission of failure in the government's own ability to deal with inflation, and, more dangerously, a commitment to defend a fixed value for the pound might require interest rates to be held at a politically unpopular level in the run-up to an election (Thatcher, 1993: 692-700; also see Howe, 1994: 450).

With monetarism in ruins, and with entry into the ERM ruled out, the Conservatives spent the rest of the decade pursuing a mixture of *ad hoc* discretionary mechanisms for economic management. The effects of this, however, were also mixed. From 1986 the deregulation of the financial services sector, coupled with a lowering of interest rates (designed to prevent sterling from breaching an unofficial ceiling of DM3.00 as part of Lawson's ill-fated attempt at shadowing the deutsche-mark), conspired to produce an inflationary, credit-fuelled boom (Smith, 1992). While this played a key role in the

Conservatives' third consecutive general election victory in 1987, a rise in inflation to more than nine-and-a-half percent by 1990 presaged another return to tighter monetary policies, with interest rates rising from ten to fifteen percent over the same period. The latter half of the decade also saw Thatcher coming under increasing pressure (especially from Lawson and Howe) to reverse her stance on Britain’s membership of the ERM. Notwithstanding a shift in the official position to one in which Britain would now join the system when certain conditions were met (namely the completion of the Single European Market, the abolition of EC exchange controls and a reduction in Britain’s inflation rate to the ERM average), in October 1989 the fault-lines running through the senior levels of the government were starkly exposed when Lawson sensationally resigned following the Prime Minister’s refusal to sack her economic adviser, Alan Walters, for his public criticism of the regime (Bonefeld *et al*, 1995).

By the end of the decade the economic boom, and with it the government’s image of economic competency, were starting to crumble. Unit labour costs, wage demands, bankruptcies and unemployment were all rising, profits, output and productivity growth were all in decline, inflation and interest rates were at a five year high and sterling had lost a fifth of its value since spring 1989. Levels of political disquiet were also rising, with the issue of European integration, turmoil over the poll tax and Thatcher’s increasingly autocratic style of leadership proving to be increasingly vexatious, both for the Conservative party as well as the wider electorate. By September 1990 the proportion of the general public considering the state of the economy to be one of the main issues facing the country had increased to twenty-four percent (from eight percent in 1987), while levels of dissatisfaction with the government's economic policy had reached a nadir of minus twenty-one percent (from plus eighteen percent at the height of the Lawson boom). Discontent with the government's handling of the economy had also helped to send the

Prime Minister's satisfaction ratings plummeting to an all-time low of minus forty-three percent (from plus six percent during the latter half of 1987); the popularity of the government as a whole having now collapsed to a record minus fifty percent (figures calculated from MORI Political Monitor, 2009; 2009a; 2009b).

Against this backdrop, and with credible alternatives thin on the ground, ERM membership began to look increasingly attractive. By subordinating core policy decisions to the maintenance of the exchange rate, and by ruling out currency depreciation as a means of accommodating slack economic performance, membership would send a clear signal of intent regarding the government's anti-inflationary credentials and put pressure on producers to improve competitiveness (Howe, 1994; Lawson, 1992). In this, the credibility of the regime would be key. An internal Treasury paper noted that while reducing inflation was 'bound to be costly' in terms of unemployment and lost output, especially given the rigidities of the British labour market, the costs would be reduced if expectations, and hence economic behaviour, could be adjusted to fit the contours of the regime. '[T]he more the authorities could persuade people that they would take tough action if necessary', it explained, 'the less tough the action they would actually have to take' (H.M. Treasury, 1993: 40-1).

The exogenous nature of the ERM, as bound-up with broader European commitments, was considered to be particularly beneficial. As was well-observed in the Treasury, membership would provide officials with 'a credible external discipline', entailing the 'total subordination of economic management to the maintenance of sterling's position within the bands' (H.M. Treasury, 1994: 2; also see 1993: 11). The expectation, too, was that these constraints would be enhanced by the inflationary pressures resulting from German reunification, since interest rates in Germany, and throughout the ERM, would be 'likely to rise substantially' in the near future, a sequence of events that would make it easier for officials to resist any ‘unwelcome pressure’ from domestic producers for cheaper credit. ‘[S]ome rise in German interest rates – which might reduce that pressure', it was thus observed, '– might not be unwelcome to us’ (H.M. Treasury, 1993: 25-8).

