Dama Academic Scholarly Journal of Researchers | Published by: Dama Academic Scholarly & Scientific Research Society

https://damaacademia.com/dasj May 2020 Pages: 01-08 Volume 5 | Issue 5

Black Wednesday of 1992: The Day the Pound Sterling Came Under Attack

Amina Sammo

School of Finance & Financial Management, Business University Costa Rica

Email: minasammo@gmail.com

Abstract

The Black Wednesday of 1992 refers to the momentous day when the British Pound was under attack by currency speculators. This day created history in the Foreign Exchange markets because of the fact that the Pound was considered to be one of the strongest fiat currencies in the world. In fact it was the reserve currency of the world before the dollar took over. Hence the notion that the British pound could be under attack from speculators in the foreign market was dismissed as being mere conspiracy theory without any substance. Also, Black Wednesday was unprecedented in the fact that this was the day when open markets took on a powerful central bank with virtually unlimited access to money and the power to create more money if required and won! In this article, we will describe the events that lead to the Black Wednesday in detail.

Keywords: Black Wednesday, Pound Sterling, Currency Attack

1.0 INTRODUCTION

The Soviet Union was one of the countries that emerged as a superpower after the Second World War. The post war economic system was basically a competition between the American capitalist system and the Soviet based socialist system. The decades after the war were often referred to as the cold war as these two superpowers opposed each other's plans for world domination. However, the Soviet Union ended up disintegrating in the 1990's. As a result of this disintegration 15 countries were formed. None of these 15 countries were in great economic shape. However, Russia which was the modern incarnation of the mighty Soviet Union went bankrupt in 1998! Russia had to peg its currency to the very dollar that they vehemently opposed! They later had to break the peg, significantly devalue their currency and default on their debt obligations. For a country which had plans of world domination, the events that happened in 1998 were nothing short of a humiliation. Russia has recovered from the shock. However, the story of the 1998-ruble crisis still makes an interesting case. In this article we will find out more about this crisis.

Foreign Denominated Soviet Debt

Russia being the modern incarnation of the Soviet Union had inherited all of the Soviet's debt. A major portion of this debt was in foreign denominations. Hence, the Russian economy was in essence facing a debt crisis ever since the day it was born. The Russians made valiant attempts to pay off the debt. However, the damage had been caused long before the issue came to their hands. Russia did not have enough foreign exchange reserved to fulfill its debt obligations. Currency speculators were aware of this shortfall and therefore in 1998, after the Asian contagion, Russian became the next victim to fall to a currency attack mounted by powerful speculators.

1.1 Subsidies for Private Enterprises

The Russian economy may have become capitalistic in nature after it broke off from the Soviet Union. However, the Soviet socialist spirit was still present. As a result of the disintegration of the empire, a lot of private enterprises were in their nascent stages and as a result were not making profits. Some statistics estimate that after government abandoned employing everybody, only 40% of the workers were paid on time wages by private enterprises that struggled to make any profits! As such, the Russian government intervened and started providing subsidies to Russian enterprises that were employing a lot of workers if they paid their workers on time! The problem was that the Russian government was already bankrupt! An already bankrupt government was forced to periodically raise more debt in order to provide subsidies. The Russian debt was therefore increasing at an unsustainable rate.

https://damaacademia.com/dasj May 2020 Pages: 01-08 Volume 5 | Issue 5

1.2 High Public Debt

To add to that, the government of Russia was also used to spending money the way it did in the socialist Soviet Union. The Russians therefore paid no regard to the fact that their tax collections were dwindling and the government was not generating any significant revenue. They kept on spending money with the high handedness derived from the former powerful Soviet Union. This ended up adding to the debt that was being piled on by servicing Soviet's old debt and the debt that had to be taken on because of subsidies. In order to cut their debt, the Russian government attempt privatization of its resources as this would create additional revenue in the form of taxation as well as receipts from sale. However, the Russian privatization attempt was marred by corruption as Oligarchs used their government contacts to acquire resources at bargain basement prices and make a fortune for themselves in the process. Thus, the hope of the Russian government to be able to mobilize cash by selling its resources failed.

