A History of Indecision: Examining the Stalemate in British EMU Policy

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"God is opposed to Britain joining EU's single currency"

-Headline in the Daily Telegraph May 14, 2001[1]

The United Kingdom's decision not to join the European Monetary Union has been the focus of many scholars, and sarcastic Daily Telegraph writers, in the last decade. While God may not be to blame, the perpetual unresolved nature of the EMU issue in Britain could lead some to believe that this is the case. From Prime Ministers Margaret Thatcher to Tony Blair, no British political leader has successfully resolved the issue of whether or not Britain should embrace deeper European integration through adopting the single currency, or whether the country would benefit the most from maintaining their national sovereignty above all else.

Many scholars have examined Britain's decision not to join the Euro zone, but this body of work has largely focused on identifying the economic incentives and disincentives to join the EMU, and discussions of whether or not adopting the Euro would be economically advantageous for the UK. While this work has been important in analyzing whether adopting the Euro is economically viable, the current literature fails to address what combination of political factors have kept Britain from overcoming the same economic hurdles faced by current EMU members. While the idea of a single currency never promised instant economic rewards for any European country, the commitment to European integration by EMU members allowed them to reach a political consensus on implementing the single currency. As a result, this paper will argue that the mixed economic signals from the Treasury's Five Tests do not provide the British populous with clear cues on the EMU issue, and as a result the policy choice is essentially *political* rather than economical. Like current EMU members, in order to chart a long-term resolution on whether or not to join the euro zone, the UK must find a political compromise to balance the domestic distribution of policy preferences.

1 ? Carey & Burton, *The Influence of the Press*, 623.

To explain why Britain has been unable to overcome the political hurdles necessary for EMU membership, the paper will argue that evolving party platforms on the EMU issue, heterogeneous party preferences, and the First Past the Post (FPP) electoral system, have all resulted in the inability of the British political elite to broker an agreement on Euro policy. This lack of leadership has resulted in the devolution of decision making power away from British political elites, and through a national referendum on the issue, back into the hands of the famously Euroskeptic British population. Without the ability of elites to broker coalitions on the national level, and over rule the skepticism of their constituents, no progress has been made towards a definitive EMU policy stance. With largely Euroskeptic views, and without significant cues from political leaders or economic indicators, the UK's voter driven EMU policy model has left little hope of a referendum resulting in a decision to adopt the Euro.

Because this paper is interested in a long term resolution of the Britain-EMU issue, it will also discuss whether the currency policy is a stable equilibrium, or if remaining outside the euro zone could produce negative economic or political consequences that would propel the UK into the EMU with or without the approval of the British public. The entrenched viewpoints of the British public, combined with the lack of political leadership on the part of Parliament, suggest little future impetus for change. But based on recent developments in international financial markets, it appears that the biggest threat to the UK status quo could come through a threat to their dominance as a European financial center. As the need for central bank coordination has become more apparent due to the sub-prime market's international effects on liquidity and financial stability, central coordination within the European Central Bank may become a more palatable, and viable economic policy. As a result, changes to the current financial market structure, as indicated by recent events, create the most likely scenario for both the British public and Parliamentary leadership to embrace EMU membership.

EMU Policy and Economic Analysis

When tracing the UK's history with attempts at monetary union, it becomes more evident why British leaders initially concluded that the most reasonable approach to EMU policy would be to evaluate membership based on economic considerations. Questions about the UK's involvement in monetary union originated before the creation of the EMU, and instead started in the 1970's when Britain faced the decision of whether or not to submit its economy to the financial restraints of the European Monetary System (EMS). In March 1979, The EMS had been launched with the goals of achieving full monetary union and establishing a union-wide central bank. From January 1987-September 1992 a great deal of macroeconomic convergence among EMS member states occurred, and confidence in the monetary experiment grew.[2] As part of the Exchange Rate Mechanism (ERM) included in the EMS, the members' currencies were set to the German deutschmark using an adjustable peg. This meant individual countries could adjust their exchange rates as economic indicators, such as GDP, diverged, but only within a narrow exchange rate band. As the anchor of this system, Germany's central bank was not subject to the same restraints of the adjustable peg, and in times of downward business cycles had greater freedom to keep their monetary policy in line with domestic preferences. Other ERM members, however, had to depend on the decisions of the Deutsch Bank to dictate important monetary levers such as the interest rate.[3] While this system put restraints on ERM members' domestic

2 [?] Salvatore, *The Common Unresolved Problem*, 24.
3 [?] Heisenberg, From the Single Market, 242-3.

policies, which would also be required of Britain as a member, these sacrifices were necessary in order to eventually move towards the goal of a single unified currency.

During the 1980's, Prime Minister Margaret Thatcher was consistently questioned about whether the UK would join the ERM. After the macroeconomic instability experienced in Britain over the previous 20 years, the main attraction of the ERM was its potential to provide external exchange rate-discipline through the historically more stable deutschmark. John Major eventually convinced Thatcher to join the ERM in 1990—a decision she later regretted—and when Major became Prime Minister at the end of that year he brought a much more pro-European attitude to the government and famously vowed to put Britain at the "Heart of Europe." Even so, when signing the Maastricht Treaty in 1991, Major insisted on a clause that would allow Britain to opt out of any future plans for full European monetary integration. As one of the least Euroskeptic prime ministers in British history, Major's ambivalence was a sign to come of the UK's future hesitation on EMU-related policies.[4]

[4] [?] Gamble and Kelly, *Britain and EMU*, 102.

But the Prime Minister was forced to dramatically shift his policy after September 16, 1992, on what became known as "Black Wednesday." Prior to this fateful day, the United Kingdom had been in a deep recession as a result of a demand shock that was affecting all of Western Europe except for Germany. Fresh from the unification of the East and West, Germany's central bank was still dealing with high inflation as they restructured their economic policy.[5] As a result, the German central bank would not respond to the recession occurring in the rest of Europe by lowering interest rates, and the UK economy suffered greatly. Britain's membership in the ERM meant that political leaders had to wait for the recession to go away naturally—a decision that can be extremely costly for any democratically elected government. Major decided to pull Britain out the ERM in September 1992 and the UK subsequently became the first large European country to pull out of the recession. Major attributed the UK's rapid post-recession recovery to Britain's greater flexibility in domestic monetary policy. No longer restrained by the adjustable peg, British leaders could take the needed economic steps to combat the retraction in their domestic economy.[6] While Major had championed membership in the ERM, the Black Wednesday crisis demonstrated to the whole country the perils of losing the ability to use domestic mechanisms to adjust to asymmetric shocks.

5 ? Heisenberg 243.
6 ? Salvatore, *The Common Unresolved Problem*, 26.

After Tony Blair's election in 1997, and the launch of the so-called "New Labour," the UK's leadership became strongly pro-European. But although he favored closer relations with Europe, Blair still promised to only take the UK into the EMU if a national referendum passed. Despite his Europhile zeal, the Black Wednesday crisis and the EMS disaster had taught the whole country to be cautious when surrendering British sovereignty over the domestic economy. Although in the 1980's joining the ERM was considered a way to stabilize the volatile British economy, since leaving the EMS the British economy had become more stable than the ERM bloc, with lower levels of inflation, unemployment, and economy volatility. [7] Consequently, the argument that Britain needed to join an external currency arrangement to ensure financial stability was much less compelling that it had been previously, and it further contributed to the need for economic qualifications to be met before the UK joined the EMU. In the end, Britain opted out of joining the first wave of EMU members, and the UK Treasury imposed five economic tests that needed to be passed before a national referendum on the issue would be considered. The tests are as follows:

i) Are business cycles and economic structures compatible so that Britain could live comfortably with euro interest rates on a permanent basis?
ii) If problems emerge, is there sufficient flexibility to deal with them?
iii) Would joining the EMU create better conditions for firms making long-term decisions to invest in Britain?
iv) What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly in the City's wholesale markets?
v) Would joining the EMU help to promote higher growth, stability, and a lasting increase in jobs? (Gamble and Kelly 98).

[7] [?] Gamble and Kelly, 103.

Clearly, ERM membership had taught Britain to be cautious about surrendering too much economic sovereignty too soon, and the consequences that could result in losing the flexibility to conduct independent macroeconomic policy. At the same time, Britain had to acknowledge that as a member of the EU, and a signatory to its treaties, it would be subject to the broader process of EMU. The effects of this process would be seen in changes to important trading partners' monetary, fiscal, and employment policies, all without the UK having a significant say in these decision as a non-EMU member.[8] But since the disastrous ERM experience, British leaders have been cautious to include Britain in any European scheme that may hurt the health of their national economy, while depriving them of effective domestic remedies to deal with potential downturns. As a result, at the time, assessing the EMU based on *economic* tests, rather than resolving domestic *political* tensions, seemed like the most viable policy route towards brokering a solution.[9] Consequently, the tests proposed by the Treasury represented a way for Britain to be more confident this time around that becoming an EMU member would result in economic benefits, unlike the disastrous ERM experience.

8 [?] Gamble and Kelly, 93.
9 [?] Heisenberg, 248.