Naturally, electoral considerations were also evident. With both the government and the Prime Minister experiencing their highest levels of unpopularity since coming to power, the need for a political as well as an economic revival was becoming ever-more urgent. The key governing dilemma, as outlined by John Major, the Chancellor since Lawson's departure, was to square the circle between the ‘vital’ need to ensure against a fall in the exchange rate in order to ‘maintain the downward pressure on inflation’, while simultaneously cutting interest rates in order to boost the electoral popularity of the government. Since reducing rates outside the ERM would provoke a fall in the pound and a rise in inflationary pressures, the growing consensus within senior government circles was that ERM membership offered the only viable means by which they could be reduced without undermining the Conservatives' anti-inflationary credibility. By September, the view within the Treasury was that 'some interest rate cut would be desirable, if not immediately, at least pretty soon; and that such an interest rate cut would risk an unwelcome fall in sterling unless the UK joined the ERM' (*Ibid*.: 21). This opinion was shared by Major, who noted that 'we could not contemplate an interest rate reduction outside the ERM', and was one which, as the Treasury observed, proved to be 'a powerful argument with the Prime Minister' (*Ibid*.: 22). The expectation, then, was that the ERM would provide a politically and economically advantageous framework, enabling inflation to be reduced while facilitating a virtuous circle of cheaper credit, rising consumer spending and economic growth. As Major put it: ‘we needed to get re-elected, the economy needed tough decisions’, and entry into the ERM offered ‘the only circumstance in which we are likely to achieve both these objectives’ (Major, 2000: 153-60; 661).

Towards the end of the summer, with Thatcher's political authority in decline, and with membership of the ERM continuing to command strong support both inside Westminster and beyond, the Prime Minister finally assented to sterling joining the system within the six percent fluctuation band. With the decision made, attention turned to the rate at which the pound would join the regime. On this, the general view in Bank, Treasury and ministerial circles was that a suitably high parity would be needed in order to buttress the government's anti-inflationary aims. As the Prime Minister and the Chancellor both noted, a depreciated rate of entry carried the danger that lower interest rates would be required in order to prevent sterling from rising through its ERM ceiling; while conversely, the defence of a relatively high exchange rate would require relatively high interest rates and would thus add extra deflationary pressure (Major, 2000: 158-65; Thatcher, 1993: 721-2). As was again noted in the Treasury, 'the key consideration' was 'the desire for a challenging dis-inflationary rate', since joining at a competitive parity 'would make it harder to secure a rapid decline in inflation' (H.M. Treasury, 1993: 29-35; 1994: 3). While an exchange rate of DM2.75 in April was deemed to be 'comfortably above' the level believed to be necessary to 'maintain downward pressure on inflation' (H.M. Treasury, 1993: 32-5), on 5 October the government announced its intention to join the ERM at a central parity of DM2.95.

Early trials

The news of Britain's entry into the ERM was widely welcomed. Despite some concerns about the chosen level of the exchange rate, the City, the Confederation of British Industry (CBI), the Association of British Chambers of Commerce (ABCC), the Trades Union Congress (TUC) and the mainstream press all declared their support for the decision. The move also stole a clear march on the Labour party, which, having long-pressed for Britain to join the ERM, could now do little more than snipe about the timing (See *The Observer*, 7/10/90; *The Guardian*, 6/10/90; *Financial Times*, 6-8/10/90, 15/10/90; *The Times*, 6/10/90). The initial euphoria, however, proved to be short-lived. With the move being accompanied, at Thatcher's behest, by a cut in interest rates from fifteen to fourteen percent – a thinly-veiled attempt to boost Conservative party fortunes in the run-up to its annual conference - question marks were immediately raised about the credibility of the government's anti-inflationary commitment, putting the pound under pressure.

Moving to assuage fears that the government were trying to engineer a mini 'boomlet' as the prelude to a general election, Major emphasised the constraints that the ERM would impose on economic policy decisions. Pointing out that the future level of interest rates would now need to be 'allocated to maintaining the exchange rate', the Chancellor maintained that ERM membership would not only preclude any further relaxation of monetary policy 'until it is prudent to do so', but that it would also rule out 'a more active fiscal policy' and thus 'impose an extra discipline on the Government's conduct'. Also rejecting criticism of the rate of entry, claiming that this merely reflected the 'average inflation-adjusted real rate of the past decade', Major set out a grim warning to producers about the need to adjust to the pressures of the new regime. Since 'joining the ERM means that devaluing our currency to bail out uncompetitive firms is no longer an option', he stated, the consequences of high pay rises would 'lead to only one result: lost markets, redundancies, plant closures and ultimately company failures'. Wage levels, therefore, would have to fall to 'realistic and justifiable' levels, and tight monetary conditions would 'have to be sustained to put continued downward pressure on inflation'. In sum, the message was unmissible: 'The government cannot keep companies competitive – they can only warn them of the dangers they face. Their fate is in their hands' (House of Commons debates, 23/10/90, Cls.198-202; *The Guardian,* 8 & 12/10/90; *Financial Times, 19 &*

23/10/90; *The Times* 16 & 19/10/90). The Governor of the Bank of England, Robin Leigh-Pemberton, also entered the fray in support of the government. Denying that the cut in interest rates represented ‘any significant easing of our policy stance’, the Governor warned that businesses would ‘now have no excuse for expecting a lower exchange rate to validate any failure to control costs’ (*Financial Times,* 6-7/10/90). In an even blunter fashion, the line from the Treasury was that an economic slowdown was now ‘a necessary prelude to the reduction in inflation’ (*The Times*, 31/10/90).

