The British Euro in the Light of the Crisis

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Szerző: Heisz Máté
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Szak: Nemzetközi Kapcsolatok, V. évfolyam
Kar: Társadalomtudományi Kar
Konzulens: Dr. Benczes István
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Introduction

This paper reconsiders Britain’s euro adoption in the light of the recent economic crisis generated by the US subprime mortgage crisis. The kick-off question shall be the following: “Did the recent financial and economic crisis anticipate the adoption of the euro by the UK?” It is attempted to circumvent the dilemma of the traditional reasoning, where economic and political arguments pro and contra the euro are finely balanced. Inspired by Walsh (2007), this paper argues that the British monetary policy is influenced by political trade-offs rather than scientific arguments, as politicians seek to maximise votes. Thus, all five monetary policy switches that occurred in Britain in the period between 1929 and 1997 were induced by negative economic shocks. If so, and if the European Central Bank presents an alternative superior to policies conducted by the Bank of England, the late 2000s crisis’ stake may turn out to have been no smaller than the abandonment of the sterling in favour of the euro.

The paper’s methodology may seem somewhat reminiscent of István Magas’s 2009 paper on cyclical fluctuations and crises in the US economy, insofar as both apply an historical approach to determine future developments. In contrast, this paper focusses on the UK rather than the US and endeavours to identify and forecast political and institutional rather than economic development.

In Chapter One past crises and their consequences are subjected to an economic historical analysis, applying Walsh’s (2007) methodology – which, briefly, says policy switch is likely when the existing policy fails, an alternative policy idea exists, which explains the reasons of the recent failure and provides prescriptions, and which is not rejected by public sentiment. Thus in each historical event the nature of the policy failure is examined, to allow comparison with present-day events.

There have been a large number of contributions to the euro-sterling debate. The economic slowdown has fuelled this debate, deploying some new arguments reflecting contemporary difficulties. Chapter Two summarises these and illuminates new factors relevant when contemplating euro membership.

In Chapter Three the late 2000s crisis’s roots and effects on the British and euro area economies are examined, outlining differences. Its consequences for Britain in the Walshian sense outline above are investigated in Chapter Four.
Chapter One – An Economic Historical Examination

In this section the period between 1920 and 2010 is examined. This is the same period Istvan Magas (2009) investigates in his paper on cyclical fluctuations in the US economy. Comparably to Magas, who concludes that “the length of [...] recessive periods [...] has clearly shortened towards the present” (2009, 354), this paper attempts to formulate a trend related to economic crises of the past century. In contrast, this paper focusses on the UK rather than the US and endeavours to identify and forecast political and institutional rather than economic development.

To realise this research based on economic history, Walsh’s theory on policy failure will be employed. It was an inspiration, methodologically, to the current writer (Figure 1.1).

“Policy failure endangers the career prospects of politicians, and leads them to search for and consider alternative policy ideas. They select and seek to implement a rival idea, ceteris paribus, that identifies casual mechanisms that explain recent failure and offers an intellectually coherent and politically attractive set of policy prescriptions” (Walsh, 2007, 2)

Figure 1.1 – Policy failure and policy change. Source: Walsh, 2007, 9. This figure, adopted from Walsh (2007), illustrates the political mechanism of policy change.

<table>
<thead>
<tr>
<th>Has extant policy failed?</th>
<th>Does policy idea exist that explains failure and provides prescriptions?</th>
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<tbody>
<tr>
<td>Yes</td>
<td>No Policy Change</td>
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<td></td>
<td>Policy Change</td>
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<td>Policy Drift (return to previous policy)</td>
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<td>e.g. post ERM 1992-1997</td>
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The purpose of this section is to present a number of historical policy changes in a chronological order. Each is relevant to the issue of this paper, due to their similarity to the most recent crisis either in economic preconditions or in terms of their outcomes, or both. If Walsh is correct, new policies always addressed problems generated (actually or apparently) by the previous policy.
The Wall Street Crash of 1929

As the US emerged victorious from World War I, its economy was thriving unlike its European allies’ such as Britain’s. Electrification, post-war telecommunication technologies and booming car industry changed the everyday life in the 1920s. Consumer culture was flowering on a scale never before seen.

Already during World War I a particular investing behaviour evolved in America. Citizens bought government bonds issued for financing the War. Inspired by the idea of securities, bankers soon started to market products such as corporate bonds to the public. Thus people started to raise money for private companies, thereby making profit for themselves. Thus a broad stock exchange investment culture developed involving 3 million Americans by the mid 1920s (Bartholomew, 2009). In six “bull market” years preceding September 1929 prices in New York Stock Exchange (NYSE) almost quadrupled (Figure 1.2).