But as of June 2003, the UK Treasury reported that only one of these tests had been sufficiently met, and thus "the time was not yet right to push for EMU membership."[10] Although the high costs of EMS membership in the previous decade had indicated that EMU entry must be evaluated based on economic qualifications, using the economic tests as a litmus test for EMU membership has failed to provide clear cues, to the British public or the political leadership, on whether or not adopting the Euro is the best policy choice. Without a clear consensus from economists or financial experts, the Treasury's Five tests have been unsuccessful in brokering a long term resolution on the EMU issue based on economic considerations, and instead a political solution must be brokered to end the EMU policy stalemate.

To begin with, when evaluating the underlying economic factors in the Five Tests, economists must consider the existence of trade-related transaction costs. When trading with fellow EMU members, adopting the euro would eliminate the transaction costs of currency-exchange, but EMU membership would also require the massive cost of overhauling the British financial network to a euro-based system. The logic behind the benefits of eliminating transaction costs is that joining the euro zone would eliminate the need for currency exchanges between pounds and euros, and would thus save resources reflected in the margins of currency dealers who perform the exchange transactions. In a 1999 survey by the European Commission, however, it was shown that eliminating these transaction costs for countries with advanced banking systems, like Britain, would only result in savings of 0.1 percent of GDP.[11] The estimated savings are so low because hand-to-hand currency exchanges mainly involve tourists traveling in between countries. In the technological modern world, financiers wishing to exchange currency through a banking institution can make transactions across borders with a

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10 ? Heisenberg, 248.
11 ? Minford, *Britain, the Euro, and the Five Tests*, 76.

click of a button online, and any costs associated with exchanging currency are virtually eliminated. As of 2004, the estimated .1 percent GDP savings from eliminating transaction costs would have resulted in a 1 billion pounds savings for the British economy.[12] But in the last nine years (from 1999 when this percentage was calculated,) technology has rapidly increased and the percentage effect on GDP as a result of transaction costs has also diminished. At the same time, the cost associated with having to change over ATM software, accounting systems, and other financial tools of the British economy, would amount to a cost of 30 billion pounds (according to a 2000 study by the House of Commons Trade and Industry Committee.)[13] For the purpose of a cost comparison, it would take 30 years for the reduction in transaction costs in 1999 terms (which would likely be overstated in today's more technologically advanced world) to make up for this one-time technology switch over cost to Euro-compatible equipment. As a result, it appears that as technology in the banking system increases, the transaction cost argument in regards to Euro adoption becomes increasingly less viable. This conclusion provides one source of economic opposition to British EMU membership[14]

But assessing the economic benefits of EMU membership based on the Five Tests becomes more complicated when considering the potential rewards from increasing transparency in price comparisons. In theory, improvements in price transparency will make it easier to compare prices between the UK and mainland Europe because Euro-Pound exchange rates will not obscure differences between prices. Therefore the consumer will benefit as prices converge in response to a producers' weakened ability to price distort in different markets. Some economist dismiss this argument as invalid because the UK does not share any land borders with the rest of Europe, and therefore people on either side of a border are not constantly engaged in

12 ? Minford, 77.
13 ? Ibid., 77.
14 ? Ibid, 76-8.

price comparisons[15]. While this argument may have been more salient a decade ago, technological changes have revolutionized how consumers conduct price comparisons. Today consumers can compare prices across borders simply by logging on to a company's website. As a result, other economists argue that improvements in price transparency are an economic incentive for Britain to join the EMU. According to these economists, transparency of price comparisons across borders encourages less market-distorting behaviors on the part of firms (such as price discrimination.) With less market distorting behaviors presents, the likelihood of the "law of one price," where identical goods sell for the same price everywhere, is more likely to hold among EMU countries. One illustration of this point is the case of the annual IKEA catalogue. The Swedish household furniture retailer sends out catalogs to all the members of the EMU, and the catalogs are all exactly the same apart from the language used. Because the prices are denominated in the same currency, IKEA loses the ability to disguise price discrimination between countries and is therefore forced to set the prices equally across borders. While the process of total price convergence is often slow, in the long run the possibility of establishing a "law of one price" in Europe, in which the UK could take part as an EMU member, is a powerful argument in favor of adopting the Euro. As a result, the potential benefits of increased price transparency from EMU membership makes the economic incentives for political leaders and British citizens less clear-cut.[16]

Perhaps the most important economic variable to evaluating the Treasury's Five Tests is determining whether or not Britain is part of an Optimal Currency Area with the rest of Europe. Resolution of this question is key to predicting how difficult it would be for the UK to align macroeconomic variables with the Euro zone, and also how its economy would be affected

15 ? Minford, 79.
16 ? Buiter, *Optimal Currency Areas*, 12-16.

during times of business cycle downturns. Traditionally, OCA theory has argued that exchange rate adjustments may be a relatively efficient way to absorb temporary macroeconomic asymmetries between countries. As a result, the rationale for separate currencies for separate states will exist when using exchange rate flexibility to cushion country-specific shocks is still optimal. Mundell's seminal 1961 paper on the subject uses the Western and Eastern portions of the United States as an example. If macroeconomic shocks in the US were more strongly correlated along regions, instead of nationally, it would be logical according to OCA theory, to introduce an "East" and "West" dollar. But because as a rule shocks are nationally consistent in the US, keeping a single currency for all 50 states remains the optimal monetary policy.[17]

In his paper on the UK-Euro question, Salvador Barrios[18] attempts to make the same type of regional comparison as Mundell, but this time in regards to the UK, by using four different econometric models analyzing macroeconomic fluctuations in (1) UK regions, (2) the UK and EU, (3) the EU segmented by individual countries (excluding the UK), and (4) the UK and US. The results of this analysis are important for more than just OCA theory. They also demonstrate how successful euro zone economic harmonization policies, and subsequent monetary and fiscal policy coordination, would be between the UK and the EU. After performing econometric tests, however, Barrios finds that regardless of the time interval assessed from 1966-1997, "intra-UK interregional correlations are significantly stronger than correlations among euro-zone countries, and intra-euro-zone correlations are stronger than correlations between UK regions and euro-zone countries."[19] The data suggests that a relatively low historical business cycle correlation exists between the UK and the Euro zone, while within the UK itself business cycles are highly correlated. Additionally, while business cycles have become more synchronized among euro-

17 ? Buiter, 30.
18 ? Barrios, *A Tale of Two Cycles, 265-292*.
19 ? Barrios, 274.

zone countries, no such trend can be discerned in the relative economic fluctuations of the UK and the euro-zone countries. In other words, the UK is a more optimal currency area on its own then if it were to join with the EMU, and the stronger cyclical convergence within the current EMU suggests that their transition to monetary union was less economically painful than it would be if Britain joined. Consequently, when applying OCA theory the "stubbornly asynchronous nature" of the UK and euro-zone business cycles significantly raises the UK's economic costs of participation in the EMU.[20]

While these results bring an interesting dimension to the UK-euro debate, Willem Buiter strongly disagrees with many of the assumptions Barrios makes. In his paper,[21] Buiter contends that William Mundell's original 1961 OCA theory is seriously outdated. Mundell's work was based on a world with limited financial capital mobility, in which exchange rate adjustments could easily clear any trade surpluses or deficits. The author argues that continuing to apply a theory based on the financial apparatus of the 1960's is seriously misguided considering the rapid flow of capital in today's financial world, and how the globalization of finance dilutes the ability of monetary policy officials to control shocks with domestic remedies. The author refers to this assumption as the "fine tuning delusion".[22] With a high degree of international financial integration, the ability of central bankers to use policy levers to set national interest rates or exchange rates is extremely limited. Furthermore, with such high financial mobility, independent exchange rates more often serve as a source of shocks (for example the Asian Financial Crisis), due to herd behavior and bandwagon effects, than a resource for alleviating them. Consequently, Buiter strongly disputes the merits of maintaining an independent, free-floating currency for the purpose of adjusting to macroeconomic shocks. This argument goes

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20 ? Ibid., 273-6.
21 ? Buiter, *Optimal Currency Areas*, 1-65.
22 ? Ibid., 15.

directly against much of the OCA assumptions Barrios made in his paper, in which he compared the cyclical convergence of regions in order to determine the viability of sharing a currency. Furthermore, it clouds the ability of the British public and the UK Treasury to gauge what type of OCA evaluation will most accurately predict how well the UK economy could align with the Euro zone's macroeconomic cycles in the case of a currency union.[23]

The author concludes that because of this "fine tuning delusion" an updated version of OCA theory is needed, which he calls the *financial integration approach to optimal currency areas*.[24] This new theory of OCA would base shared currency compatibility not on the divergence of macroeconomic shocks, but instead on the basis that all nations linked by unrestricted international mobility of financial capital form an OCA. As a result, the UK is far too small geographically, and far too open financially, to constitute an optimum OCA on its own. The important caveat, however, is that a minimal degree of political integration would be needed to make this OCA viable, otherwise the US, European Union, and Japan could theoretically be an OCA (or eventually the entire world as international financial integration grows.)[25] While Buiter's updated OCA theory may need the input of other economists to make it rival the original version pioneered by Mundell, his forward-thinking approach acknowledges how the rapid evolvement of the global economy has changed the way economists must evaluate the viability of UK-EMU membership. Buiter's more forward-looking theory could also change economic evaluations of the Five Tests. If true, adopting the Euro could be a preferable economic policy in the coming years.