Yet even with a cut in interest rates the political popularity of the government failed to improve. With the Labour party enjoying a strong sixteen point lead in the polls, and with the Conservatives suffering a series of by-election defeats, towards the end of the month the build-up of internal party tensions finally erupted with the resignation of Geoffrey Howe over the government's less-than-enthusiastic approach towards Europe. This set in motion a series of events which led to the demise of Thatcher, on whom the Cabinet now rounded, and to the surprise ascension of John Major to the Premiership. The new leader's opening gambit as P.M., however, reflected his closing assertions as Chancellor. Again emphasising the constraints of the ERM, Major warned that high rates would need to continue ‘until it is clear to the markets that we are determined to succeed and that rates can be safely lowered’. Norman Lamont, the new Chancellor, offered a similar assertion, maintaining that the government would not seek ‘to escape from the exchange rate discipline’ (‘however strong the pressure’), and insisting that there could be ‘no question of a reduction in interest rates which is not fully justified by our position within the ERM’. Highlighting the benefits of the policy to date, both Major and Leigh-Pemberton further averred that membership had enabled the recent turmoil within the Conservative party to be weathered with less instability than would have otherwise been the case. Had sterling been outside the ERM during this time, Major argued, the ‘political uncertainties’ would have forced the government 'to put interest rates up….to offset the inflationary consequences' (*Financial Times,* 13/12/90, 7 & 21/1/91; *The Guardian* 19 & 31/12/90, 2/1/91; *The Observer* 9/12/90, 20/1/91).

Nonetheless, during the early weeks of the new year the government's commitment to the rigours of the ERM was put to the test as the downturn began to gather pace. Unemployment was now approaching two million, manufacturing production was falling at its fastest rate for a decade, home repossessions were running at record levels, wage deals were continuing to rise, and a slight tightening of German interest rates had pushed sterling to the bottom of its ERM band. As the economic difficulties began to increase, so too did the political pressure. The CBI and the TUC called for fiscal changes and a reduction in interest rates in order to ease the strain of the slowdown (*Financial Times*, 10/12/90; 14/1/91; *The Times*, 26/10/90), the Labour party were now attempting to pin the blame for the recession directly on Downing Street (see e.g. comments made by Gordon Brown, House of Commons debates, 30/1/91, Cl.948), and several high profile observers, most notably John Biffen (the Chief Secretary to the Treasury in the first Thatcher Cabinet), and, via an open letter to the *Times,* a disenchanted coterie of monetarist economists (including Alan Walters, Patrick Minford and Tim Congdon), called for a devaluation, or for sterling to be withdrawn from the ERM altogether (*The Times,* 5 & 7/11/90; *Financial Times,* 10, 14 & 30/1/91; *The Guardian,* 20/12/90).

The response of senior state officials to these growing pressures was to duck firmly behind the ramparts of the ERM, and to insist that the direction of economic policy would continue to be determined by the conditions set by the regime. The line from the Treasury was that 'the need to meet the UK's ERM obligation' was the 'overriding factor' in interest rate decisions (*Financial Times,* 4/2/91), Major slammed calls for interest rate cuts as 'politically opportunistic and economically naive' (*The Guardian,* 13/2/91), and Lamont continued to insist that upholding the value of the pound within the ERM remained the government's 'overwhelming priority'. Warning that a 'quick-fix' devaluation would produce nothing but 'renewed inflation and higher interest rates' (*Financial Times,* 1 & 14/2/91), the Chancellor emphasised that rates could only be lowered 'when sterling's position in the Exchange Rate Mechanism permits' (*The Guardian,* 14/2/91).

Yet the internal tensions of the ERM strategy remained close to the surface. Although the constraints of the regime provided officials with a justificatory device for resisting pressure for a more relaxed economic policy, the desire for lower interest rates nonetheless remained central to the equation. Insofar as this could be achieved without undermining sterling's position within the ERM and without creating renewed inflationary pressures, cheaper credit, and its anticipated accompaniment of higher consumer spending, remained the key to economic recovery and electoral renewal. As such, notwithstanding the need to avoid any impression that political pressures were being allowed to influence the direction of policy, with inflation now starting to fall, in February officials judged conditions to be sufficiently safe for them to embark on a series of interest rate cuts, reducing them in stages to twelve percent by April.