In September 1929 NYSE became erratic. Bankers, however, refused any government intervention declaring the market would correct itself. Yet on 23 October 1929 the stock market crashed and between 23 and 30 October DJIA lost almost a third of its value (Figure 1.2) along with investors’ money. “It was the biggest stock market crash since the records began” (Bartholomew, 2009, 00:10-00:15). Bartholomew (2009) list a series of events which might have led to the Crash (and to the Great Depression), including faltering US economy, increasing speculation in the stock market and lack of governmental supervision. Venn endorses this set of arguments saying that “both in the United States and the world economy there were indications before 1929 of underlying structural problems as well as more immediate difficulties” (2002, 149). Galbraith, however, confronting the accepted view of events, argues that “the crash did not come […] because the market suddenly became aware that a serious depression was in the offing” but massively due to a speculative boom (1992, 112-113). Bierman endorses this argument outlining that “it was far from obvious that the market was too high in October 1929” thus downfall was unforeseen and much predetermined (1991, 182). The very trigger of the sudden loss of confidence in the stock market remains unknown (Bartholomew, 2009; Bierman, 1991) but according to Galbraith “the downturn in the indexes frightened speculators, led them to unload their stocks, and so punctured a bubble that had in any case to be punctured one day” (1992, 113).
Figure 1.2 – Value of Dow Jones Industrial Average (DJIA) between 1920 and 1939. DJIA is calculated from stock prices of the 30 largest public companies in the United States. The creation of the speculative bubble and its burst is spectacular. 22 and 30 October 1929 closing values were 326.51 and 230.07 respectively. Therewith DJIA lost almost one third of its value. A “bear market” accompanied the Great Depression. The continuous decline in prices lasted until 8 July 1932 with DJIA closing value 44.22. Therewith DJIA had lost over 86% of its value since the beginning of Wall Street Crash. Source: Dow Jones Industrial Average, 2009.

Figure 1.3 – UK Inflation (annual harmonised Consumer Price Index), GDP growth rate and unemployment rate between 1920 and 1939. Sources: Mitchell, 1962; National Statistics Authority, 2010c.
The Wall Street Crash may have not been an exclusive reason for the subsequent “bear market” and the Great Depression but it was fuel to the flames. People were losing fortunes. Banks, brokerages and companies evaporated. Unemployment soared. The sharp fall in prices was accompanied by deflation (Mitchell, 1962). European nations such as Britain, still suffering from World War I, were hit even harder (Figure 1.3). Their stock markets had crashed similarly (Bédarida, 1976).

In response to the economic crisis, Franklin D. Roosevelt’s new US administration in 1933 introduced a thorough financial regulation and adopted Keynesian ideas to stimulate the economy by implementing fiscal policy. Anti capitalist movements such as the Nazi Party in Germany and communism in Eastern Europe strengthened as American style capitalism shattered. Protectionism, thus, led to trade wars (including competitive currency devaluations) and eventually World War II (Bédarida, 1976; Bartholomew, 2009).

Interestingly, on the eve of Wall Street Crash, the Assembly of the League of Nations was addressed a call for monetary integration in Europe. On 9 September 1929, Gustav Stresemann, Foreign Minister of Germany during the Weimar Republic, suggested a common European currency to defy economic division of Europe (League of Nations, 1929). He would not see his recommendations sinking into oblivion, because of his sudden death in October 1929.
The Collapse of the Bretton Woods system and the Oil Crisis of 1973

Apparently, “beggar-thy neighbour” policies of the 1930s were harmful. After World War II the global financial order was built anew. The 1944 Bretton Woods Conference created a system of fixed exchange rates with the US dollar as anchor currency (Papadia and Saccomanni, 1994; Johnson, 1996). The new financial order corresponded with Walsh’s criteria for new policy pursuing policy failure. It promised monetary stability addressing extant difficulties, mostly economic, including monetary instability. Furthermore, it provided an explanation for recent failure such as competitive devaluations. “Bretton Woods gave long periods of stability” (Johnson, 1996, 31).

By the early 1970s economic integration of Europe had already begun. In 1973, after decades of hesitation, Britain joined too. Moreover, the idea of monetary integration had been recalled and resumed. The Werner Report of 1970, drawn up by Pierre Werner, Prime Minister of Luxembourg, presented a stage-by-stage plan towards economic and monetary union to be realised by 1980. As an introduction, the European currency snake was created in 1972, as a sort of replacement of Bretton Woods. Every EC member was to participate (Johnson, 1996; Barber, 2001; Venn, 2002).

By the late 1960s the Bretton Woods system was apparent to have become unstable, mostly due to the stumbling US economy, trustee of the key currency of the system (Venn, 2002). As Johnson argues, “it is no coincidence that the Werner Plan [...] was introduced in 1972, a year before the Bretton Woods system was abandoned” (1996, 32). Previously, there had been no actual need for a separate European exchange rate system, because Bretton Woods had guaranteed monetary stability for Europe to develop the customs union from 1958 to 1971 (Johnson, 1996, 31-32).

A couple of months after the collapse of the Bretton Woods system, oil prices rocketed. In October 1973 the Organisation of Arab Petroleum Exporting Countries (OAPEC) declared it would no longer ship oil to countries supporting Israel during the Yom Kippur war. Remaining countries of the Organisation of Petroleum Exporting Countries (OPEC) increased oil prices to compensate high inflation generated by previous devaluations of the US dollar (Venn, 2002). The stock market downturn of 1973/4 (Figure 1.4) is associated with the collapse of the Bretton Woods system and the Oil Crisis.
The 1929 and 1973 crises are different in nature, insofar as the latter was generated on macroeconomic rather than microeconomic levels and, as hinted above, it was a supply-side shock where demand management inspired by Keynesian macroeconomics is inefficient. Unlike in 1929, in 1973 there had been no speculative inflation in the stock market (compare Figures 4.3 and 4.5). The overall consequences of 1973 were less disastrous, although the unemployment rate rose and a considerably high inflation ensued (Figure 1.5), which subsequently initiated monetary policy change in Britain (see page 19).

