George Soros and the Bank of England: A Huge Gamble That Paid Off

ByJulija A.December 05, 2019

"Go for the jugular."

On September 15, 1992, George Soros looked at his associate, Stan Druckenmiller, and calmly told him it was time to go nuclear. No more steady build-ups, no more waiting around — go for the jugular. It was time to bet against the pound and win. Tomorrow, they would short the British pound sterling and enter history as trading legends. They would be forever known as the men who broke the Bank of England and earned $1 billion in a single day.

George Soros and the Bank of England clashed on September 16. The victor was Soros, an assertive, quick-witted, larger-than-life man who remains a legend among investors. Ever since that day, people have been wondering: "How the hell did he do it?" We're here to answer.

George Soros, the British Bank, and the History of the Exchange Rate Mechanism

To understand how it all happened, we first need to review some history. After World War II, a handful of European countries decided to consolidate their powers and build a better, stronger economy. Establishing trade relations and helping each other out reduced the likelihood of another war, so Italy, France, Belgium, the Netherlands, Luxembourg, and West Germany came together in 1951. They signed the Treaty of Paris and established the European Coal and Steel Community. Its aim was to protect trade and diplomatic relations.

But wait — aren't we supposed to be talking about how George Soros ruined the Bank of England?

Don't worry, we'll get there.

These countries continued strengthening their relations after 1951. The Treaty of Rome was signed in 1957, and the European Economic Community (EEC) was established with the same purpose as the European Coal and Steel Community that had preceded it. In 1973, the United Kingdom joined the EEC.

Over the years, member countries realized Europe would benefit from a single currency to strengthen its economy, but they were reluctant to give up their individual currencies. It took a lot of negotiating, but in 1979 they established the Exchange Rate Mechanism (ERM). This ensured all member countries established fixed exchange rates with each other's currencies.

Now, back to our protagonist.

For George Soros, currency manipulation is an art form. Even back then, he paid close attention to how Europe handled this new system and he noticed the UK's reluctance to obey it. The country refused to use the ERM, keeping its own floating exchange rate instead. Later, when Soros tried to crash the pound, the Brits would come to appreciate this instinct.

Impressed by the ERM's success, members of the EEC realized their dream of creating an all-European currency was possible. In 1991, this currency would finally emerge under a unifying name: the euro. But before that could happen, the ECC had to prepare. Reducing exchange rate variability and stabilizing monetary policies were the top priorities. Since Germany had the strongest economy at the time, each country tied its currency's value to the deutschmark.

All the pieces for the George Soros scandal were falling into place. All that was left was for the UK to join the ERM.

George Soros, Black Wednesday, and the Lead-Up to the Event

What made the UK finally join the ERM? Inflation. From 1988 to 1990, inflation rose from 3% to a whopping 10.9%. To combat this severe rise, the country entered the pound sterling into the ERM, hoping to stabilize it.

By tying itself to the deutschmark, Great Britain was hoping to position its economy alongside Germany's. Unfortunately, this proved more difficult than hoped. Inflation in the UK was three times higher than in Germany, and interest rates had risen to 15%. The country was experiencing unsustainable economic growth, which meant it would soon enter a recession. For George Soros, the Bank of England was already starting to look like an easy target.

Entering the ERM meant the UK was obliged to keep the pound stable in relation to the deutschmark. The pound's value was set at 2.95 deutschmarks with a 6% margin of error either way. That meant the currency could dip as low as 2.78 and rise as high as 3.13 deutschmarks. This is called a semi-peg.

As the UK slowly entered a recession, keeping the pound steady became increasingly difficult. The George Soros vs the Bank of England showdown was getting closer by the day.

To maintain control within a recession, the reserve bank would normally lower interest rates to prop up the economy. But lowered rates have a negative effect on the value of currencies. If the UK wanted to stick to the ERM, it had to tap into its foreign currency reserves and buy pounds to drive up the currency's value. For Soros, breaking the pound would be easy so long as he kept careful track of the situation. That's exactly what he did.

Black Wednesday 1992 Explained

From 1990–92, England supported its currency by spending billions to keep it afloat. Currency traders around the world had already started shorting the British pound, and the bank had to keep buying it from the market to increase its value.

How, then, was George Soros the man who broke the Bank of England? He wasn't the only one with the idea of making obscene profits by shorting a currency, so why is everyone talking about him?

Unlike a lot of other traders, Soros knew how to be in exactly the right place at exactly the right time. He positioned himself perfectly to make massive gains and undermine the government's efforts to keep its currency steady.

There were several reasons no one else dared make such a drastic move. First of all, there was the golden rule of finance: don't fight the Fed. Very few people throughout history have had the chutzpah to go up against a major government power like a national bank and win. George Soros broke the Bank of England, the British equivalent of the Federal Reserve, not the Fed itself. But the principle remains the same.

It's also worth noting that the market believed the British government would keep its currency stable. That belief kept the pound safe for longer than it perhaps should have been. But at the end of the day, Soros collapsed economies because he knew he could pull it off. Nobody else had the cunning — or, one could argue, the greed — required to attempt such a move.