Contrary to governmental expectations, however, the cuts failed to improve the Conservatives' position in the polls. While victory in the Gulf war allowed Major to bask in the glory of being the most popular Prime Minister for thirty years, the government's overall level of popularity remained lacklustre. Continued by-election defeats (largely attributable to unrest over the poll tax) combined with large losses in the May local elections effectively put paid to any plans, rumoured to be under consideration in senior government circles, to call an early general election before the severity of the recession increased (*The Times*, 7/6/91). To compound matters further, the cuts also failed to alleviate the gloom surrounding the economy. While the pound remained stable (if somewhat anaemic) within its bandwidths, by the summer most other indicators were looking decidedly negative. Manufacturing output was now seven-and-a-half percent lower than at the time of ERM entry, unemployment was nearing two-and-a-half million, the growth of earnings was continuing to outstrip that of productivity, and business optimism had slumped after a brief spring revival (calculated from Economic Trends, 1994).

With the cuts also failing to stifle pressures for an economic policy relaxation, state officials were forced to remain steadfast in their adherence to the political defence mechanism of the ERM. The Treasury and the Bank of England continued to warn that a premature lowering of interest rates would endanger the downward trend in inflation and threaten the position of the pound (*The Observer,* 19/5/91; *The Times,* 10-12/6/91), while Lamont continued to assert that interest rates would 'be set to honour our commitment to stay within the ERM band'. Acknowledging that the process of reducing inflation would be painful in terms of 'high interest rates, frustrated hopes, bankruptcies and lost jobs', the Chancellor maintained that the 'uncertainty and strife' caused by inflation were markedly worse. High unemployment and a recession, then, were a price 'well worth paying' (House of Commons debates 19/3/91, Cls.165-7; *Financial Times,* 17/5/91). On this, John Major was equally adamant. Dismissing calls for a further loosening of interest rates as 'completely stupid', and maintaining that the scope for greater reductions was now 'very considerably more limited' (*The Times* 13/7/91), the Prime Minister predicted that the economy would start to recover during the latter half of the year once membership of the ERM had 'made explicit' the need for levels of pay to 'be linked to performance and productivity' (*Financial Times,* 22/5/91). For all this, with the economic situation looking ever-more parlous, but with inflation still on a downward path, the temptation for further interest rate cuts proved to be compelling, and towards the end of April the government launched into another series of reductions, cutting rates to ten-and-a-half percent by early September.

Weathering storms

Despite enduring a tumultuous twelve months, the first year of Britain's ERM membership was viewed with satisfaction by the governing authorities. The view from the Treasury was that the policy had 'delivered substantial success; more than most of us expected' (H.M. Treasury, 1994: 3). Despite a crisis in the housing market, a huge rise in business failures, and the highest level of unemployment for three years, the dials of several key economic indicators were now starting to point in a favourable direction. By October inflation had fallen to a three year low of four-point-seven percent, interest rates had been reduced to their lowest level since 1988 and sterling was enjoying a greater degree of stability than at any time during the previous decade (*The Times,* 13/9/91, 7/10/91).

In political terms, too, officials had reasons to be cheerful. Despite enduring sustained pressure for a more relaxed economic policy, the ERM had proved its usefulness as a justificatory device for resisting such calls, and as a means of shielding officials from the political consequences of the recession. Notwithstanding their persistent by-electoral failings, by October the Conservatives were closing the gap on Labour in the national polls and the government's 'satisfaction balance' (the mean monthly differential between satisfaction and dissatisfaction ratings) had enjoyed an encouraging improvement; the admittedly still-wretched level of minus twenty-seven being a substantial improvement on the record depth of minus forty-nine averaged during the nine months prior to joining the ERM. The satisfaction balance for John Major himself was far more striking, with an average level of plus twenty-seven during his ten months as Prime Minister far exceeding Margaret Thatcher's apex (an average of just below seven reached during the first half of

1983). Three quarters of the electorate also considered Major to be performing well as Premier, and the Conservative leader remained far ahead of Neil Kinnock both in the popularity stakes (by a ratio of almost two-to-one) as well as on the specific issue of economic management, where he held a formidable twenty-five point advantage over the Labour leader. On this issue, too, belying their overall level of unpopularity, the Conservatives maintained a considerable lead over their opponents, with a gap of seventeen points (forty-two to twenty-five) compared to a lead of just four at the time of ERM entry (calculated from MORI Political Monitor, 2009b; also see *The Times,* 15/8/91, 7/10/91, 4/11/91; *The Guardian,* 13/12/90).