Yet in a way 1929 and 1973 are akin. Although the collapse of Bretton Woods was not unexpected, the Oil Crisis was a serious economic shock (Figure 1.5). 1929 and 1973 affected political decisions in a similar manner. Edward Heath, Britain’s Prime Minister between 1970 and 1974, approves in his autobiography that “after [the oil crisis] even the most ambitious government could not look far beyond the immediate struggle for survival” (Venn, 2002, 170). As a result of 1973/4, the single market and single currency were postponed, as countries turned inwards once again (Johnson, 1996; Barber, 2001; Venn, 2002).
Figure 1.4 – Value of Dow Jones Industrial Average between 1964 and 1983. 11 January 1973 and 6 December 1974 closing values were 1051.70 and 577.60 respectively. Therewith DJIA lost over 45% of its value (DJIA, 2009). At the same time, British stock prices fell by 73% during 1973-1974 (Dampier, 2003). Source: Dow Jones Industrial Average, 2009.

Figure 1.5 – UK Inflation (annual harmonised Consumer Price Index), GDP growth rate and unemployment rate between 1964 and 1983. Source: National Statistics Authority, 2010c.
The 1992 ERM crisis

The European currency snake was abandoned by countries one after the other, hoping to regain control over escalating inflation and unemployment more easily, particularly after the Oil Crisis.

In 1979, however, the European Monetary System (EMS) was created and the currency snake was reset. The kernel of it was the Exchange Rate Mechanism (ERM), a fixed but adjustable exchange rate system, similar to Bretton Woods. The Deutsche Mark was to become the anchor currency, thus its stability and the high credibility of the German central bank would be exported (Filc, 1994; Johnson, 1996). According to Artus and Bourguinat (1994), Tietmeyer (1994) and Johnson (1996) the ERM brought unprecedented exchange rate stability to participating currencies, especially in the period between 1987 and 1992. It helped to bring down inflation after the turbulent 1970s (Johnson, 1996). Yet Artus and Bourguinat (1994) argue that disinflation deteriorated the competitiveness of certain countries such as Spain and Italy. Johnson (1996) claims that in the period between 1987 and 1992 the ERM was such a success that it accelerated further integration towards monetary union.

Britain joined the ERM in October 1990. According to Johnson (1996) the accession was a failure. Britain joined the ERM 11 years after it was established in 1979, therefore she had far less influence on the structure and staffing on the new institutions than if she had been a founding member. He mockingly argues that “[Britain’s] decision to join was taken at the wrong time [too late], at the wrong interest rate [too high], at the wrong exchange rate [overvalued], for the wrong reasons [internal political interest], and in the wrong way [unilaterally, without discussing it with other ERM countries]” (1996, 2). As Walsh (2007) argues less ideationally, policy failure plays a significant role in British economic policy. As it has been explained, change in monetary policy has generally been triggered by the failure of the previous policy.

For example, as a response to the oil crisis, Britain adopted a strict money supply targeting policy, believed to be capable of managing high inflation and unemployment, the two central economic ailments effectively. Monetary targeting had never before been implemented, ergo it had never failed. The underlying theory presumed that it would be sufficient to target the growth of the money supply in order to contain inflation. This turned out to have been unsatisfactory, as the behaviour of monetary aggregates proved to be too difficult to forecast
and exchange rate was uneasy to control by money supply targeting. As a consequence, high inflation had reoccurred as a result of sterling depreciating rapidly (Figure 1.7). Interest rates were therefore very high, too. Monetary targeting had thus failed. There were multiple alternative policy ideas such as creating an independent central bank and joining the ERM. It was the latter that addressed extant economic difficulties, namely high inflation, high interest rates and mostly, exchange rate instability, best (Walsh, 2007).

Thus Britain had returned to the floating exchange rate regime and in 1997 independence was granted to the Bank of England. According to Walsh (2008), by central bank independence the government’s main goal was to restore its credibility after the humiliating exit from the ERM. At the same time, the return to floatation addressed the previous flexible exchange rate regime, regarded as an obstacle to growth.

As Johnson (1996) holds, ERM accession by Britain in 1990 was anachronistic. As a number of authors explain, the trigger of Britain’s breakup with the ERM was a massive speculative attack against sterling on the foreign exchange market (Johnson, 1996; Gilibert, 1994; Walsh; 2007). As sterling had been significantly overvalued, government intervention to maintain the exchange rate failed and on Wednesday, 16 September 1992, Britain left the ERM and let her currency float. This day, usually labelled “Black Wednesday” is sarcastically called by some “White” or “Golden” Wednesday because the ERM membership deteriorated Britain’s economic performance but it would significantly improve after 1992 (Figure 1.8) (Gilibert, 1994).

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2 Between October 1989 and the ERM accession in October 1990 the Bank of England base rate was as high as 14.8750%. The following one year it was lowered to 10.3750% (Bank of England, 2009b).
Figure 1.7 – Value of British Pound (GBP) expressed in Deutsche Mark (DEM) between 1973 and 1993. Source: Oanda, 2009.

Chapter Two – Literature Review on the Euro-Sterling Debate

This chapter aims to briefly revise traditional arguments, either economic or political, for and against adopting the euro. This issue was basically swept off the British political agenda in 2003 by then Chancellor of the Exchequer Gordon Brown, after conducting an investigation known as the five economic tests:

1. Are business cycles and economic structures compatible so that we and others could live comfortably with euro interest rates on a permanent basis?
2. If problems emerge is there sufficient flexibility to deal with them?
3. Would joining EMU create better conditions for firms making long-term decisions to invest in Britain?
4. What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly the City's wholesale markets?
5. In summary, will joining EMU promote higher growth, stability and a lasting increase in jobs?

Regarding the first test, the investigation presented by HM Treasury (2003b) found that although there had been an increase in convergence between UK and euro area business cycles, it was still unsatisfactory. It added that some important structural differences had remained such as in the mortgage market (see page 5).