23 ? Butier, 13-17.
24 ? Ibid, 14.
25 ? Ibid, 13-17.

Clearly, the economists who have used the Treasury's Five Tests as a guide for evaluating the economic incentives for British EMU membership have not come close to a consensus. Without agreement between economists or financial experts, the Treasury's Five tests have been unsuccessful in brokering a long term resolution on the EMU issue. After Britain's disastrous ERM experience, assessing the EMU based on *economic* tests, rather than resolving domestic *political* tensions, seemed like the most viable policy route towards brokering a solution. But this has not proven to be a successful strategy. The many conflicting evaluations of the Treasury's Five Tests amongst economists have served as a justification for Britain's ambivalence to EMU membership, instead of leading towards a long-term policy course—either for or against EMU membership. Consequently, instead of evaluating joining the euro zone based on economic considerations, a political solution must be brokered.

Political Leadership and the EMU Stalemate

Because of the mixed economic signals that result from evaluations of the Treasury's Five Tests, the UK must focus on brokering a political resolution for EMU membership. The distribution of preferences within parliament is often the starting point for evaluating EMU policy from a political angle. This section will highlight the impact on EMU policy of party platform heterogeneity, the FPP system, and the formation of non-party fringe groups. The effective reversal of the platforms of major political parties during the 1980's and 1990's, which was then followed by a period of intra-party division, helped provide the conditions under which voter preferences to the EU were less constrained by elite signals, and instead were formed independently of political lobbying. This section will also argue that even without the divisive personalities of Prime Ministers like Margaret Thatcher and Tony Blair, the UK's First Past the

Post (FPP) electoral system naturally encourages heterogeneous party preferences and the formation of non- party fringe group, which reduces the ability of Members of Parliament to form political coalitions on EMU issues. Analysis of these variables is important because it demonstrates why British political leaders have been unable to broker a solution on EMU policy on the national level, and how this failure has resulted in the devolution of power away from political elites, and into the hands of the British public through a national referendum.

The conservative party, under Margaret Thatcher, had the first opportunity to take a definitive position on the single currency issue. Thatcher was also the first Prime Minister to learn that her policy positions on Europe would not easily translate to changing the attitudes of the British public. As a long-tenured Prime Minister Thatcher had the opportunity to set the tone for British policy on EU questions.[26] In the 1960's and 1970's, public support of European issues in general were highly volatile, and this lack of entrenched viewpoints gave Thatcher, who held strong views on Europe even before she was elected, an opportunity to put her stamp on European policy.[27] Voter preference volatility on European issues was frequently seen in polling data. For instance, in 1975 a referendum on continued British membership was successfully, and easily passed. But only four years later, Gallup polling showed 60-percent of the British population would now vote to withdraw from the community, a reversal of the 1975 referendum outcome.[28] Coming into office in May 1979, Margaret Thatcher had the advantage of dealing with a British public whose opinions on EU-related issues were willing to be shaped and molded by her own viewpoints. As a result, the Conservative party has the opportunity to make EU integration issue an elite-driven process without much grassroots opposition.[29]

26 ? Rasmussen, *What Kind of Vision Is That?,* 111-2.
27 ? King, *Britain Says Yes: The 1975 Referendum*, 25.
28 ? Ibid.
29 ? Rasmussen, 115

Thatcher had early success in molding public opinion. In public opinion surveys from 1980-85, the British public seemed to have coalesced around Thatcher's viewpoint, which during this period was accepting EU integration while valuing UK sovereignty above all else. The Conservative party was openly Europhile during the 1970's, but became increasingly Euroskeptic as Thatcher's term progressed.[30] Unlike the previous decade, public opinion was no longer swinging back and forth wildly between strongly positive and strongly negative viewpoints. Instead, consistently less than half of voters said they would be saddened if the UK were to withdraw from the EU. Additionally, the number of "I don't knows" in the polls had shrunk from highs of 40-percent of respondents, to only an average of 6-percent. Early on in her tenure, Prime Minister Thatcher seemed capable of transmitting her more Euroskeptic viewpoints, a Conservative party shift from the party's platform in the previous decade, to the British public.

But as Thatcher's term progressed, her ability to reign in British public opinion quickly dissipated. This change in Thatcher's power over voters is evident when correlating yearly survey data results with the timing of important national political events. In the May 1983 elections the Conservative party supported continued European Community membership, while the Labor leadership supported EC withdrawal. Based on their pro-EC platform, the Conservatives won significant gains in Parliament during this election. Shortly after the election, UK viewpoints became positive towards the EC, with a small, but meaningful majority of voters supporting continued EC membership. But the Conservative party's support of the EC did not successfully change the opinions of British voters past a short time frame around the election. Consequently, weakly positive EC viewpoints in May 1983 were quickly reversed in July 1983 to more strongly negative viewpoints. While voter's support of the conservative party's pro-EC

30 ? Ibid.,112.

platform during the election indicated that they now held more strongly pro-EC views, in the long run, voters held on to their own independent, more negative views, after the election cycle had passed.[31]

This trend of voter independence continued as Thatcher's decade in power progressed. Thatcher and the Conservative party she led, which had just recently campaigned for continued EC membership, began voicing an increasingly hostile take on the EC and its encroachment on UK sovereignty. In her infamous "Bruges Speech" in September 1988, Thatcher proclaimed "[w]e have not successfully rolled back the frontiers of the state in Britain only to see them reimposed at a European level, with a European super-state exercising a new dominance from Brussels." [32] Following this resolute proclamation, opinion survey data briefly supported Thatcher's more aggressive tone on European issues. But just days after the speech, public approval of Thatcher's overall handling of European issues had slipped to levels of 5-percent.[33] Although Thatcher tried to move her party to a more skeptical position on Europe, by ratcheting up the aggressiveness of her policy position, she only served to distance herself further from the British mainstream, instead of galvanizing the public to support her altered policy stance. As a result, Thatcher failed to successfully transmit her views on Europe to her constituents, indicating the independent spirit of the British public in making their decisions on Europe free from the influences of political elites.[34]

Disentangling Thatcher's views on Europe—from supporting continued EC membership, to her vehement Bruges Speech, to later hesitantly going along with John Major's proposal to join the ERM (as discussed earlier)—is indicative of the Conservative's party inability to take a hard line as either Euroskeptics, or EU and EMU supporters. While public opinion in Britain

31 ? Rasmussen, 113
32 ? Ibid, 116.
33 ? Ibid, 118.
34 ? Ibid.

became rather entrenched along a decidedly Euroskeptic line after the volatility of the early decades of the EU, the failure to adopt a consistent viewpoint on European issues also had consequences for the party, as evidenced by Thatcher's inability to transmit her views on EU issues to the public. Thatcher's failure to transmit her views to the public on EU issues, which frequently changed from accommodative to extremely hostile, demonstrates that the lack of a coherent policy platform can disrupt the ability of political elites to control the direction of public opinion and party support.[35]

The Conservative Party had been experiencing an evolution of party preferences since Thatcher first took office. While the Conservative party had been originally composed of members from elite sectors of British society, beginning in the 1960's the party became increasingly less driven by social rank, and instead membership was based on a shared set of preferred ideological and programmatic positions. By 1992, Prime Minister John Major, Thatcher's successor, was faced with the decision to ratify the historical Treaty of the European Union, now commonly known as the Maastricht Treaty. The treaty contained the controversial Social Chapter (which the UK negotiated an "opt out" option for) and also the timetable for a single European currency and monetary union. Most observers, whether they welcomed it or not, saw Maastricht as a milestone for European union federalism. But the ratification of the treaty in Parliament, with the single currency timeline intact, ignited a rebellion among Conservative party members who opposed Major's pro-Maastricht position. In effect, the issue of ratifying the Maastricht treaty exposed a major fault line in the Conservative party. Under Thatcher and Major, three-quarters of new members in Parliament came in as Euroskeptics. This change in the party's EU policy stance stood in contrast to the old school Conservatives of the pre-Thatcher era that had held largely Europhile viewpoints. As a result, as the 1990's

35 [?] Evans and Butt, *Explaining Changes in British Public Opinion*, 180.

progressed, the issue of the single currency under the Maastricht Treaty served to expose important divisions within the Conservative party on the EMU issue.[36]

The lack of Conservative party unity has important consequences for their relationship with constituents. When utilizing British Election Panel Studies (BEPS) from 1992-1996, it is evident that the Conservative party struck an inconsistent tone with voters during Major's tenure as Prime Minister. The BEPS consist of stratified random surveys with repeated interviews of the same set of respondents over a five-year period starting with the British Election survey in 1992. Most useful for this paper are voters' answers on issues of European integration, and the positions voters attribute (pro- or anti-European) to the major political parties. What emerges from analysis of these surveys is that the Conservative party would have benefited the most electorally from taking a *unified* Eurosceptic position—from the party leadership down to every MP—in order to best align their viewpoints with the British public.[37] But due to the Conservative party's lack of unity on the European issue, their party's position was sufficiently polarized to offend both Euroskeptics and Europhiles simultaneously. The result, as demonstrated by the BEPS survey results, was a party that lost power over their own party's supporters on the European issue. [38]