1.3 Oil Shock

The last blow to the Russian economy came after the Asian crisis of 1997. This crisis led to the fall in the prices of oil and metals in several nations which came as a severe shock to the Russian economy. The Russian economy was largely dependent on the export of oil. However, the Asian crisis caused asset prices all over the world to collapse and this caused the oil prices to go down as well. Hence, Russia which was already facing difficulty paying off its existing debt was not only mounting more debt as a result of subsidies but also faced a declining income. This was when the currency speculators took over and started hammering the ruble. Wave after wave of panic selling hit the market and the Russian central bank was no match for the negative sentiment generated by the currency speculators. The Forex reserves set aside by Russian central bank were depleted by the speculators in a matter of hours with their relentless selling. The ruble ended up losing 40% of its value in a matter of a few days. This caused the Russian government's finances to be strained and one of the mightiest nations in the world ended up defaulting on its debt obligations in the bond market. The Russian default had several casualties. One of the biggest one was a fund called Long Term Capital Management which ended up destroying close to a trillion dollars in value!

2.0 THE MEXICAN CURRENCY CRISIS (TEQUILA CRISIS) OF 1994

The Mexican peso crisis, which is also known as the tequila crisis was one of the first major currency crisis in the South American continent. The Mexican peso almost collapsed as a result of this crisis. The government was close to default on its national debt. The level of foreign reserves was dwindling to dangerously low levels and in the end the Mexican government required a bailout to stay afloat financially. Also, foreign investors that had invested in Mexican bonds ended up losing 15% of the value of their investments in a single day and over 40% of the value in the long term. These rates are catastrophic considering that bonds are fixed income investments and losing money on bonds is considered to be a very distant possibility.

2.1 Causes of the Mexican Crisis of 1994

Currency Mismatch: The Mexican government faced a major currency mismatch on their balance sheet. This meant that even though the Mexican government earned all their revenues in peso, they had issued a major portion of their debt which could be converted into United States dollars. Thus the Mexican government owed money in US dollars whereas its receipts were in pesos. Ideally, a government can swap the pesos for dollars on the market and pay off their debt. However, the Mexican government was maintaining a currency rate peg with the United States. This meant that the Mexican Central Bank would conduct foreign market operations to keep the value of their debt stable as compared to the United States. Hence, they needed dollar reserves to conduct these operations and therefore did not have the dollars to pay up on their loans.

Overvalued Peso: The Mexican government had maintained a currency peg with the United States. As a result, the value of the peso would float in tandem with the United States dollar. Hence, if the value of the dollar went down by 5%, the Mexican government would conduct Forex operations to ensure that the value of the peso also went down by exactly 5%. A currency peg can be dangerous if there is runaway inflation in any country. This was the case with Mexico where the government was creating credit in huge quantities driving inflation through the roof. If the peso were a freely floating currency, it would have undergone a serious devaluation. However, since the peso was pegged, its value remained stable to the dollar. Hence it was extremely overvalued which could have been observed by the rising imports and the dwindling exports.

Current Account Deficit: The Mexican government was also facing a major current account deficit because of the overvalued peso. This deficit was largely being financed by portfolio investments in the Mexican stock market. In the short run it appeared to be harmless. However, portfolio investment can leave countries within a matter of minutes. Therefore, it is an unstable foundation to finance something as important as current account deficits. The Mexican government paid the price of this mistake later as it witnessed a massive flight of capital and had no avenues to finance its deficits.

Maturity Mismatch: Along with currency mismatch, the Mexican government also had a major maturity mismatch on its debt. This meant that a large amount of debt was to come due almost immediately in 1994. This was dangerous given the fact that there were no reserves to pay off the debt. Hence, in 1994, the government owed $35 billion in interest and principal payments whereas it only had $6 billion in reserves bringing shivers up the spine of Mexican officials. Also, the Mexican government was so far up in debt that it could hardly finance any more deficits by borrowing more money.

Political situation: The political situation in Mexico also began to scare investors. There were a lot of high profile kidnappings during that time which suggested to investors that law and order situation within the country had broken down. Also, there was the assassination of a Presidential candidate which sparked further fears amongst investors. Also, the Mexican president started seeking counsel of his foreign minister, eminent economists and labor unions in a very public manner. The media started speculating about the gravity of the situation and investors in the Forex market started exiting the peso as fast as they could.

US Interest Rate Increase: The last nail in the coffin for the Mexican government was the fact that interest rates in the United States rose at the same time. Investors were getting a better return without having to face the risks that the Mexican economy brought along. Hence, investors started dumping dollar denominated Mexican debt and buying United States treasuries. Mexican debt had no buyers and given the rapid devaluation of the peso, Mexico was headed towards troubled times.