Regarding the second test, in 1997, when the tests were first conducted, HM Treasury claimed that further progress was necessary. In 2003 as conditions were re-examined it was concluded that labour market flexibility had significantly improved, yet not convincingly enough.

As for the third test, it was argued that EMU membership might increase investment but only in case of the first and second tests being satisfied.

Regarding the fourth test, HM Treasury acknowledged that British financial services industry would benefit from euro membership, as it would eliminate sterling conversion transaction costs thus enabling capacity reallocation and luring more financial companies to Britain.

Since the five economic tests were first published, many authors have argued either in favour of, or against them. Some of those supporting euro, such as Begg (2008) and Hay (2003), suggest that this framework is incomplete and neglecs a list of factors equally important.
when considering membership. Moreover, Begg suggests that the “primary political purpose [of the five tests] was to quarantine an issue that has so often been toxic in British politics”, for example the 1992 ERM crisis (2008, 2).

One ignored factor in the five tests framework, according to Begg is the relation between monetary regime and financial stability. “Changing fashions in monetary policy have placed price stabilisation ahead of financial stability” (2008, 21), he argues, adding that the current crisis has revealed the deficiency of this approach. Also, he holds that the single currency has helped to coordinate remedial policies and fight the crisis. In contrast, the Economist (2009b) highlights that although at the beginning of the crisis the euro might have looked resistant, by now it has become clear that negative effects on euro banks have been comparable.

A large number of papers exist dealing with business cycle convergence within the EMU and between Britain and the EMU. Furceri and Karras (2008) argue that since the single currency has increased intra-euro area trade, it had also largely contributed to cycle synchronisation. Bootle (2006) holds that euro is superfluous, for British external trade comprises considerably more extra-European trade compared to other European nations. Wolf (2008), however, claims that “there is no evidence that EMU has improved the economic dynamism of its members”, therewith casting doubt on Furceri and Karras’s initial finding. Dunn (2008) acknowledges that there are business cycle differences between individual EMU member states but notes that these differences are declining. Montoya and Haan (2008) endorse his views. Hallet and Richter have developed a sophisticated model to decompose business cycles into their component cycles. They conclude that “there is no general convergence as such within the [euro area, but] there is some evidence of a tendency towards convergence” (2008, 15). They note that while small economies, such as the Netherlands, have become more flexible, large ones, such as France, have remained too rigid. Already in 1996, Johnson argued that the single currency could be expected to bring lower interest rates, which is good for British economy. Minford confronts this idea arguing that “joining the EMU means that the UK interest rate is set by the European Central Bank in Frankfurt to suit the needs of the whole euro zone, which may of course be very different from the UK’s” (2002, 43). He also recalls the ERM crisis. According to his interpretation British economic slowdown in the early 1990s was due to the German central bank recently having raised interest rates. Apparently, Minford assumes that British and euro area business cycles are doomed to remain incompatible. On the contrary, Massman and Mitchell conducted an investigation in 2002 and concluded that, in spite of significant dissimilarities remaining, UK and euro are business
cycles had become more correlated since the early 1990s. Yet they emphasises that correlation was extremely dependent on the method used to calculate it. Buiter (2008) humorously claims that “UK business cycle is now so synchronised with that of the [euro area] that the country looks like a suburb of Frankfurt”. He holds that the current financial crisis demonstrated this spectacularly.

There are some authors who argue that the role of business cycle convergence is overestimated, as “there is simply no way to tell whether Britain is now at the same point in the business cycle as its euro zone neighbours, nor, if it is, whether the convergence is stable and sustainable” (Hay, 2003, 3).

Regarding product and labour market flexibility, most contributors agree that Britain’s economy was at least as flexible as that of the euro area (Johnson, 1996; Hay, 2003; Hay et al, 2006; Buiter, 2008; Stevenson, 2008). Buiter (2008) gives the example of Central and Eastern European immigrants who came when British economy was booming and are leaving now that the economy is slowing down.

The case of investment, according to Hay, who is in favour of EMU membership, is more ambiguous. In accordance with HM Treasury, he holds that “at best [...], in aggregate terms, membership [...] is likely to prove neutral with regards to FDI” (2003, 5), as it might further increase Britain’s net foreign direct investment (FDI) surplus, already significant. In contrast, it is unquestionable that domestic investment in the productive economy would benefit from euro membership. As Hay et al put it, “there is no reason for thinking that the British economy would not [...] enjoy the benefits [...] of reduced transactions costs, more effective price signalling mechanisms and the elimination of exchange rate uncertainty” (2006, 19). This statement contradicts Wolf’s (2008) above quoted diagnose. In Ziltener’s (2003) opinion the whole economic integration theory might be wrong. Quite the opposite, Mills declares that “the euro has achieved many successes” (2009, 2). These assertions are not too coherent.

One point of consensus seems to be the case of the financial sector. London is already the world’s most important banking centre with an average daily foreign exchange turnover of $1,679 billion in October 2008 (Bank of England, 2009b). Membership might shift Europe’s financial services in London’s direction even more (HM Treasury, 2003c; Minford, 2002).

Johnson (2001), in spite of being in favour of membership, asserts that “it has become the conventional wisdom, even among supporters, that the main advantages of British entry into
the euro are political and that the economic arguments are finely balanced, impossible to prove and can point either way”. He (1996) reckons that joining the EMU might not only increase British influence within the EU but also on EMU monetary policy, thus confronting Minford (2002), who, as it has already been pointed out, fears that independent ECB decisions might not be favourable for British economy. Jansen (2008) provides some evidence in favour of Johnson, claiming that in the ERM era the Dutch central bank still enjoyed some degree of policy autonomy. Johnson, however, resignedly adds that failure to join in time will deteriorate the UK’s influence on the structure and staffing on the new institutions.