This observation is demonstrated by taking into account voter's perceptions of political parties position on European issues, and then matching that with their own political (Conservative, Labor, or Liberal Democrat) self-placement politically. From 1992-1996, it was found that conservative party supporters increasingly identified themselves as anti-integrationists. Indeed, across political parties, both Conservative and Labour party supporters identified themselves as anti-integrationist more and more during this time period. Although in

36 ? Berrington and Hague, Europe, *Thatcherism and Traditionalism*, 44 - 71
37 ? Evans and Butt, 575.
38 ? Ibid., 589.

principle the Conservatives had been taking an increasingly anti-integration line since Thatcher's tenure, Prime Minister Major's pro-Maastricht stance confused many in the party. Consequently, Conservative supporters did not view the party as completely Euroskeptic in their policy positions. During these years Conservative supporters believed that their party's position on Europe was *further away from their own* position more than five times more frequently than Labor supporters when asked the same question. Heterogeneous policy preferences in the Conservative party resulted in the failure to build public support because voters did not know where the whole party stood on the issues. The Conservative party would have most benefited from taking a unified Euroskeptic position, in line with public opinion, but instead fractions within the party on European issues compromised this unity. Voters who did not know where the Conservative party really stood were less constrained by party signals when forming their own viewpoints on the Maastricht treaty and other European issues. [39]

This Conservative party split has significant consequences for the party's failure to make headway on more firmly resolving Britain's place in the EU. The failure of Prime Ministers to rally the British public around their own personal views on European integration, as evidenced by the experience of Margaret Thatcher, combined with the Conservative's inability to form a unified party message, has resulted in the British public shaping their opinions on EU issues independent of political racketeering. Building public support can be near impossible if polling data shows that the UK population does not have a clear idea of where a political party stands. Without the public's support behind them, the result has been the historical failure of Conservative party leaders to make definitive steps towards resolving the issue of EMU, and the subsequent stalemate in political forums on adopting the common currency.

[39] ? Evans, 589.

Since Major's tenure ended in May 1997, however, it is has been up to the Labour party to direct the political elite on the single currency issue. By 1997 it became clear that the once Eurosceptic Labour party had reversed course and had began championing the positive aspects of what integration could do for British industry and workers. The Labour Party argued that if British trade and financial sectors grew as a result of closer ties with Europe, every day British citizens, the party's base, would benefit through a more robust UK economy. [40]

This Europhile outlook represented a stark break from earlier Labour party platforms. In 1975 Labour party leaders opposed Britain even remaining in the European Community, let alone joining a currency union, while Conservative party members under Thatcher advocated that the UK should not leave the EC. Furthermore, the 1987 manifesto claimed that continued EU membership would prevent the Labour government from pursuing "radical, socialist, policies for reviving the British economy."[41] But ten years later, the Labour manifesto now advocated that "Britain has to be European, not on the margins but right at the center of Europe[…]cooperating, engaging and leading" in the EU.[42] Within a two-decade time span the Labour and Conservative parties had effectively switched their EMU policy preferences. Still disenchanted from the ERM crisis, 66-percent of Conservative MP's *agreed* "Britain should never permit its monetary policy to be determined by the ECB." On the other hand, 65-percent of Labor party MP's *disagreed* with this statement, and supported the common currency. While voters had previously been confronted with a Conservative party divided along Euroskeptic and Europhile lines, it appeared that the new Labour party position reflected a unified outlook on the UK's place in Europe.[43]

40 ? George, *Britain: Anatomy of a Eurosceptic State*, 25
41 ? Heffernan, 180.
42 ? Ibid., 17.
43 ? George, 25.

Indeed, from the time Tony Blair took office as Prime Minister it was clear that the Labour party meant to strike a different tone on the issue of EU and the EMU than the Conservatives. Within two weeks of the 1997 British general election, Blair's new Foreign Secretary, Robin Cook, had issued a foreign policy mission statement that included the aim of making the UK a "leading player in the European Union of independent nation states."[44] For his part, Tony Blair announced that the British government should "share the goal of a constructive partnership of nations in Europe."[45] The determination of the new government to be a leading player in the EU raised the question of whether Britain would lead in a direction that most of the British citizenry did not want to take, or whether they could promote and gain public support for a new approach to EU policy.

In an attempt to bring public opinion over to the Labour side, Tony Blair engaged in an active campaign to change the dialogue on European integration within the British populous. In his February 1999 speech to the House of Commons, Blair proclaimed, "to be pro-British, you do not have to be anti-European."[46]   The Blair government wanted to promote their desire to preserve national autonomy and sovereignty whenever possible, like the Conservatives, while also accepting that greater EU unity could be beneficial to Britain. This outlook embraced "pooling" sovereignty, rather than "surrendering" sovereignty. It also acknowledged that any British political party must govern against the background of Europeanization. This includes the impact of globalization on the UK economy, as well as the pursuit of national interests and preferences through interstate bargaining within European institutions. Under the leadership of Tony Blair, the Labour party had launched a clear public relations campaign to change the dialogue on European integration issues, while attempting to convince the British public that

44 ? Hughes & Smith, *New Labour-New Europe?,* 93.
45 ? Ibid., 93.
46 ? Heffernan, 182.

greater Europeanization was not at odds with British ideals. According to Labour leadership, a closer relationship with the EU would help the UK prosper economically and politically as the forces of globalization propelled the nations of Europe closer together.[47]

But even after this aggressive public relations campaign, from the outset of his term Tony Blair's government failed to persuade voters to come over to the Prime Minister's side. While the government had re-engaged in the idea of European integration, the general was still satisfied with remaining on the sidelines of the EU. Furthermore, the idea of a greater role for the EU in British internal affairs seemed more like a threat, rather than an opportunity, for change.[48] Public opinion polling in 2000 reflected not only a lack of growth in pro-European opinions since Blair's public campaign, but instead a reversal of course to a higher degree of Euroskepticism. According to a Eurobarometer survey data, support for the Euro stood at 36-percent in autumn 1998, shortly after Blair took office. But by July 2000 support for the single currency had shrunk to 22-percent of voters. At the same time, the number of people who stood firmly against the Euro (instead of "unsure," or "don't know") had grown from 55- to 61-percent.[49] Clearly the Labour party had been unsuccessful at persuading a large percentage of voters to reduce their opposition to the EMU, while at the same time failing to keep those who had once been in favor of the EMU from jumping to the other side. While Blair was clearly pro-EMU, appealing to the public on the issue resulted in a loss of support, rather than an increase, for his favored policy position.

As the Conservatives experienced previously, the viewpoints of the British population on European Union issues are not easily swayed to one side or another by Parliament's political maneuvering. The experience of the Conservatives demonstrates that heterogeneous party

47 ? Heffernan., 183.
48 ? Stephens, *The Blair Government and Europe*, 67
49 ? Heffernan, 182.

preferences increase the difficulty of influencing public opinion to change towards the party's preferred viewpoint. Although unified publicly, since 1997 the Labour party has been divided in shifting coalitions between EMU enthusiasts, pragmatists, and skeptics. The party's decision to use the Treasury's Five Tests as a basis for an EMU referendum emphasized the underlying "wait and see" policy of the party, and openly undermined Tony Blair's public displays of Euro-enthusiasm. In contrast to Blair's Europhile zeal, Treasurer of the Exchequer Gordon Brown, the current Prime Minister, set a much different tone on the EMU issue. As the head of the Treasury, and with a clearly influential role in British currency policy, Gordon Brown still remained to be convinced of the merits of EMU membership.[50] As the face of the Labour party Blair was openly enthusiastic about EMU, but other party leaders like Gordon Brown contributed to the underlying skeptical, and sometimes even negative, collection of viewpoints within the Labour party rank and file.

But as his tenure as Prime Minister wore on, even Tony Blair exhibited "euro fatigue." In what was seen as a symbolic change of leadership by many observers, Blair removed Robin Cook, the government's greatest single currency enthusiast, from the Foreign Office and replaced him with the considerably more Euroskeptic Jack Straw. Another pro-euro enthusiast, Stephen Byers, was moved from the Trade and Industry bureau, to one concerned with regional transportation.[51] David Clark, a former special adviser to Cook, publicly attacked the government for these staffing changes. He claimed in *The Guardian* that Downing Street repeatedly prevented Cook from putting forward the case for the euro, or trying to make it a government policy priority. Clark also doubted the veracity of Gordon Brown's promise to put the nation's economic interests first, through a fair and timely evaluation of the Treasury's Five

50 ? Heffernan, 182.
51 ? Baker, *Britain and Europe*, 326.

Tests. As Clark told *The Guardian*, "[i]t was Labor's self-interest that prevailed in […] the famous five tests. The tests may well be economic in content, but *their purpose is political*: to enable Labour to time any referendum to suit its own interests."[52] During this period of discontent, Brown and Blair began to spar in the press about the exact intent of the government's policy on the euro referendum—were they going forward quickly, or willing to wait out a more thorough evaluation of the Five Tests?[53] As Clark had told *The Guardian*, the Labour party's early enthusiasm for bringing Britain into the euro zone began to quickly fade as political maneuvering within the party exposed inter-party factions. In addition, the increasing awareness that the timing and evaluation of the Five Tests was a political issue instead of an economic one, demonstrated that the Labour party as a whole was not unified behind the idea of bringing an expedient referendum to the public.