Moreover, despite the ongoing calls for lower interest rates, the government's anti-inflationary policy continued to attract a broad degree of support. Hailing the reduction in inflation, the TUC anticipated that this would be soon be reduced to German levels; a joint memo from industrialists and trade union leaders at the National Economic Development Council called on the government to direct its policy efforts at securing a rate of zero inflation, while the constraints imposed upon the political strategy of the Labour opposition were succinctly revealed by Bryan Gould (the shadow environment secretary), who later lamented that Labour officials were now 'incapable of doing anything but bleat about the consequences of the policy because we couldn't attack the policy itself' (*The Times*, 30/9/92). While the City remained naturally supportive of the government's efforts to secure a sound monetary framework, support also hailed from the ranks of industry. John Banham, the Director-General of the CBI, for example, lauded the government's 'single-minded determination' to beat the scourge of rising prices, and asserted that the country needed to 'redouble' its efforts 'to squeeze inflation out of the economy' (*The Times*, 4/11/91). The Deputy President of the Confederation, Sir Michael Angus, hailed the 'hard discipline' of the ERM as 'something to concentrate the mind' (*The Times*, 5/11/91).

Britain’s second year within the regime, though, began with more inclement economic weather. Manufacturing output continued to stagnate, sterling fell to its lowest point since February, and unemployment continued to rise. Pressures for a reduction in interest rates from the City, the CBI and the TUC also increased; the expectation being that opportunities for further cuts would soon be foreclosed by the political sensitivities of a general election campaign, which would need to be held by the summer at the latest (*Financial Times,* 15/11/91; *The Times* 9/9/91). In response, officials sought to talk-up the economy and re-emphasised the benefits of their anti-inflationary position. Announcing, much to everyone's surprise, that ‘technically, the recession has ended’, the Chancellor reaffirmed that the government would ‘do whatever was necessary’ to maintain sterling’s position within the ERM, and rejected calls for looser credit on the grounds that this was not warranted by the position of the pound (*The Times,* 28/11/91 and 6/12/91), Major, too, hailed the positive economic indicators on inflation, pay deals and interest rates as ‘a vindication of our entry into the ERM’ (*Financial Times,* 16/9/91), a point on which Leigh-Pemberton was quick to concur. Noting that the economy was ‘undeniably improving’, the Governor was keen to warn against any ‘quick-fix’ measures, claiming that a further cut in rates at the present time would ‘invariably’ lead to renewed inflation *(Ibid.,* 19/9/91, 3/12/91). In December, the government sought to bolster its commitment to the ERM still further by signing up to the tough convergence criteria and binding procedures of the Maastricht Treaty, a move designed to enhance its anti-inflationary credibility, even if it did secure an opt-out from the third and final stage in the move towards a single European currency.

These latest attempts at resisting pressures for an economic relaxation with recourse to the constraints of the ERM, however, were now undermined by events elsewhere. In mid-December a rise in German interest rates and a surge in the deutsche-mark led to a tightening of credit across Europe, putting Britain under strong pressure to follow suit. While disgruntled monetarist academics and Conservative Party backbenchers (the most prominent now being Nicholas Ridley, the ex Secretary of State for Trade and Industry) remained at the forefront of calls for a devaluation and/or an exit from the ERM, discontent from business and labour groups was also increasingly evident (*The Times* 24/12/91, 7-8/1/92). Peter Morgan, the Director-General of the Institute of Directors, for example, warned that a 'realignment' of the pound might now be required to secure cheaper credit (*Financial Times,* 31/12/91), while the CBI and the TUC reissued calls for more active fiscal measures to ease the effects of the recession; the latter calling for higher levels of public spending, the former calling for greater business incentives in the form of tax cuts (*The Times* 8/1/92). By the end of the year the electoral situation, too, was looking decidedly grim. The Labour party remained ahead in the polls, satisfaction ratings for the government had fallen back to minus thirty-three, and while the popularity of the Prime Minister remained strong (at plus nineteen), this too was starting to decline (calculated from MORI Political Monitor, 2009b).