An important aspect of the anti euro reasoning is the democratic deficit of the EMU. Several contributors (Cooper, 1994; Henning, 2007; Howarth, 2007) have expressed their reservations towards ECB, trustee of the single currency. Cooper sarcastically describes the ECB as “a body of Platonic monetary guardians, accountable to no one, to frame and execute one of the most important aspects of policy in modern economies, affecting hundreds of millions of people” (1994, 2).

As it has been shown, arguments for and against adopting the euro are finely balanced. *Chapter Three* investigates whether the late 2000s crisis has led loss in equilibrium.
Chapter Three – The Subprime Mortgage Crisis and Its Effect on Economies

In his book on the Wall Street Crash, first published in 1954, Galbraith ponders that “it would be good to know whether, indeed, we shall someday have another 1929” (1992, 25). Since 2007, many eminent academics and businessmen have compared the subprime mortgage crisis and the following financial and economic crisis to 1929 (Krugman, 2008; Soros, 2008).

According to some of the most up-to-date analyses by Hull (2009), Loonetz (2008) and Mian and Sufi (2008) the subprime mortgage crisis in the US was primarily led by a change in mortgage lending practices around 2000. House prices began to rise more rapidly from 2000 (Figure 3.1), due to the demand created by new entrants in the market, who had been turned down in 1996. Due to steeply ascending house prices between 2000 and 2007, mortgage lending criteria were gradually relaxed, luring vast numbers of new subprime borrowers. Along with trustworthy mortgages, subprime mortgages were securitised and sold worldwide.

Lenders, mortgage-backed security holders and borrowers were wrongly expecting ever rising house prices. Once the market realised what a hazardous game it had been playing, banks first stopped lending to one another, then to customers. This pushed down demand, which obviously affected prices (Elliott, 2008). As Figure 3.1 indicates US property prices started to fall in 2007. UK prices followed with a less-than-one year lag. Decreasing real estate prices worsened mortgage holders’ ability to refinance their debts, thus a vicious circle had been created. Both in the UK and the US a market low was reached in the first quarter of 2009. Since then, house prices have seen a moderate increase.

Bartholomew (2009) accuses governments of insufficient supervision of the financial sector. He holds that Roosevelt’s financial rules introduced after the Great Crash were ignorantly dismantled in the 1980s and 90s, once people’s trust in market forces had returned. Murphy (2008), however, argues that the financial crisis should not be blamed on deregulation. Preferring the term “financial modernisation”, he underlines that those companies that were eventually forced to declare bankruptcy, were in fact unaffected by the 1990s deregulation. In contrast, companies affected by the modernisation were closely supervised by the Federal Reserve Board and eventually bailed out.

3 Less credit worthy borrowers.
Figure 3.1 – US and UK house price index between 1990 and 2009. 2000=100%. UK house prices peaked at £184.1 thousand in the third quarter of 2007 and were worth £149.7 thousand in the first quarter of 2009, losing more than 18% of their value. Sources: S&P/Case-Shiller, 2010 for US data; Nationwide, 2010 for UK data.

Figure 3.2 – Germany and France house price index between 1990 and 2009. 2000=100%. Own calculations based on house prices. Source: Global Property Guide, 2010.
Figure 3.2 reveals that there was no housing bubble burst in Germany and France. Mortgage credit market practices in Britain and the euro area are significantly different. According to the European Mortgage Federation (EMF, 2009a), the residential mortgage debt to GDP ratio in Britain is 86.3%, outweighed only by the Dutch and the Danish debt ratio. Other EU countries’ ratios are much lower.\(^4\)

Moreover, most UK mortgages are at variable or short-term fixed rates. This increases British households’ sensitivity to changes in official interest rates compared to that of euro area households. In the euro area, mortgage markets remain more heavily regulated than in Britain. In Germany and France, most mortgages are long-term fixed rate, 80% and 60% respectively. The rest are short-term fixed (Bank of England, 2008a; HM Treasury, 2003a).

The UK economy is also more vulnerable to financial crises because of its intense reliance on cheap credit (Elliot, 2008) and the financial sector (Telegraph, 2009), accounting for 8% of the GDP (Economist, 2009a). Thus the British economy contracted by 4.8% in 2009, the most among Western advanced economies (Figure 3.3). Simultaneously, unemployment started to rise as a result of credit unavailability and economic slowdown (Figure 3.4). Inflation decreased as a consequence of declining housing and housing services prices (Figure 3.5). In early 2009 Retail Price Index, including mortgage interest payments, became dangerously low because of plummeting mortgage interest payments as a consequence of the central bank rate cut to 0.5% to stimulate the economy (Figure 3.6). The Bank of England (2009b) even warned of the risk of deflation which may become increasingly harmful during recessions, as consumers tend to postpone purchases if they expect lower prices in the future (BBC, 2009a).

Although the euro area economy, in general, did not suffer from mortgage and real estate market breakdowns, the credit crisis contaminated its financial sector and subsequently the entire economy (Figures 3.3-6). The EMF maintains that “the [...] crisis in the EU [was] a secondary symptom resulting from the exposure of European banks to the USA’s [and UK’s] ‘toxic’ loans due to the wide re-distribution of these loans through an insufficiently transparent securitisation process” (2009b, 2).

\(^4\) 47.7% in Germany, 34.9% in France, 19.8% in Italy, 61.6% in Spain.