As shown earlier by the experience of the Conservatives, the result of a party that shows heterogeneous positions in the UK parliamentary system will be a government that polarizes voters on both sides of the political spectrum—Europhiles and Euroskeptics. By establishing a unified policy position among all of its top members the Labour party would be more capable of building their party base around the EMU issue. Without this unity, however, the Labour party has widened the already large gap between politicians, British citizens, and the ability of these politicians to shape British public opinion. Geoffrey Evans and Sarah Butt[54] conducted a study on the connection between voter political party identification and positions on the EMU. Their research found that by the early 1990's, voters' attitudes towards the EMU, and voters' positions on the left-right political scale, were largely independent of each other. This disconnect between EMU positions and party identification could be linked to the dramatic shift in the Euro positions

52 ? Baker, 322.
53 ? Ibid., 317.
54 ? Evans and Sarah Butt, *Explaining Change in British Public Opinion on the European Union*, 173-190.

of the major parties during the 1990's, and the confusing signals this sent to voters. But even after Labour and Conservative positions on EMU became solidified in the late 1990's, this relationship did not correct itself. Although Tony Blair aggressively campaigned for Labour support of the EMU, from 1997-2004 there was no evidence that being left-wing was correlated with being pro-euro. Using multivariate analysis, the authors link this breakdown in Labour voter-party support to the mixed signals sent by party faithful on the merits of European integration. This research demonstrates the significance of weakening cues from political parties for the Euro issue. Without strongly held and consistent viewpoints on euro policy, neither the Conservative party or Tony Blair's Labour party could strongly influence the opinion of their constituents on EMU policy, and the result was a British electorate who determined their viewpoints independent of political party affiliation.

This inability to connect with the British public on European issues is evident when viewing polling results from the beginning of the Labour's party reign of power in Parliament in the late 1990's. From 1997-1998, Tony Blair's enthusiasm for European related policies led to a tremendous growth in polls that asked "What party, Conservative, Liberal, or Liberal Democrat, has the best policies on European issues?" In 1997 only 19-percent though the Labour party did, but by May of 1998, right after Blair's election, this number had skyrocketed to 43-percent. However, by the next year this percentage had already shrunk to 26-percent, and it remained in this range for the rest of Tony Blair's tenure. Strikingly, as of September 2007, only 9-percent of people polled on the same question ranked the Labour party as having the best policies on European issues, while 33-percent thought Conservatives had the better policies on EU issues.[55] This polling data reveals two main political realities. First, it demonstrates the inability of Tony Blair, and other Labour party leaders, to "convert" the British public to their more Europhile

55 ? Ipsos-MORI, "Best Party on Key Issues", 2008.

viewpoint during their time in power. And secondly, the failure of political parties (only 42-percent of the total electorate correlated their views with any party) to mobilize voters behind either of their chosen positions on Europe. In the beginning of Blair's tenure the party's unified pro-EMU position inspired a sharp increase in public support of 23 percentage points. But as more cracks were exposed in the Labor party's EMU platform, the public began to adhere less to their vision of Europe, and instead take a viewpoint independent of party politics.

From this discussion of the two major British political party's evolving views on deepening European integration, it becomes clear that neither side has been able to successfully mobilize the public behind their viewpoint for a sustained amount of time. Heterogeneous party preferences, a lack of party unity, and ever-evolving party positions, has allowed the public to chart their own course on this issue. The Conservatives supported continued EU membership early on, but its leader Margaret Thatcher later became a vocal critic of the EU's grasp on British sovereignty. In the late 1990's Tony Blair became Labour's leading champion for further European integration, but the result of weak party cohesion has been the inability to mobilize voters behind Labour's official EMU policy stance. Polling numbers from 1991-2007 show that consistently only an average of 30-percent of voters would support a Euro referendum even if the *government in power strongly urged it*, while an average of 55-percent said they would still oppose joining the single currency despite the government's position.[56] These polling results shows that neither political party has been able to translate their views on Europe to the general public, and as a result gain more political control over the resolution of the Euro issue.

It could be observed that the fractions within each major British political party are merely a reflection of the ambivalence of the British public as a whole on the issue. But while other populations in Europe have doubted the merits of joining the Euro zone, their governments'

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56 ? Ipsos-MORI, *Joining the euro-with government urge*, 2008

Proportional Representation (PR) systems have allowed them to form coalitions in order to pass legislation on the issue. In Britain, however, the First Past the Post (FPP) electoral system has contributed significantly to the inability of the British government to do the same. Given that the UK is not alone in having a vocal minority hostile to European integration among its electorate, it is important to note how the major domestic power-sharing institution, Parliament, channels pro and anti-European sentiment in a fundamentally different way than in other member states.[57]

In any country, the electoral system acts as the key intervening variable between social preferences and policy outcomes. The electoral system determines which leaders will win, and what positions will gain the most traction in policy circles. Under the FPP system, small parties are penalized and there is a strong incentive for prospective candidates to seek membership with one of the two main parties if they wish to have a reasonable chance of success. At the same time, the party leadership has to accommodate those members with both anti-integration and pro-integration policy positions. This system stands in sharp contrast to the Proportional Representation (PR) model, used in most EMU countries, where it is much easier for those on the fringes to gain election. To be elected those on the political fringes do not have to be incorporated into the major parties, and cohesion among party members is stronger. Members of fringe parties with views on EU integration outside the mainstream can be marginalized, while those in the center form a governing coalition that can push EU legislation through to passage. In contrast, the FPP system encourages major parties to accommodate the diversity of positions on EU integration issues, while at the same time inhibiting the ability to form a united policy platform on EMU legislation. [58]

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57 ? Aspinwall, *Structuring Europe: Powersharing Institutions*, 416-20.
58 ? Aspinwall, 213-4.

In a FPP system, this spirit of accommodation, in addition to appeasing fellow MP's, is also accepted in order to maximize voter support, and not to offend the multitude of EU integration opinions within the general pool of Labour or Conservative voters. But since neither party can accurately represent the diverse view on the EU within its party, a natural tension remains. This tension could be resolved in a split in the party, as it would in a PR system, but in the UK the FPP system makes this choice unlikely because major party affiliation is needed for electoral success. Instead of a party split, what happens in the UK is an *externalization* of the EU debate through third-party interest groups. Free from the constraints of seeking electoral success, these groups can adopt whatever structure and position they feel best represents their EU interests and priorities. The liberty to construct a discourse based around clear costs and benefits to the public —instead of a muddled compromise among major parties—often gives these outside groups a greater chance of their policy positions having an impact on public opinion. The hedged positions of major political parties serve to bewilder voters, but third party groups can provide clear alternatives that mobilize public opinion.[59]

The UK has a long history of anti-European non-party groups, reaching back to the early 1960's. Current anti-EU interest groups within the UK cross party lines and include "Conservatives against a Federal Europe" and "Labour Against the Euro."[60] In the beginning, these non-party groups were inspired by individual political distress rather than general public disquiet.[61] For example, despite the fact that public support for the EU was at a high-point during the time of the Maastricht Treaty, a boom of anti-EU groups occurred during this period. Therefore, in the beginning, many non-party groups are a non-threatening political consequence of the FPP system and the fact that the system does not accommodate viewpoints outside the

59 ? Usherwood, *Opposition to the European Union in the UK*, 219-23.
60 ? Ibid.
61 ? Usherwood, 226.

mainstream. In this way, third-party groups act as an outlet for disenfranchised major party members to express their individual viewpoints on the Euro issue.[62]

But the existence of these non-party groups also has important consequences for already existing divisions within major political parties. While strongly anti-EU political forces were previously not given a voice in the FPP system, mobilization of these interest groups makes party cohesion even more difficult. As non-party groups gain political traction and a media platform, party positions are pulled even wider apart. This process has been demonstrated in practice. Part of the heightened public confusion during the Major administration of 1992-1997 over the party's stance on the Maastricht Treaty was caused by non-party groups controlling more of the dialogue, and pulling Conservative party members further apart on the issue.[63] Additionally, in the run up to the 2001 general election, the strength of Conservative anti-European fringe groups resulted in a concerted effort to select parliamentary candidates with more extreme positions than the official party line, which resulted in a widening gap between EMU positions within the party.[64] As a result, the FPP system forces major political parties to forge a compromise position on the EMU in their official platform, but the tension created by this compromise encourages the formation of non-party groups. These non-party groups serve to radicalize members on the party fringe away from the mainstream, and results in an even greater lack of party cohesion.