But the response of the governing authorities remained unyielding. Dismissing calls for interest rate cuts or devaluation as 'quack remedies', Major claimed that ERM membership had itself delivered cheaper credit, and argued that rates might have been as much as five percent higher had Britain remained outside the regime (*The Times*, 2 & 8/1/92). This was a view that was also shared by Lamont, who rejected any suggestion of 'prematurely' lowering interest rates to reduce the strains of the recession, and who derided devaluation as 'fool's gold'. Lowering sterling's value within the ERM, he claimed, 'might actually lead to higher interest rates since the markets would have no guarantee that a government prepared to devalue once would not do so again' (*The Times*, 31/12/91; *Financial Times,* 2-3/1/92). 'The real answer', therefore, was 'to make our costs equate with the currency and that is what we are doing' (House of Commons debates 28/2/91, Cl.1102). The Governor of the Bank of England launched an equally staunch defence of government strategy. Maintaining that 'current conditions and policy' were not the problem but rather the solution to Britain's economic difficulties, Leigh-Pemberton roundly criticised the 'short-termism' of those seeking cheaper credit or a lower exchange rate, adding that membership of the ERM had already enabled interest rates to be reduced to lower levels 'than would otherwise have been feasible' (Leigh-Pemberton, 1992).

End of days

The general election of April 1992 was thus fought against a backdrop of deepening recession and growing clamour for a loosening of economic policy. Despite this, however, the issue of monetary policy was markedly absent from the campaign. Instead, the battleground was dominated by the issues of tax, health, unemployment and education. Importantly, too, as far as most people were concerned, responsibility for the economic downturn was not attributable to the current ministerial cohort. Just one in ten voters blamed the Major government directly for the recession, while more than half placed the blame on the current state of the world economy and on the policies of Lawson and Thatcher (*Financial Times,* 6/4/92). Discontent with the government's economic policies, now at the relatively minor level of minus four percent, had also fallen to its lowest point since the expiry of the Lawson boom (calculated from MORI Political Monitor, 2009a).

Although it remains impossible to determine the extent to which this displacement of responsibility was due to the depoliticising aspects of the ERM, two points stand out as being particularly worthy of note. First, while it could be argued that the strong public preference for the Conservatives on the question of economic management was due to discontent with the Labour party rather than satisfaction with the policies of the current incumbents, Labour's sustained lead in the polls on almost every other issue clearly warns against making such an assumption. The substantial improvement in the government's ratings for handling the economy since joining the ERM, and this at a time of steep and worsening recession, is hard to reconcile with a view of ERM membership as having been a political disaster. Second, while it is also possible to argue that the ongoing pressure for a relaxation of economic policy demonstrated that the issue was not depoliticised, the real point here is one of relativity. Given that pressure for a more accommodating economic policy is entirely unremarkable at a time of recession, and given the impossibility of displacing chronically high levels of unemployment from the political agenda by any method, the key issue is not-so-much that the government found itself under pressure to take ameliorative measures during this period, but rather that this failed to have any significantly adverse effect on its economic strategy, or, more importantly, on the general perception of its political culpability for economic conditions. This point becomes more apposite still when it is considered that, had Britain not been in the ERM at this time, even higher interest rates would have been needed to shore up confidence in the pound and to avoid an inflationary decline in the exchange rate; and that state officials, reliant, as they would have been, on discretionary measures, would in all probability have been thus exposed to a greater degree of opprobrium for the effects of the downturn, and to an even higher degree of pressure for remedial action than was currently being endured. In this respect, then, the political benefits of ERM membership, as a means of dealing with the core governing problems of the time, are plain to see.

Although the issue of monetary policy was pushed onto the agenda towards the end of the election campaign, as expectations of a Labour win led to a sharp fall in the pound, this hardly proved to be detrimental to the government. Instead, ministers claimed this as proof that Labour would have to raise interest rates by between two to five percent in order to defend sterling's position in the ERM, thus highlighting their own anti-inflationary credentials in contrast to the economic uncertainty that might follow a changing of the guard at Downing Street (*The Guardian,* 4/4/92). Aided by a late swing, in part encouraged by these events, the outcome of the election was a fourth consecutive victory for the Conservatives, who successfully managed to buck all the laws of electoral physics to emerge from the depths of recession with a parliamentary majority of twenty-one. This was immediately followed by news of growing economic confidence and by a rise in sterling to within a fraction of its central parity (*The Guardian,* 29/4/92).

Yet pressures that would ultimately destroy the ERM policy were starting to gather momentum. The first of these related to conditions within the system itself. The rejection of the Maastricht Treaty by a Danish referendum at the beginning of June, followed shortly thereafter by the announcement of a French referendum to be held in September, created mounting uncertainty on the currency markets amidst fears that the entire project of European monetary integration, and with it the rationale for the ERM, could soon collapse. The second set of pressures concerned domestic affairs. By the summer hopes for an economic revival, and with it the last vestiges of post-election euphoria, were rapidly ebbing away as it became clear that Britain remained firmly stuck in what was now the longest recession since the 1930s. Although the annual rate of core inflation had fallen to three-point-eight percent during the last twelve months (its lowest level for over four years), unemployment was approaching two-and-three-quarter million and manufacturing pay awards were now running at seven-and-a-half percent, a slight rise over the previous quarter and the fourth fastest rate of increase in the OECD behind Italy, Portugal and Greece (*Financial Times,* 13-15/5/92; *The Guardian,* 15/5/92).