Figure 3.4 – Euro Area and UK unemployment rate between January 2007 and January 2010. Sources: Eurostat, 2010a, National Statistics Authority, 2010a.
Figure 3.5 – Euro area and UK annual harmonised Consumer Price Index between January 2007 and January 2010. Source: Eurostat, 2010b.

The macroeconomic symptoms of the recent crisis in the UK and the euro area have thus been remarkably similar. GDP growth, unemployment and inflation have moved parallelly. The sterling and the euro have moved almost hand in hand against the dollar (Figure 3.7). Showing comparable trends, however, does not mean an equation mark can be put between UK and EMU data. After a somewhat bigger contraction Britain’s economy faces a faster growth in 2010 and 2011, according to the IMF (Figure 3.3). Unemployment rate in the euro area has remained significantly below the UK rate (Figure 3.4). Although the Bank of England warned of the hazards of falling consumer prices, deflation only occurred in the euro area (Figure 3.5). Since inflation is closely related to the monetary policy, it can be judged that in controlling inflation the Bank of England proved more successful than the European Central Bank.

Figure 3.7 shows exchange rates of sterling, euro and dollar. Although the sterling and the euro appreciated rather parallelly against the dollar until early 2008, then depreciated through early 2009 and reappreciated until late 2009 in concert, a steady depreciation of the sterling compared to the euro has occurred since late 2007. This triggered concerns in the EU as it had been believed that Britain was deliberately allowing sterling to depreciate to stimulate her economy by gaining competitive advantage over the euro area (Financial Times, 2009a). Financial Times notes that article 124 of the EU treaties outlaws competitive devaluations.

Figure 3.7 – Value of the euro (EUR) expressed in United States Dollar (USD), value of the British Pound (GBP) expressed in United States Dollar (USD), value of the British Pound (GBP) expressed in euro (EUR) between January 2001 and March 2010. Source: Global View, 2010.
As the British currency depreciates, those who have euro-based mortgages suffer as their repayments soar (Telegraph, 2008a). At the same time, sterling denominated mortgage repayments have plummeted since the Bank of England reduced the base rate to 0.5%. As a consequence, £8 billion was repaid in the fourth quarter of 2008 as mortgage holders with variable rates responded to low rates (Guardian, 2009).

Since late 2009 currency markets have seen an appreciation of the dollar against the euro and, to some extent, the sterling. This has been due to fears in capital markets that a debt crisis may ensue in Europe as a result of fiscal stimuli provided by European governments in their struggle against the economic crisis. To date, Greece has practically already got into a debt crisis with a public debt of 108% in 2009 (CIA, 2010).

The recent crisis’ microeconomic symptoms in Britain can best be illustrated by historical prices of FTSE 100. The illustration of a 20-year-long period is crucial in order to enable comparison with Figure 1.2 that shows the remarkable inflation, burst and deflation of DJIA in the United States prior to and during the Great Depression. Figure 3.8 shows the dotcom bubble of the late 1990s and the real estate bubble of the 2000s. In both cases shares on the British stock exchange was far from suffering a depreciation and a bear market comparable to that of DJIA between 1929 and 1932.

Figure 3.8 – Value of FTSE 100, the most widely used British share index, between January 1990 and March 2010. FTSE 100 is calculated from stock prices of the 100 most highly capitalised UK companies listed on the London Stock Exchange. Source: Yahoo Finance (2010). The dotcom bubble of the late 1990s was comparably large, with a somewhat less remarkable depreciation (aggravated by 9/11) and subsequent recovery, though.
Chapter Four – The Late 2000s Crisis’ Consequences for Britain in the Walshian Sense

The purpose of this chapter is to detect whether Britain might be facing a monetary policy switch from sterling to euro in the near future. Therefore, Walsh’s idea (2007) about policy change is useful to be recalled (Figure 1.1).

An important criterion for the relevance of this theory is the nonexistence of a clear majority preference. Accordingly, as long as lobby group influences do not outweigh one another, decision remains in politicians’ hands. To confirm the topical relevance of Walsh’s theory (and thus the following research methodology), a survey was conducted to estimate social preferences in Britain. As Figure 3.9 indicates, neither supporters nor opponents of the euro represent a strong majority.

Figure 3.9 – Survey on British attitudes towards the euro. Statement rated: “I support British Euro (currency) membership.” This survey was designed and conducted by the author of this paper in March 2009. It is based on a 42-strong non-probability accidental sample featuring University of Hull staff and students. For further findings, see Appendix.
To perform the Walshian analysis, main findings of the historical investigation need to be recalled. Therefore, please view Figure 3.10. A scenario resembling one of the events marked in blue is more likely to accelerate the British euro adoption, since events B and D either produced international fixed exchange rate regimes (Bretton Woods) or convinced Britain to join such (ERM). In contrast, a scenario resembling events marked in red is unlikely to encourage Britain’s EMU accession, as each of these set off a protectionist turn. The question is whether event F eventually turns blue or red.