Consequently, the FPP system channels more power to the public in deciding on EMU because Parliamentary parties must preserve their need for both voter maximization, by pleasing constituents, and party cohesion, by appeasing diverse MP viewpoints. The compromise position major parties must strike on EMU policy ultimately results in party unity being severely damaged. Additionally, the ability of non-party groups to more efficiently respond to a cost-

62 ? Ibid.
63 ? Evans, 580.
64 ? Ibid.

benefit analysis of the EU issue, instead of presenting a muddled compromise, also makes voters less susceptible to the influence of major political party racketeering. This effect was clearly demonstrated in the 1997 General Election. The Conservatives offered a referendum on the single currency as an attempt to limit the damage on overall party cohesion caused by the Conservative fringe group, The Referendum Party. The Labour party was compelled to offer the same referendum to the public, in order not to lose voters on this issue. As a result, the entire political system was moved to a more skeptical EU position than it had taken before due to non-party group mobilization. In the process, the general public also gained more influence in the issue due to the guarantee of a referendum on the EMU in the UK.[65]

From this discussion of the politics of integration in the UK, the prospects for resolution on the EMU issue appear remote. Euroskeptic voters have thus far controlled the policy outcome, because political parties have been unable to establish unified positions or overcome the limitations of the FPP system. As a result, political elites have not built strong enough coalitions to enact legislation against the restraints of public opinion. The experience of other EMU states, from France to Germany, demonstrates that elites must take the reign of integration efforts in order for any progress to be made on the issue.[66] The Euroskeptic viewpoints of the British public, and the limitations of the UK's parliamentary system, means that without a significant alteration in the incentives for British EMU membership, a change in the current policy track is unlikely. This alteration in the incentive structure could result from macroeconomic shifts that changes the potential economic benefits of EMU membership, or a change in the global landscape that makes political cooperation with Europe more palatable for Great Britain.

[65] ? Usherwood 229

[66] ? Schmidt, *The Politics of Economic Adjustment in France and Britain*, 247-64; Dyson, *European States and the Euro*, 173-188.

Without these kinds of major structural changes, it is probable that the EMU policy will continue on its stalemated course without any long-term resolution.

<u>The Voter Driven Model of UK-EMU Policy</u>

Political elites have ceded control over EMU policy due to the effects of heterogeneous party preferences, the FPP system, and non-party fringe groups. As a result of this devolution of power, British voters have been put in control of the future of the EMU through a proposed national referendum. This puts the outlook for adopting the Euro in a perilous state because of the famously Euroskeptic viewpoints of the British public. As of January 2007, when asked "If there was a referendum today on whether Britain should be a part of a single European currency, how would you vote?", 57-percent of polled voters said they would vote *against* the single currency, while only 26-percent said they would vote in favor of such a measure.[67] The highest level of British public support for the EMU, 33-percent of those polled, occurred in July of 1998 during the peak of Tony Blair's Europhile zeal. In contrast, in the months before the single currency was officially launched, a new high of 60-percent of UK voters were still firmly *against* membership in the scheme. Using polling data from 1990 on (post-Thatcher) these polling numbers have generally hovered around 30-percent of the population supporting EMU entry, and about 55-percent opposing it.[68] The amount of voters answering "I don't know" is also largely entrenched at 15-percent when averaging the quarterly polling data. Clearly, the British public's viewpoints on the EMU issue have remained fairly intractable along Euroskeptic lines, and have proven immutable to political pressures from either Conservative or Labour party leaders.

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67 ? Ipsos-Mori, *EMU entry and EU Constitution*, 2008.
68 ? Ipsos-Mori, *EU/Euro surveys*, 2008.

These polling results also indicate that UK voters will not willingly pass a referendum on the Euro any time soon. This feeling is compounded when considering the most recent Eurobarometer polling data[69] on British citizens general feelings towards European integration. While 48-percent of total EU citizens reported that they trusted the EU governing body, only 25-percent of UK citizens shared this sentiment. Additionally, the UK ranked the highest among EU states for the percentage of respondents, 28-percent, which thought their country's general membership in the European Union was a *bad thing* for the country. Finally, while in the EU as a whole 58-percent of the citizens think that their home country has benefited from EU membership, only 37-percent of UK citizens (more than 20-percent fewer) share this opinion. Comparing this polling data between UK citizens and the general EU population reveals that on the whole the British are clearly more skeptical about European integration efforts, beyond just the specific EMU issue, than the rest of the union's members. This indicates that British government leaders would naturally have a more difficult time persuading the public in favor of EMU than other European governmental leaders whose general population is more in favor of integration projects.

Integration through supranational institutions is traditionally viewed, from scholarly works on intergovernmentalism and historical institutionalism[70], as an elite-driven process that takes place without the restraints of public opinion. But recent research on the specific case of EMU integration has found evidence that contradicts these elite-driven hypotheses. In a 2003 paper by Banducci et al.[71], the authors found that lack of diffuse public support for the EU will have an influencing factor in a country's choice to enter the EMU. Additionally, their findings indicate that the public's willingness to adjust to EMU austerity and changeover measures is

[69] Eurobarometer 68, *Public Opinion in the European Union*, 2007.

[70] For a more detailed discussion of Historical Institutionalism and Liberal Intergovernmentalism please see Moravcsik, *Preference and Power*; and Pierson, *The Path to European Integration*, 123-163.

[71] ? Banducci, Karp, and Loedel, *The euro, economic interests and multi level governance*, 685-703.

directly related to how much importance they place on the EU integration project overall. In countries where the EU is a policy priority, citizens will be more willing to join the EMU even if it causes negative domestic political consequences. For instance, in countries with diffuse support for the EU, citizens are more likely to support adopting the common currency even if it is not in their own economic self-interest. This has clearly not been the case among the UK citizenry, as indicated by the required evaluation of the Treasury's Five Tests. Additionally, the authors find that EU citizens are more likely to accept a European-wide currency when their own national currency has performed poorly (notably, this variable was significant at the 1-percent level.) Currently, the British Pound Sterling is trading at nearly twice the value of the US dollar, and is also stronger than the euro, with an exchange rate of 1.24 €/£.[72] By combining the importance of the national currency's strength and the lack of diffuse EU support within the UK, the Banducci et al. model does not predict a favorable outcome for British EMU membership.

The Banducci study explains how a lack of public support for the Euro can be a determining factor for a country's EMU membership outcome, but this paper does not address what factors have made the British population so Euroskeptic to begin with. Kaltenthaler and Anderson[73] more specifically address this question, and they find that when determining public support for the European common currency, three variables will be most influential: national identity, national economic performance, and general support of the EU integration project. The significance of a "general EU support" variable in this study serves to confirm the importance the Banducci et al model put on diffuse public support. The two remaining variables, national economic performance, and national identity, are also especially applicable to the case of UK-

[72] *Benchmark Currency Rates*, Bloomberg, 2008.
[73] Kaltenthaler, KC & Anderson 2001 *Europeans and their money: Explaining Public Support for the Common European Currency*.

EMU policy. Although much of the pre-Euro debate focused on the fact that Britain could not thrive economically outside of the EMU framework, as of yet the failure to adopt the euro has not damaged the British economy. In December 2000, two years after the introduction of the euro, Britain's quarterly growth rate was 3.1-percent, compared to 2.7-percent and 2.9-percent in Germany and France respectively. The UK inflation rate also hovered around 1.5-percent, compared with 2.75-percent for the euro zone. Even trade with the euro zone had moved into a small surplus during this two-year period, despite the strength of the sterling and the weakness of the euro.[74] Since then, the British economy has not faltered, with fifteen years of uninterrupted growth as of 2007, even while the euro zone has gotten over its initial growing pains and now is recording record highs in exchange rate values. Currently, the UK is experiencing GDP growth around 3-percent, while France and Germany's growth varies between 2-2.3-percent.[75] The economic indicators suggest that while Britain has not surged ahead of the euro zone as a result of maintaining the pound as a national currency, it has not faltered either, and most significantly has avoided any period of economic recession for the last decade. At the same time, the British have not been subjected to the national political costs of implementing EMU austerity measures. This fact, compounded with the mixed signals coming from evaluations of the Treasury's Five Tests, provides little impetus for a change in UK public opinion polling when considering the significance of national economic performance in the Kaltenthaler and Anderson model.

Britain's historical struggle to define itself as a country also relates to the significance of the "national identity" variable in this model. The authors find that national identity will have a negative influence on public support for the Euro if a country characterizes itself with a stronger domestic, rather than European, identity. In the winter of 2008, Prime Minister Gordon Brown

74 ? El-Agraa, *The Euro and Britain*, 372.

75 ? *Dismal Scientist Europe*, 2008.

commissioned a contest for a citizen to formulate a definitive slogan for what it meant to be British. Most tellingly, the winning slogan was “No Motto Please, We’re British,” followed by “At Least We’re Not French” and “Once Mighty Empire, Slightly Used.”[76] While the British have trouble defining themselves without sarcasm, the more telling question for European integration efforts is whether the British would ever define themselves outside of national lines, and instead embrace a hybrid British-European identity?

If history can be a guide for answering this question, the outlook would be less than optimistic. The concept of “British Exceptionalism,” based on Brits’ feelings that they are separate and apart from the rest of mainland Europe, has been around for centuries. These exceptionalist feelings have been forged by the natural geographical separation of British territory from mainland Europe, and the political separation between Britain and the continent following the Hundred Years War.[77] While the rest of Europe experienced constantly changing regimes, borders, monarchs, and constitutions, the democratic tradition of the Magna Carta held strong in Britain. This unbroken tradition of parliamentary democracy has encouraged the British public to put a strong value on their national sovereignty, and oppose the infringement of the undemocratic European Commission onto their democratic traditions.[78] Tony Blair even once described Britain as “a proud and independent-minded island race.”[79] Clearly, Britain has historically considered itself as a separate, even sometimes superior, entity to the rest of mainland Europe. One reader’s letter to the Daily Mail in 1997 sums up much of the country’s attitude: “[w]e appear to be one tick away from losing our sovereignty, our independence, and not just the 1,000 years of history, but history from when the first man sought to protect this

76 ? Lyall, *Britian Seeks Its Essence*.
77 ? Ash, *Is Britain European?,* 2-4.
78 ? George, 20.
79 ? Ash, 6.

country from an invader."[80] While it would be an exaggeration to say that all of the British public considers their country "exceptional" to the rest of Europe, the general skepticism towards Europe shown in UK opinion polls, relative to the rest of the EU, reflects the pervasive attitude that the UK is an island nation separate both politically and socially from the rest of Europe. The fact that the British more often identify themselves along domestic lines, rather than European ones, indicates that according to the Kaltenthaler and Anderson model the "national identity" variable will have a negative influence on British public support for joining the EMU.

