7
Britain’s Membership of the Exchange Rate Mechanism

Introduction

As well as establishing grounds for a reinterpretation of Britain’s return to the gold standard in 1925, an open Marxist approach also provides a useful means of analysing other episodes of exchange rate policy-making. In this chapter, Britain’s membership of the Exchange Rate Mechanism (ERM) from 1990 to 1992 is examined from this alternative theoretical perspective. While this is commonly understood to have been primarily motivated by economic concerns, and, in similar terms to the return to gold, to have been a major policy disaster, it is also possible to interpret this episode in a rather different manner. In contrast to conventional analyses, Britain’s membership of the ERM is instead considered here to have been the central component of a wider governing strategy designed to address growing economic and political difficulties within the British state through the imposition of financial discipline and through the depoliticisation of monetary and economic policy-making. Moreover, it is also considered to have been a relatively successful strategy for Britain’s governing authorities. Although membership of the ERM did not lead to any significant improvement in Britain’s competitiveness compared to its main economic rivals, it nonetheless facilitated a substantial reduction in inflation, provided an effective means of containing class struggle, and for the most part enabled officials to effectively displace responsibility for economic conditions and policy-making away from the state, thereby enhancing their governing autonomy.

The Exchange Rate Mechanism

The ERM was the central component of the European Monetary System, which was established in 1979 as a means of restoring
monetary stability within the European Community (EC) following the collapse of the Bretton Woods system. Nations participating in the ERM were required to establish a centrally defined parity for their exchange rate with the European Currency Unit (a notional currency made from a weighted average of all EC currencies), through which a series of bilateral parities were thereby established with all other ERM currencies. This central rate was to be maintained within a narrow 2.25% fluctuation band on either side of the parity for ‘full’ ERM members, or within a broader and transitional range of 6% for countries that were not yet ready for such a rigorous constraint. Intervention in defence of the parity was obligatory once a currency reached the limits of its fluctuation margin, and various support mechanisms, including the provision of extensive short-term credits, were available for this purpose if required.

In a similar fashion to the gold standard, the ERM thus served to constrain the exchange rates of participating nations within tightly defined limits, thereby linking together their national price levels, and compelling them to pursue economic policies that were broadly in line with those pertaining throughout the system. Any country experiencing excessive inflation or deflation relative to the ERM average would experience a corresponding fall or rise in the external demand for its goods and services, and hence a fall or rise in its exchange rate within the ERM. Eventually, once the exchange rate reached the limits of its fluctuation band, this would force the imposition of countervailing measures, such as changes in monetary or fiscal policy, in order to maintain the currency within its limits.

In practice however, since the risk of speculation against the exchange rate was far greater for member states experiencing above-average rates of inflation, and since countries joining the ERM did so primarily for anti-inflationary reasons, membership of the ERM effectively entailed a commitment to follow the monetary policies of the least inflationary country. In reality, this tied its participants to the monetary policies of the German Bundesbank, whose political independence and constitutionally enshrined commitment to the maintenance of price stability had long endowed it with a strong anti-inflationary credibility, and had effectively installed the German Deutschmark (DM) as the ERM’s dominant, or ‘anchor’ currency. Membership of the ERM thus offered participating countries an effective means of importing the anti-inflationary credibility of the Bundesbank for themselves, enabling them to impose financial discipline upon the expectations and behaviour of capital and labour, and