It has been suggested that in its economic conditions the late-2000s recession resembles the Wall Street Crash most among the crises examined. Both arose as microeconomic anomalies and eventually intoxicated the entire global economy, generating high unemployment and low growth. Thus a protectionist turn may ensue with not only Britain but many other countries turning inwards. Some commentators have indicated the option of EMU breakup, as member countries are trying to fight the crisis (Mills, 2009; Economist, 2009c). Some regard the depreciation of the sterling as a symptom of the protectionist turn (Financial Times, 2009). Even policy responses have been comparable to those in the 1930s, hence the expression “Keynesian revival” referring to a hypothesised shift back to economic policies featuring fiscal stimulus, monetary expansion and a reregulation of the financial services sector to contain speculation (Giles et al, 2008; Reddy, 2009). A real protectionist cataclysm, including “beggar-thy-neighbour” policies such as competitive currency devaluations, has, however, not occurred, which questions the comparability of the Great Depression and the late-2000s recession in terms of political outcomes related to monetary policy change. Depressed interest rates that currently characterise Western economies’ finances, including that of the UK, is no monetary policy change but a manoeuvring within the frame of the extant regime.
<table>
<thead>
<tr>
<th>Location</th>
<th>Name of extant policy</th>
<th>Features of policy / period</th>
<th>Name of crisis</th>
<th>Features of crisis</th>
<th>Adopted policy</th>
<th>Adopted policy addresses</th>
</tr>
</thead>
<tbody>
<tr>
<td>A. advanced Western economies</td>
<td>up to 1929 market fundamentalism</td>
<td>insufficient market supervision, speculation</td>
<td>1929 Wall Street Crash, Great Depression</td>
<td>economic slowdown, deflation, unemployment</td>
<td>Keynesianism, protectionism, financial regulation, “beggar-thy-neighbour” policies, competitive devaluations</td>
<td>insufficient market supervision, economic slowdown, deflation, unemployment</td>
</tr>
<tr>
<td>B. advanced Western economies</td>
<td>1929-1944 Keynesianism, protectionism</td>
<td>protectionism, “beggar-thy-neighbour” policies, competitive devaluations</td>
<td>1939-1945 World War II</td>
<td>monetary and economic instability</td>
<td>Bretton Woods</td>
<td>protectionism, monetary and economic instability</td>
</tr>
<tr>
<td>C. United Kingdom</td>
<td>1944-1973 Bretton Woods</td>
<td>dependency, pressure on USD, Yom Kippur War</td>
<td>1973 Collapse of BW, Oil Crisis</td>
<td>high inflation, high unemployment</td>
<td>floatation, monetary targeting</td>
<td>dependency, high inflation, high unemployment</td>
</tr>
<tr>
<td>D. United Kingdom</td>
<td>1975-1990 floatation, monetary targeting</td>
<td>1980s sterling instability, theory oversimplified, it presupposed that it was sufficient to control money supply in order to contain inflation</td>
<td>high inflation causing high interest rates</td>
<td>ERM</td>
<td>exchange rate instability, high inflation, high interest rates</td>
<td></td>
</tr>
<tr>
<td>F. United Kingdom</td>
<td>since 1992 (1997) floatation, central bank independence</td>
<td>insufficient market supervision, speculation, credit unavailability, default</td>
<td>2007 Subprime Mortgage Crisis, Credit Crunch, Late 2000s Crisis</td>
<td>economic slowdown, danger of deflation, unemployment, public debt boom</td>
<td>Keynesian revival, reregulation of the financial sector, shadow Office of Budget Responsibility</td>
<td>economic slowdown, unemployment, little supervision, public debt boom</td>
</tr>
</tbody>
</table>

**Figure 3.10** – Historical events and policy changes. Self-made figure, 2010.
To answer the question formulated in the *Introduction*, Walsh’s (2007) methodology needs to be recalled once again, see Figure 3.9. Policy change is likely when

\[ a. \] the extant policy fails,
\[ b. \] an alternative policy idea exists,
\[ c. \] which explains the reasons of the recent failure and provides prescriptions and
\[ d. \] which is not rejected by public sentiment.

Regarding point \( a \), an economic crisis where the population is doomed to suffer such as that of the late 2000s may well be a substratum for policy failure. Indicators as of March 2010, however, suggest that economies hit by the crisis, including the UK, have gained momentum and have stepped on the path of recovery. Unless a severe double-dip recession or a repercussive crisis such as a debt crisis occurs, public sentiment is unlikely to revolt against the extant economic regime in Britain, which, apparently, has successfully adapted and survived.

Commenting the effects of the crisis on the EMU, the Commission said that, because of the financial crisis, Britain was considering EMU membership more seriously than ever before. Later, however, the British government denied any change in the approach on EMU (BBC, 2008a). This is more than understandable bearing in mind the findings of *Chapter Three*, where it is suggested that the UK and the euro area have similarly suffered from the crisis, with UK indicators being less disastrous. The following question might be formulated: Would the crisis have been less devastating if Britain had been member of the EMU? Would recovery have been faster if Britain had been member of the EMU? Can recovery be accelerated by joining? According to HM Treasury (2003a), euro membership did not transform the Dutch mortgage credit market, similar to the British. Consequently, it is unlikely that the subprime mortgage crisis in Britain could have been foregone by euro membership, thus alleviating it to an extent. The nature and severity of the crisis were comparable in Britain. The euro did not prove a safe haven against toxic assets in the financial services sector and the resulting credit crunch and economic crisis. Neither has been the recovery of EMU member states faster than that of Britain. What’s more, remedial policies in the euro area and Britain have been remarkably similar. They have been characterised by two elements: the Keynesian revival, i.e. monetary and fiscal expansion, steps toward a reregulation of the financial sector, private and public. Therefore, the EMU in its current form
is an alternative policy idea (point b) that, however, does not in the least explain the reasons of the recent failure and that does not provide distinct prescriptions (point c).