The Brits' lack of identification with mainland Europe, and lack of commitment to the European project, becomes more apparent when contrasting the experiences of the UK with those of current EMU member, Germany. Britain's tight hold on their national sovereignty has made generating public support for joining the Euro zone difficult, while Germany was so eager to lead the way towards a European Monetary Union that they acquiesced much of their domestic economic controls in the process. During the government of Gerhard Schröder, Germany accepted the Europeanization of monetary policy into their Bundesbank and established the goal of price stability as the most important element of long-term stable growth—a sentiment that holds in the ECB policy mandate today. At the same time, Germany had to humbly admit in the early 1990's that as their unemployment rose, and their growth decreased, that they were no longer the "Model German Economy" that could impose their economic model on the rest of the EMU.[81] Consequently, the road to EMU for Germany became about domestic transformation rather than just accommodation—both structurally and in relation to economic policy. The benefits to adopting the Euro were still very uncertain, but Germany ceded sovereignty over its economy because its people valued leading the way towards a strong

80 ? Ash, 6.
81 ? Dyson, 186-7.

European union of nation states. On the other hand, the UK Treasury's Five Tests demonstrates that they are much less willing to accept any such accommodation in exchange for becoming a more integral member of the European integration project. As a country with an already less than enthusiastic attitude towards embracing the idea of a more integrated Europe, Britain requires concrete reasons—the Treasury's Five Tests—to give up their national currency and claims to sovereignty in monetary issues. While Germany and other first round EMU members proceeded with uncertainty because of their faith in the Europeanization process, the UK public is much less enthusiastic about accepting domestic costs in exchange for greater European rewards.[82]

Comparison between how the single currency issue was handled in Britain, and current EMU members, demonstrates the influence voter-driven policy making can have in Euro zone outcomes. One obvious comparison arises between the contrasting EMU policy outcomes of France and Britain. On the surface, when evaluating recent events, France and Britain are very similar countries politically. Both countries suffered from severe economic crises in the late 1970's and 1980's, and went through periods of deep political division between business oriented neo-liberal reformists and those on the left promoting socialist and collectivist policies. Additionally, both countries have single-actor systems, with concentration of power in the executive and a majoritarian electoral system (rather than the Proportional Representation system seen in much of the rest of Europe.) [83] Many differences become apparent, however, when looking at how EMU policy was handled in these two countries. From the time of Prime Minister Margaret Thatcher, British politicians have needed to legitimize their decisions on EU integration with the general public. For Thatcher European unity represented an opportunity—

82 ? El-Agraa, 371-3.
83 ? Schmidt, 251.

emblematic of her commitment to open borders and open markets—but also a threat to undermine British sovereignty through supranational institutions. When Thatcher's dialogue on Europe turned more strident, as opposed to the stance of the party's pro-business constituency, her abrasive attitude caused her political undoing. After Thatcher's tenure, John Major's accommodating approach to Maastricht Treaty negotiations, and the implementation of a single currency timeline for the UK, led to Major's plummeting approval ratings among the growing movement of Euroskeptic voters in his party. As a result, dating back to the 1980's, public criticism of the handling of European Union policies became an accepted part of the British political dialogue, and public discourse on EU-related issues helped determine policy outcomes.[84]

This tradition stands in sharp contrast to France, where criticism of the EMU and even the EU, had been largely taboo until recently. In the 1980's France needed to find an economic paradigm—socialism or capitalism—that would best promote growth and lift the country out of its incessant economic doldrums. While the Socialists under Mitterand won in 1981 based on a return to neo-Keynesianism, the failure of the Socialists' policies to ignite the economy, or tame runaway inflation, prompted the government to formulate more neo-liberal oriented policies (much like Thatcher in Britain.) But unlike Thatcher, neo-liberalism was not the normal public discourse for the Socialist party. As a result, the policy discussion in France focused mostly on economic necessity, and the need to remain in the European Monetary System for economic stability, rather than publicly acknowledging a reversal in the Socialist party's economic ideology. While this worked in the short term, the Socialist government never legitimized the seemingly illogical contradiction between an emphasis on belt-tightening neo-liberal economic policies and the expansive socialist policies originally advocated by its party platform. The

84 ? Ibid., 257-8.

failure of this discourse was not terribly problematic during the late 1980's when the economy had picked up and social spending continued to spiral upward. But by the 1990's, another economic recession had set in, and EMU austerity measures were requiring a reduction of domestic expenditure spending. Instead of a legitimating discourse in France, that included an extensive cost and benefit analysis, the leadership on both the left and right talked mostly of using European integration as a shield against globalization. The ability of French leaders to join the EMU, without a legitimating public discourse on the economic costs and benefits of this change in economic policy, stands in sharp contrast to the history of public discourse in the UK.[85]

While British leaders had to gain approval of their EMU policy positions through a public discourse, up until recently French leaders did not face such public scrutiny. The obvious difference in outcomes is that France was one of the members of the first wave of EMU members, while Britain still remains outside the system. The importance of public opinion in determining EU outcomes was demonstrated in May 2005 when French voters rejected a referendum on the proposed European Union Constitution. In this vote, farmers, workers, and the unemployed were among those who led to the constitution's defeat. Strikingly, 70-percent of French farmers voted "no" to the constitution, despite the fact that France is the largest recipient of European Union farm subsidies (which greatly supplements the incomes of these same farmers.)[86] The lack of support for the constitution among French farmers demonstrates that without a public discourse to establish the costs and benefits of European integration, the French people were less aware of the benefits, such as farm subsidies, they received through the EU. Furthermore, when given the choice, the French pubic acted as a roadblock to the further

85 ? Schmidt 253-6
86 ? Schiolino, *French No Vote on European Constitution*.

development of EU supranational institutions. For the purpose of this paper, the most important observation is that when the public is given an input on EU integration through referendums, or a legitimating policy discourse with policy elites takes place, the public's opinion can have an effect on policy outcomes. Furthermore, in the case of France, the public was more skeptical of EU integration than political elites. When considering the decision to enter the EMU without French voter approval, this indicates that a legitimizing policy discourse in France before entering the EMU could have resulted in the same policy outcome as Great Britain.

For Great Britain, the policy outcome has been a history of indecision, rather than action, on EMU membership. British political leaders have ceded control on EMU policy to their Euroskeptic constituents, who when compared to mainland Europe, are notably less enthusiastic about their country playing an integral role in the EU or EMU. Historically, the British have felt that they are separate and exceptional to continental Europe, and today the population continues to be skeptical about the merits of deeper integration with the European Union. Adopting the Euro, and losing the Pound Sterling as a sign of British sovereignty, does not seem like a palatable policy option for the majority of the population. By staying out of the Euro zone, the British economy has done just as good, or better, as EMU countries, without the domestic sacrifice of required EMU austerity measures. What emerges from this analysis of the politics of EMU integration in Great Britain is that no long-term resolution of single currency policy is likely unless a dramatic shift in the UK's present economic or political outlook presents itself.

<u>Looming Threats to Financial Sector Primacy—An Opportunity For Change</u>

While there is little prospect that politicians will change their patterns of Euro ambivalence, or voters will suddenly embrace a British-European identity, within the British economy one important sector presents an opportunity to break the current stalemate in British-

Euro policy making—Financial Markets. Financial services have long been one of the jewels in the crown of the UK economy, and the strength of this industry is vital for not only London, but the health of the national economy as a whole. Since deciding to stay out of the EMU, London's financial service sector has been the most compromised, with the European Central Bank's location in Frankfurt increasingly drawing greater importance to the EU's financial hub. Recent turmoil in financial markets makes the pull towards Frankfurt, and greater British financial unity with the rest of Europe, even stronger. Faced with the growing reality that no country's economy, not even England's, can be an island isolated from outside forces, the financial contagion of the subprime market melt down has made the need for financial bank coordination more vital than ever. The combined factors of the financial importance of the ECB as the center of the Euro zone system, and the need for coordination to counter possible international financial contagion, may make British EMU membership an economic necessity. Consequently, looking forward, developments in the UK's financial services sector may remove existing roadblocks to British induction to the EMU by changing the cost-benefit analysis of membership.

The importance of the UK financial sector to the domestic economy is indicated by the fact that it is the only economic sector specifically singled out in the Treasury's Five Tests:[87]

> *What impact would entry into EMU have on the competitive position of the UK's financial services industry, particularly in the City's wholesale markets?*

Few could dispute the importance of finance to Britain as a whole, and especially the city of London. From 1983 to 2000, the gross value added to the economy by the financial sector grew by 88.8-percent, while the whole economy grew by just an average of 55.3-percent.[88] London continues to be the financial leader in Europe, but the City's main European rival, Frankfurt, has

87 ? Begg and Horrell, *The Euro & Britain*, 279.