2.2 Consequences of the Mexican Crisis of 1994

Peg Abandoned: The Mexican government was forced to abandon the peg with the United States dollar since it did not have the reserves to keep trading on the Forex market and manage the exchange rate. This led to the rapid devaluation of the peso and caused considerable economic, political and social turmoil in Mexico.

Bailout: The United States government had to come to the rescue of the Mexican government. This is because Mexico was a major importer of American goods. Also, Mexico shared a long border with the United States and political turmoil there would ultimately find its way to America. Therefore, the American government somehow managed a $51 billion bailout for easing the situation in Mexico. In return, Mexico had to pledge their oil reserves as collateral. Also, Mexico was bound by investors to follow stringent monetary and credit expansion policies till their debt was paid off. The Mexican debt crisis is therefore a case in point of what can go wrong when countries try to maintain artificially high Forex rates with the help of open market operations of their Central Banks.

The South Sea Bubble

The South Sea Bubble is one of the largest asset bubbles that the world has ever seen. In fact, this bubble bankrupted the newly prosperous British economy during the 17th Century. At one point in time, all the money is Britain was not enough to pay down the debts that accrued as a result of the South Sea Bubble. Although this bubble happened 300 years ago, generations of British population have been paying down this debt. Even today, a portion of the tax collected from the general population is used to pay off this debt. The complete history of the South Sea company is well beyond the scope of this article. However, we will try to cover the important financial aspects.

Government of England Goes Bankrupt

The government of England had been at war with almost all of its neighbors during the 17th Century. These wars had proved to be very expensive for the exchequer. As a result of these wars, Britain had amassed a massive debt of $31 million pounds while at the same time it had a meager 50,000 pounds in reserves to service this obligation. The government of England was basically bankrupt as it had no way to pay the next interest installments that would be due on the loans.

3.0 THE SOUTH SEA SCHEME

A man named John Blunt came to the fore during this crisis situation. He basically offered the chancellor of English treasury an option to get rid of all the debt at once and overnight! This could be done by creating a new company called the South Sea company. This company would be given monopoly rights to trade with the South Seas i.e. Central and South America. *The money generated through such trade would have greatly increased the value of the shares*. But Central and South America were under Spanish rule and Britain was at war with Spain. However, the British somehow convinced the Spaniards to allow them to load one ship of goods per year for every South American port as well as the right to trade slaves! Not mentioning this meager trade agreement clearly, John Blunt declared that they had struck an agreement with the Spaniards and the South Sea Company was ready for business. In fact, he even gave the king and other honorary members of parliament, shares in the business. This convinced the common man of the authenticity of the shares and the price of shares started skyrocketing.

3.1 Creating Excess Shares

As the value of each share rose, fewer shares had to be issued to knock off the 31 million pound of England's debt. Thus John Blunt had authorization to create more shares and simply sell them at the market rate and pocket the profit. That is exactly what the South Seas company management did. By this time, John Blunt and anybody connected with him had become wealthy beyond imagination. The South Sea Company had a market capitalization which was close to 25% of the British GDP and could be considered to be valued at half the valuation of all companies listed on the New York Stock Exchange today! The South Sea Company did not earn a dime in operations and yet it was the most valuable company on the planet!

3.2 Keeping The Share Price Up

Since the South Sea Company did not make any money through operations, there was only one way to keep the company in existence i.e. ensuring that the share price went higher and higher. Only the sale of new stock could pay the dividend due to old stockholders and maintain the faade of a successful corporation. However, John Blunt had to come with a lot of ludicrous schemes to keep the stock price up: First he declared that the people only needed to put 20% of the money down to take ownership of the stock and the balance could be paid 2 months later. This created an obscene amount of demand since people were buying 5 times as many shares as they earlier could therefore be raising the prices higher in the process. Price of a share with a 100-pound face value went up to 500 pounds in a matter of weeks. To further prop up demand, John Blunt was loaning out money from the coffers of the South Sea Company to investors who wanted to buy the stock! Once again artificially demand was created and prices were now in the 800-pound range. Lastly, John Blunt undertook an audacious scheme and started selling shares for just 10% down with the balance to be paid out a year later. This time the stock hit the roof and the price was over 1000 pounds per share