Currently a debt crisis seems more likely than a double-dip recession. British public debt, already by 68% of GDP, will approach 100% of GDP in the medium term, according to a Standard and Poor’s estimate published in March 2010 (CIA, 2010; Napi, 2010a). EMU membership could hypothetically be regarded as a security framework for public finances thus an alternative policy idea (point b), as it necessitates that member states contain their debts and budget deficits. The case of Greece has however shown that, as a matter of fact, the euro does not protect its users from debt crises. Countries such as Ireland, Italy, Spain and Portugal had remarkable debt ratios in 2009, of which the international press has expressed its concerns (Bloomberg, 2010; Reuters, 2009; The New York Times, 2010). Even Germany’s public debt-to-GDP ratio rose to a record high of 77% as a result of fiscal expansionary policies (CIA, 2010). As a result, the EMU in its current form is no effective alternative policy idea to sterling, as it does not provide credible and feasible prescriptions (point c).

Related to the Greek debt crisis, calls for stricter fiscal rules and a common European regulatory body overseeing government expenditures have been articulated (Napi, 2010b). Should a proliferation of debt crises occur in Europe, such a measurement might prove an alternative policy idea (point b) in the Walshian sense (point c), whose implementation, however, would pose significant transaction costs, as it would require the amendment of the Lisbon Treaty signed and ratified by each member state separately. What is more, the British are actually ahead of the continent in terms of setting up such a regulatory body. In September 2008 David Cameron, leader of the Conservative Party and Leader of the Opposition in the UK said that he would set up an independent organisation, the Office of Budget Responsibility, to monitor public spending (BBC, 2008b). In December 2009 the Conservatives, who have a chance to win the 2010 general elections, decided to launch it in shadow form (BBC, 2009b). The establishment of the Office of Budget Responsibility in the case of a Conservative victory, then, will be but a minor amendment of the current monetary regime in the UK, rather than a policy change. And even if a common European framework might prove more unrelenting thus more effective than a fragmented and incomplete net of national watchdogs in controlling member states’ public finances, this idea goes far beyond the limits of a paper that attempts to focus on short-to-medium-term developments.
The question whether Britain’s current monetary regime has failed as a consequence of the recent crisis is more than undecided. Time will play a major role in giving an answer to this question and current trends suggest a no rather than a yes. As hinted above, the current resurgence of Keynesian macroeconomics cannot be regarded as a change in monetary policy. Nor does the EMU in its current form seem to present a real alternative in the Walshian sense.

What, then, could be a real alternative? As Walsh (2007) puts it, there usually exists a plethora of alternative policy ideas. The current state of affairs suggests that, should a monetary policy change occur, it will not involve the euro. Therewith the central question of this paper is answered, yet a brief outlook is worth being offered. In order not to overcomplicate the rest of the analysis, consider the main features of Britain’s current monetary regime. It is characterised by

1. participation in the EU single market and
2. non-participation in EMU
3. thus maintaining monetary sovereignty and flexible exchange rate via independent central bank.

Apparently, there are three scenarios for policy change. The first scenario is quitting the EU, which, to an extent, sets out limitations to monetary policy, e.g. competitive devaluations are outlawed. Such a scenario is unlikely to ensue as no single country has ever quit the EU. Moreover, as the survey shows, the majority of British people are in favour of EU membership (see Appendix). The second scenario, which features EMU entry, has already been disqualified. The third scenario is to withdraw central bank independence and apply a different domestic monetary policy, while staying within the limits of the EU. Such may be the adaption and adoption of a monetary regime similar to a hypothesised Islamic economic system that prohibits or discourages interest-based speculative enrichment, a major feature of the subprime mortgage crisis. The relevance of point d has not yet been emphasised. The prospect of the prohibition of interest and the notion of Islamising the British economy, however, would in all likelihood unite rather strong lobby groups in favour of the current monetary system.
Conclusion
This paper has shown that the euro–sterling debate is very much alive and the labyrinth of reasoning either for or against the euro has been complemented by some new arguments, thanks to the present-day crisis. Time and again one might find statements deployed by the two sides that fundamentally contradict each other. Therefore it is hardly possible to objectively take sides. To circumvent this dilemma, this paper adopts Walsh’s (2007) methodology to predict policy switch. Some historical crises such as the Wall Street Crash were compared to the late 2000s crisis. As a result, a number of similarities between the Wall Street Crash and the subprime mortgage crisis have been discovered. Differences in the outcomes, however, seem to outweigh similarities in the structural origins, as the recent crisis has not induced a protectionist cataclysm, featuring “beggar-thy-neighbour” policies such as competitive currency devaluations, comparable to that of the 1930s. Having implemented Walsh’s model on monetary policy change – which says switch is likely when the extant policy fails, an alternative policy idea exists, which explains the reasons of the recent failure and provides prescriptions, and which is not rejected by public sentiment – it has been found that the current economic environment is an unsatisfactory substratum for Britain to adopt the euro, as the EMU in its current form represents by no means a superior policy compared to sterling, for it does not provide distinct prescriptions for handling the economy.
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Appendix

Figure A.1 – Survey on British attitudes towards the euro. Statement rated: “EU membership is favourable for Britain.”

Figure A.2 – Survey on British attitudes towards the euro. Statement rated: “The EU will collapse in 10 years.”
Figure A.3 – Survey on British attitudes towards the euro. Statement rated: “I expect British Euro membership in 5 years.”

- Strongly Disagree: 24%
- Disagree: 10%
- Agree: 9%
- Strongly Agree: 57%

Figure A.4 – Survey on British attitudes towards the euro. Statement rated: “I expect British Euro membership in 10 years.”

- Strongly Disagree: 38%
- Disagree: 12%
- Agree: 10%
- Strongly Agree: 40%