The official response was by now distinctly Pavlovian, combining renewed exhortations for lower prices and wages with renewed warnings about the danger of a precipitate economic policy relaxation. Any monetary easing, it was explained, would first need to be earned by reduced pay deals and a prior reduction in inflation. As Lamont put it, although British industry was now entering a 'virtuous circle of low inflation, rising competitiveness and increasing market share', domestic prices were nevertheless 'still too high' and a 'sea change in attitudes to inflation' remained essential. Continued high pay increases, he argued, would 'translate directly into a loss of competitiveness and hence of market share, profits and jobs' (*Financial Times,* 20/5/92, 17-18/6/92). Sympathy for those suffering at the impersonal hands of the ERM was also hard to find at the Bank of England. Indeed, for its Deputy Governor, Eddie George, the regime's political corset needed to be tighter still. With ERM membership having now successfully entrenched support for low and stable inflation across the board, he explained, it would now be possible 'to de-politicise monetary policy decisions to a degree that was inconceivable before', namely by handing control of such issues over to an even-more stringent regime based on central bank independence (*The Guardian*, 14/5/92).

As the summer progressed, the structural cracks within the ERM grew even wider. At the centre of this was the anticipated post-reunification boom in Germany, which Treasury officials had believed would make it easier to resist pressures for lower interest rates, but which was now striking at precisely the wrong time. With a rise in German rates of two-and-three-quarter percent since the beginning of the year prompting another tightening of credit conditions across Europe, Britain's commitment to maintain sterling's parity within the ERM was placed under increasing strain given the political difficulties, against the recessionary backdrop, of raising domestic rates in its defence. By July the pound had fallen to its lowest point against the deutsche-mark since joining the ERM, raising fears on the financial markets that it may soon be devalued (*Financial Times,* 21/7/92). To make matters worse, business and labour concerns about the high value of the pound and the constraints of the ERM on the government's ability to cut interest rates were also becoming increasingly strident, and discontent, too, continued to emanate from inside the Tory party. As Labour moved ahead in the polls for the first time since the election, euro-sceptics stepped up their calls for a complete withdrawal, while a majority of Conservative MPs were now reported to be in favour of devaluation in order to allow interest rates to be lowered (*Financial Times,* 29/7/92,17/8/92, 9/9/92; *The Guardian*, 11 & 13/7/92). With the ERM's internal strains now making it easier to hang the blame for Britain's lack of economic recovery on the regime itself, opposition to the ERM policy began to reach threatening levels for the first time.

Yet for all these criticisms, the ERM strategy was not yet poised for collapse. The Labour Party, the TUC and the majority of business leaders all continued to support Britain's membership, with the Director-General of the ABCC, Ronald Taylor, slating those who were calling on Britain to 'abandon' the ERM just because it had 'hit a spot of bother' (*Financial Times,* 24/8/92), and with the CBI's newly-appointed Director General, Howard Davies, insisting that the government was being 'rightly tough on inflation', that devaluation had 'little to commend it', and that abandoning the ERM was 'even more unattractive' (*The Times,* 29-30/7/92).

Not surprisingly, government officials embarked on an attempt to salvage the strategy by re-emphasising once more the resolute nature of their support for the regime. Leigh-Pemberton announced that Britain's commitment to the ERM was 'unwavering' (*Financial Times,* 1-2/8/92); while Major asserted that the ERM would remain the cornerstone of government policy and raised the vainglorious prospect of reducing inflation 'to nil if possible'. Interest rates would only be cut, he said, 'when we can sustain the exchange value of sterling', and the situation thus remained one in which 'we will have to adjust our costs to the exchange rate rather than the other way round' (*Financial*

Times, 15/7/92; 21/7/92). Lamont, too, mounted a staunch defence of the ERM strategy. In a speech to the European Policy Forum, the Chancellor insisted that interest rates would be put at 'whatever level necessary' to maintain the pound, and rejected alternative proposals put forward by critics of the ERM as 'illusory or destined to fail'. Cutting interest rates or devaluing within the ERM, he claimed, would lead to a loss of confidence in the pound and require even higher rates to prevent it from collapsing; as would a policy of cutting rates and leaving the ERM altogether, a move which the Chancellor warned would produce 'a fall in the pound probably unprecedented in the last forty years'. A final option, that of leaving the ERM and setting interest rates according to monetary targets, was also dismissed on the basis that such an approach had been shown to be 'a poor guide to interest rate policy' in the past, and that, in any case, '[t]he government could not remain indifferent to the level of the exchange rate' (*Financial Times,* 9-10/7/92). Further still, as Lamont later remarked, losing the ERM carried a 'great danger' that 'decision-making would now be seen as entirely political' (House of Commons debates, 12/11/92).