However, the public soon realized the illusion that they had been living and started to sell off their holdings. As the prices began to collapse, John Blunt offered investors an insane 30% dividend on their stock every year for the next 10 years. This desperation by John Blunt confirmed the public fears that the South Sea Company was a gigantic bubble. A massive sale of the stock began to take place and within 3 weeks, the 1000-pound share was basically worthless. Many people had lost their lives savings in the South Sea bubble. Bankruptcies were rampant as many common people had extrapolated the trend of South Seas past success and had borrowed money to invest in the company hoping to make a windfall gain in the process. Of course, the windfall gain did not happen instead the British middle class was simply wiped out and burdened with debt which is still being paid out from tax revenues 300 years later.

https://damaacademia.com/dasj May 2020 Pages: 01-08 Volume 5 | Issue 5

4.0 SPANISH PROPERTY BUBBLE OF 2008

Spain's economy has been in an unprecedented decline since 2008. The average Spaniard found himself unemployed and had a huge mortgage bill to pay. An entire country has been bankrupted by the seemingly insatiable lust to acquire increasing quantities of real estate which drove the prices higher. This article will trace the beginning of this bubble from 1990's to its present day situation wherein it has left the Spanish economy in shambles.

4.1 Spanish Miracle

The Spanish miracle started in the 1990s and intensified around the turn of the century. Real estate prices had really started heating up in Spain. Between 1990 and 2006, the prices increased by a factor of 3. This was incredible given Spain's dismal economic growth in the recent past. Many onlookers started praising the Spanish economic system. However, very few were actually aware that the entire economy stood on shaky grounds and the fall was yet to come.

4.2 Euro Membership

The Euro membership in 1999 gave a significant impetus to the Spanish property market. Spaniards were used to high interest rates being set by their central bank. However, when the European Central Bank took over, the interest rates were comparatively quite low. In fact, there was at least a 4% drop in the percentage points at which banks were willing to lend. Also, Spanish banks started offering mortgages of longer duration. Thus, even though the price of the house was high, the monthly payment could be kept low. All this combined to create immense demand for housing in Spain. The real estate market was witnessing a sudden and unprecedented boom.

4.3 Immigration

The Spanish miracle was further supplemented by large scale immigration to Spain. The Mediterranean climate and the beautiful landscape of Spain had always made it a preferred destination amongst retirees. The retirees from all over Europe started flocking to Spain as the property boom came into existence. They could now combine a retirement home with a smart financial strategy if they purchased property in Spain! Also, the illusion of rising economic growth encouraged a lot of immigrants from developing countries to make their way into Spain. Spain witnessed its largest immigration during 1990's and the early 2000's. This immigration and the resultant demand for housing gave a further boost to the already rising housing sector.

4.4 Credit Expansion

The Spanish banks were creating more and more money as they made housing loans. This reflected in the macro-economic statistics of Spain during the period. Spanish banks witnessed an unparalleled credit expansion during the 1990's. The newly created money found its way into the real estate market further increasing its price and creating a self-reinforcing feedback loop of rising prices and increasing money supply.

4.5 Adjustable Rate Mortgages

An important fact regarding the Spanish real estate bubble is the fact that about 98% of the loans that were taken out during the bubble period were adjustable rate mortgages. These mortgages combine to form over 60% of the value of the Spanish GDP. This should give an indication that a lot of people owe a lot of money on their mortgages in Spain. To compound the problem, as the crisis has erupted after 2008, people find that their interest rates have risen and so have their mortgage payments. However, rising interest rates are also contracting the economy and causing unemployment. Hence, a lot of Spaniards are defaulting on their mortgage loans, ending up losing their life's savings in the process.

4.6 Supply and Price Rise

Another astounding feature of the Spanish bubble was that housing supply and prices both grew at an unprecedented rate during the 1990's and the 2000's. Usually, in a bubble scenario, the supply remains constant or drops. At best, there is a moderate increase in the supply. This helps create the image

https://damaacademia.com/dasj May 2020 Pages: 01-08 Volume 5 | Issue 5

of scarcity which leads to price rise. However, the Spanish case was markedly different with the number of housing units in Spain growing more than Germany, Italy, France and United Kingdom combined during that period. Spain virtually built itself many times over during that 15-year period. The seemingly insatiable desire for real estate caused prices to continue rising threefold even as supply was flooding the market.

4.7 Poor Job Growth

To top it up, the fundamentals of the Spanish economy had not changed. Most of the Spaniards were involved in low skilled jobs which paid a mediocre wage. The huge tracts of real estate that were being developed found no buyers! This is because most of the employment in Spain was in the form of menial employment provided by the real estate sector itself. Real estate contributed to over 25% of the GDP and was the largest employer. However, it certainly was not capable of creating a class of consumers who could afford to buy the end product that was being produced.