How did things manage to get so bad for the UK? The event, or rather, the person who started the avalanche was the president of the Bundesbank, Helmut Schlesinger. On September 15, 1992, he gave an interview to the Wall Street Journal and a German newspaper called Handelsblatt. He declared that European currencies needed to be realigned and floated the idea of devaluation. In Schlesinger's opinion, the pound was far too strong in comparison to the deutschmark.

These comments would lead to Black Wednesday. George Soros had been waiting for the right moment, and this was it. It was time to strike.

After Schlesinger's interview, the British government knew that if the pound didn't devalue, it would likely remain at the bottom end of its 6% margin. But if the currency did devalue, it would plummet. The government planned to buy a large amount of pounds to lift the currency's value back up. In the end, this plan failed.

On September 15, Soros began shorting the British pound aggressively. When we say "shorting," we mean he sold pounds by converting them into different currencies and agreeing to re-convert them at a later date. This caused the pound's value to drop drastically.

On September 16, as soon as the stock market opened, the Bank of England started buying its currency in an attempt to discourage bearish currency traders. But Soros was crashing the pound as soon as it rose even the tiniest bit. The bank intervened twice before 8:30 a.m., each time buying up huge quantities of pound sterling to no effect.

The struggle continued through the morning. The bank raised its interest rates to 10%, then 12%, and finally 15% to lure investors into buying pounds. Nothing worked. The currency's value dropped by 9.5% as Soros and the Bank of England continued to duel throughout the day. In the end, he won the battle. His clever tactics earned him more than $1 billion in profit.

Fallout from George Soros and the Bank of England

In the end, the Bank of England was forced to admit defeat. Soros had shorted more than $10 billion worth of pound sterling and earned a profit of $1 billion, decimating the currency's value in the process. Britain lost £3.3 billion and had to withdraw from the ERM. The country was beaten fair and square, which didn't make the blow any easier to take. The whole humiliating affair had a massive impact on the economy and damaged the Bank of England's standing.

What Soros did to currency became legendary, but he wasn't the only contributor. A lot of stock market traders shorted the pound that day. But Soros's bet was the biggest. Experts say he was the key factor in the bank's downfall. If he hadn't invested as much as he did, the bank may have been able to maintain the value of the pound. But with such an aggressive adversary who had a savvy plan and attacked at just at the right time, they had no chance.

He didn't play it safe. He didn't take it easy. He went for the jugular, and it earned him a fortune.

FAQ

How did George Soros break the Bank of England?-

The tale of George Soros breaking the Bank of England is legendary on the global stock market. He did it by betting a huge amount of money against the pound sterling in 1992, causing the currency to devalue rapidly. He then bought it back for a lot less money than he sold it for, earning $1 billion in the process.

How did George Soros make his money?-

Let's take a closer look at how shorting works. In order for George Soros to short a currency, he first had to amass a large quantity of it ($10 billion worth). To start the process, he called various banks and traders and made a deal — he would sell them the pound and then buy it back at a later date, regardless of its value at that moment. This, of course, was a big bet. If the value of the pound fell, he could buy it back for a lot less money than he'd sold it for and keep the difference as profit. If it rose, he'd have to buy it back at an increased price.

Since the value of a currency changes depending on how much of it there is on the market and how much people want it, selling such a large quantity of pound sterling made the value drop. When the pound hit its low, Soros bought it, and the difference made him a profit of $1 billion. Of course, as a cunning investor, Soros has made plenty of other profitable deals over the years.

Why did the UK leave ERM?-

After the George Soros scandal, England had no choice but to leave the ERM. The pound sterling fell below the system's semi-peg value. The country went into recession, but some politicians argue this wasn't a bad thing in the long run. After the disaster, the conservative right-wing party easily won the next election and was able to revive the economy.

Why did Britain join the ERM in 1990?-

After its refusal to join the ERM in 1979, it took Britain a long time to get on board. Despite that, the UK admired West Germany's economy and decided to shadow the deutschmark. When chancellor John Major took office in 1990, he and Foreign Secretary Douglas Hurd convinced the cabinet to join the ERM in an attempt to stabilize the pound.

What We Can Learn from George Soros in 1992?-

The greatest lesson governments can learn from this debacle is not to let one country dictate interest rates. Germany set interest rates that worked well for Germany, but it wasn't overly concerned about what would happen to other currencies. Europe, as a whole, should have dictated how it would run the markets in a way that would benefit everyone.

When it comes to individuals, though, one thing George Soros and the Bank of England showed us is that nothing is impossible if you're assertive enough. Caution is fine most of the time, but if you want to win big, you simply have to risk it all.

ABOUT AUTHOR

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Albert Einstein is said to have identified compound interest as mankind's greatest invention. That story's probably apocryphal, but it conveys a deep truth about the power of fiscal policy to change the world along with our daily lives. Civilization became possible only when Sumerians of the Bronze Age invented money. Today, economic issues influence every aspect of daily life. My job at Fortunly is an opportunity to analyze government policies and banking practices, sharing the results of my research in articles that can help you make better, smarter decisions for yourself and your family.