But such assertions were by-now firmly at odds with the reality of the crisis. With the only viable means of alleviating the strain, namely a cut in German interest rates, being rebuffed by Bundesbank officials, at the beginning of September the government announced a £7.2 billion foreign exchange loan for the defence of sterling in a last-ditch effort to convince the markets that the parity of the pound would not be altered. A seven percent devaluation of the Lira shortly thereafter, however, fuelled concerns that sterling would be next in line, leading to a rapid build-up of downward speculative pressure. Despite a series of increasingly desperate measures, including massive intervention by the Bank of England and a sharp rise in interest rates, first from ten to twelve percent, and then finally to fifteen percent, on 16 September, or 'Black Wednesday' as it came to be known, the government were finally compelled to admit defeat, and sterling's membership of the ERM was abruptly suspended (see Lamont, 1999, Chapter 10; Major, 2000, Chapter 14; Stephens, 1996, Chapter 10).

Viewed differently

Britain's membership of the ERM was a product of entwined political and economic motives; designed to impose tough financial discipline via a deliberately overvalued exchange rate while insulating state managers from the adverse political consequences by shifting the responsibility onto an external regime. Judged on this criteria, and in contrast to conventional accounts of this policy episode, membership of the ERM can be viewed as having been a relative success. Economically, the effects were clearly mixed. Economic growth stagnated, unemployment rose to chronically high levels, and average earnings continued to increase despite the recession. On the other hand, sterling remained more stable than at any other time in the preceding decade, enabling interest rates to be reduced to a level that would not have been possible under any of the alternative policy options that were available at the time (see Adam *et al*, 2001). Indeed, as was noted in the Treasury, 'the need was for a credible policy framework which would allow us to make significant reductions in interest rates', and it is 'difficult to see what other scenario policy approach [sic] would have delivered this outcome on acceptable terms' (H.M. Treasury, 1994: 3). The anti-inflationary effects of the ERM were also readily discernible. By Black Wednesday inflation had fallen to its lowest level since 1986 (a fall of almost six percent since October 1990), by 1993 it had reached its lowest level for thirty years, and thereafter it remained consistently low, fluctuating between one-and-a-half and three-and-a-half percent until the electoral crash of 1997.

Although the ERM policy was ultimately destroyed by an erosion of credibility following the lack of domestic economic adjustment to the rigours of the regime, its political impact was also broadly beneficial for the governing authorities during its time of operation. While economic conditions and policy-making remained contentious issues given the severity of the recession, the external constraints of the ERM provided officials with an effective means of displacing political responsibility for the downturn, and furnished them with a legitimate justificatory device for resisting calls for an economic policy relaxation. In short, the protective shield of the ERM helped to ensure that the governing authorities were now under less pressure over economic issues than would have been the case had they continued to remain outside the regime. Had the government not joined the ERM in October 1990 then it is highly likely that officials would have attracted even stronger criticism for the downturn, especially given the wide degree of support for ERM membership and the absence of any credible alternative. In such a scenario, even higher levels of interest rates would have been needed to avoid an inflationary loss of confidence in the pound, thus adding to Britain's economic problems and heaping further political misfortune upon the government, who would have been forced to bear a greater share of the responsibility. That a discretionary form of economic management would have had far worse consequences for the Conservatives is further demonstrated, at least to an extent, by the record slump in the government's satisfaction ratings that followed Britain's exit from the ERM, which fell from an average of minus twenty-nine for the third quarter of 1992 to an average of minus seventy for the first half of 1994. Going the other way, public disagreement with the government's economic policies rose markedly, from minus four percent in the spring of 1992 to minus thirty-one percent twelve months later (calculated from MORI Political Monitor, 2009b).

If the marginalisation of political factors from traditional accounts of Britain's ERM membership has led to an overly circumscribed interpretation of this policy episode, then their inclusion opens the way to a more rounded and nuanced understanding. While the large majority of analyses, based on economic or narrowly conceived political considerations, have seen the ERM as a lesson in abject failure, from the perspective of depoliticisation, and considering the actual events of the time, a rather different picture can be seen. Although its long-term political consequences were patently dire for the Conservatives, ERM membership nonetheless furnished officials with a greater degree of governing autonomy than would otherwise have been possible.

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