4.8 Securitization and Spread of the Crisis

Post 2008, the Spanish bubble burst. This burst happened as a result of the shocks received from the American subprime mortgage. However, the Spanish fall has been slow and less dramatic. Since 2008, real estate prices have been steadily dropping. Today the market finds itself 40% below the peak value that was quoted during the 2008 period. Some analysts believe that the fall has been much steeper and that there are areas within the country where prices have fallen by as much as 70%. To compound the problems, Spanish banks had securitized a lot of this real estate debt and sold it to pension funds, mutual funds and such other funds in the securities markets. Thus as defaults are happening, the Spanish banks are not the only ones that suffer. The life savings and pensions of people are being wiped out.

5.0 CONCLUSION

The European Exchange Rate Mechanism was an exchange rate mechanism for European currencies which chose to be a part of the group. The idea was to reduce the variability of exchange rates between the European currencies. Hence, the European Exchange Rate Mechanism proposed that the currencies should be allowed to float freely. However, the range in which they float should be pre-decided. Thus, the European Exchange Rate Mechanism was a sort of a semi-pegged mechanism.

The rate of the British pound would be allowed to change in value relative to the German Deutschemark. However, this variability will only be allowed up to a certain extent. If the market took the rates beyond a given threshold, then the Central Banks would swing into action with their open market operations and ensure that the exchange rate is maintained as desired.

However, the problem was that England joined the European Exchange Rate Mechanism at an overvalued rate. This decision was taken by England unilaterally despite oppositions from German central bankers. Therefore, from the moment England joined the mechanism, there was a possibility that they could be under attack. However, the Prime Minister of England was more focused on bringing down inflation and hence continued to join the European Exchange Rate Mechanism at a higher rate despite several warnings!

5.1 Unification of Germany

The problem began in 1992 when West Germany united with East Germany. East Germany was less prosperous and therefore the cost of the unification was too high. The German economy as a whole suffered and inflation started running amok in Germany as well. To prevent this, the German central bankers changed their monetary policy. What the Germans did was no different than what any other central banker would have done. One of the foremost responses to rising inflation is to raise interest rates. However, the problem was that the Deutschemark had become the base currency for European Exchange Rate Mechanism. All currency rates were semi-pegged to the mark. Hence by raising its own interest rates, Germany had fixed its own problem. However, it ended up creating massive problems for other member countries.

https://damaacademia.com/dasj May 2020 Pages: 01-08 Volume 5 | Issue 5

5.2 Fall of the Lira

The first casualty of the German interest rate rise was the Italian Lira. Like the British Pound, the Lira was also overvalued. The Italian economy was in dire straits and the Italian Central Bank was desperately taking action to preserve the value of the Lira. The German Bundesbank was also required to assist Germany in this market action as per the European Exchange Rate Mechanism agreement. The German central bank did help the Italians for a while. However, when it started affecting their domestic operations, the Germans gave up sending a very dangerous signal to the speculators in the market. The speculators now knew that the Bundesbank was only co-operating with other members to a certain extent and beyond that the members were on their own.

5.3 Attack on the Sterling

The markets as well as the British had pre-empted an attack on the British pound after the lira. It is for this reason that the British government officials were regularly in talks with Bundesbank officials asking them to lower interest rates. However, the Bundesbank officials did not respond to British pleas. Speculators who were observing these developments began buying the Deutshemark and selling the Pound in the market. This widened the exchange rate gap between the two currencies. The British Central Bank began to intervene in the market. They were buying all the currency that was being sold by speculators and as a result maintaining the prices. However, the speed at which the market was selling pounds quickly left the Forex reserves of the Bank of England depleted. As a result, the Bank had to admit defeat. It had to exit the European Exchange Rate Mechanism and lower the value of the pound!

Thus, a bunch of speculators had forced the mighty Bank of England into admitting defeat. The pound fell much below the lower threshold of the European Exchange Rate Mechanism as it continued to free float after the attack. George Soros was one speculator who gained a lot of fame after the attack on the British Pound. "Quantum fund" i.e. the hedge fund managed by George Soros ended up making upwards of 1 billion dollars in profit from the fall of the British pound. Also, his influence over the currency markets was ascertained and he came to be known as the "man who broke the Bank of England"

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https://damaacademia.com/dasj May 2020 Pages: 01-08 Volume 5 | Issue 5

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