88 ? Begg and Horrell, 278-9

benefited from its shared location with the ECB, and Paris and Luxembourg have also grown in niche markets. With the growing strength of their European rivals, and the UK's current stance as an EMU outsiders, the importance of the financial services sector to the entire British economy demonstrates that it is essential for London to maintain is dominant position in European financial services.[89]

London's supremacy in finance stems from its roots as a historical trading and commercial center. The strength of the British economy as a 19th century colonial power established London as the busiest port in the world, and goods from all over the world flowed into its harbors. But after World War I this preeminence declined as British industrial strength shrank relative to the United States. In the 1960's, London once again rose as a financial power, largely in part to its comparative advantage in European currency trading services. Today that advantage continues. London's use of the English language, location in a favorable time zone, political stability, and large amount of skilled professionals, has allowed the City to maintain its dominance in finance. But many advantages London holds as a financial center, such as a favorable legal and fiscal environment, are creations of public policy that could easily be compromised if European rivals adopt the same favorable policies. For that reason, London financiers cannot proceed with the attitude that their city's preeminent position as a financial hub will go unchallenged. This is not to say that London's position in the financial world is on the brink of disaster. London may continue to thrive, even outside of the EMU, for the next decade. But the UK can not proceed on its current course of non-involvement in the EMU, and ambivalence towards future membership, without considering the potential implications for London's financial services industry. [90]

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89 ? Ibid., 277-9.

90 ? Luo, *A Choice Between Two Paradigms*, 1-15.

Fortunately for Britain, London has thus far remained the pre-eminent financial center in Europe despite the UK's uncertain attitude about joining the EMU. While it may appear that London's financial leadership would be inherently threatened by staying out of the EMU, in some ways the deepening of integration within Europe has encouraged a move away from country-based research, and instead to a more sectoral (agriculture, manufacturing, etc.) focused approach. Because London is recognized for having a critical mass of financial experts in all sectors, London has benefited from a more over-arching European financial approach because it would be difficult, in the short term, to shift all of these talented personnel to a new European financial hub.[91]

In the long term, however, this shift to a new financial center is possible. Such a move would be catastrophic for the approximately 60,700 jobs in London that depend on demand from EU countries—just over 20-percent of total financial employment.[92] While London has thrived as a European and global financial center, its livelihood also depends on the continued preference of other European entities to conduct business in London. These countries operational preferences help determine the strength of London as a financial center. If European banks or companies decide to operate elsewhere, the ripple effects could be extremely costly to the UK economy. This type of massive structural change in the composition of the European financial community is possible in the long term, and represents a motivation for the UK to embrace EMU membership.[93]

In fact, EMU member states have already attempted to establish a single European wholesale market. Called the *Financial Services Action Plan*, the proposal was drafted at the 2000 Lisbon European Council with an original (and unfulfilled) deadline to have the market

91 ? Begg and Horrel, 289.
92 ? Ibid., 290.
93 ? Begg and Horrell, 288-90.

launched by 2005.[94] Because of its current preeminent position in the financial world, London is a frontrunner to be the hub of this single market, a prize that would only strengthen its international position. But a number of factors could keep London from winning this prize. To begin with, domestic ownership of the British financial sector has been diminishing, with investment banking firms increasingly being taken over by American and continental European investors. This shift away from national ownership has caused many insiders to wonder whether Britain's claim of preeminence, in both experience and personnel, is decreasing as outsiders take over London's largest firms. Additionally, other European financial centers are contesting London's stance as the de facto front-runner to be the market's central operational city. Frankfurt in particular has the strongest claim, as the location of the ECB and the place where decisions on EMU monetary policy are made, to be the center of the wholesale market. Consequently, if the UK's lack of EMU membership threatens its position as the center of the new wholesale market, the British could become more cognizant of the costs of remaining outside of the EMU system.[95]

While the UK government leaves open the possibility of EMU membership, sentiment towards the British will most likely remain generally positive within Europe. But if hesitation on joining the EMU becomes outright opposition, EMU members could freely develop policies unfavorable to UK interests in the areas of financial regulation or taxation. One possibility for this type of action stems from the long-running dispute, eventually settled on terms acceptable to the UK, over the EU-withholding tax. The UK claimed that this tax would harm its competitive financial position and push businesses to hold more of their financial assets offshore.[96] The UK won the fight on the withholding tax during the first round, but their bargaining position could be

94 ? Ibid., 297-8.
95 ? Ibid., 287-9.
96 ? Luo, 10.

weakened if they are still the "odd man out" in Europe when future negotiations arise. If the British do not embrace an essential part of deeper European integration, the single currency, EMU countries could also discount their opinions on other key EU issues. The future of London as a financial center therefore seems increasingly dependent on the will of other European countries. While London currently has many advantages in the financial services sector, that supremacy could diminish in the long term if the EMU establishes policies that alter London's comparative advantage in finance. If Britain does not join the EMU, and remains only a reluctant partner in the EU, its bargaining position during discussions of these financial matters could be severely weakened.[97]

Clearly, even before the current turmoil in financial markets arose, London's position as a financial center was highly dependent on EMU members' continued willingness to do business in the City. But the global liquidity squeeze caused by the sub prime mortgage meltdown in US financial markets has made it more apparent than ever that national economic actors do not operate in a bubble. On December 13, 2007, the leaders of the US Federal Reserve, the Bank of England, the European Central Bank, the Bank of Canada, and the Swiss National Bank all joined together to coordinate ways in which the liquidity crisis could be mitigated with minimal international economic damage. This display of central banker solidarity came as an acknowledgement that the situation at hand was of an international nature, and that each individual bank could not act alone to provide liquidity where needed. These meetings were also a triumph for the ECB's method of acting as a market of last resort for troubled financial institutions by auctioning off funds to a broad set of actors against a wide range of collateral. The Fed and Bank of England had to acknowledge that the ECB's auctioning method was a superior approach because of the stigma associated with approaching a central bank's discount

[97] ? Begg and Horrell, 299-300.

window to meet short term liquidity needs. Consequently, the current international liquidity squeeze has emphasized that sharing ideas between central bankers can be a valuable source of market information, and that the ECB's method for providing liquidity to troubled banking houses has proved to be the most successful strategy. The need for greater coordination between central bankers to fight financial crises, combined with the international nature of any financial market down turn in today's globalized world, emphasizes the benefits that could arise from having UK monetary policy more closely coordinated with the rest of Europe through EMU membership. [98]

During this financial melt dow, it has also become apparent that the central banks of England and Europe share a more similar monetary policy outlook than that of the US Federal Reserve. As Robert Frost, Harvard economist and former chief economist at the IMF recently quoted from a Robert Frost poem, "Some say the world will end in fire, Some say in ice." [99] The Federal Reserve, said Mr. Rogoff, believes the world will end in fire, and has been scrambling to douse financial crises and recession through swift interest rate cuts, flooding credit markets with liquidity, and creating new lending facilities. Furthermore, the Fed controversially helped JPMorgan Chase rescue Bear Stearns, America's fifth-largest investment bank, from complete collapse. On the other side of the spectrum, when it comes to an economic meltdown the European Central Bank and Bank of England instead fear ice, not fire. Whereas the Fed is more worried about recession, these central banks are most concerned with the dangers of inflation brought on by rate cuts too swiftly enacted. These large interest rate cuts could invite the birth of a new, and more dangerous, asset bubble. Much of this monetary policy divide has to do with history. The Great Depression is still a part of the American conscience, while in countries like

98 ? *A Dirty Job*, 2007
99 ? *A Dangerous Divergence*, 2008

Germany, the home of the ECB, the legacy of hyperinflation is just as strong. An intellectual rift also exists. The Federal Reserve has argued that central bankers should not try and prick asset bubbles and instead just clean up the mess once they burst. On the other hand, central bankers in Europe see a direct link between loose monetary policy and the dot-come and housing bubbles of recent years. What this means for the ECB and the UK is that in a time where the need for central bank coordination is becoming more apparent, joint action between the Bank of England and ECB, as opposed to the Federal Reserve, appears the most realistic because their chief bankers share a common monetary policy philosophy. Beyond simply presenting the most painless way of coordinating central bank policy, increased coordination between the Bank of England and the ECB may become an economic necessity.[100]

Evidence already exists that financial officials in the UK and the EMU are acknowledging the necessity of working closely together to deal with new developments in financial markets. For one, the credit crisis has the potential to substantially advance European cross-border bank regulation. Charlies McCreevy, Europe's commissioner for international markets and services, has proposed a multinational group to oversee cross-border banking activity. Under McCreevy's plan, banks with operations in several European countries would not be only supervised by the regulator in the country where they are headquartered, as they are now, but each bank would instead also have to answer to a "supervisory college." This college would consist of a group of experts and regulators in each country where the bank operates. Perhaps surprisingly, the UK Treasury publicly backed Mr. McCreevy's proposal. This support may have come as a result of the bank run on UK mortgage leader Northern Rock PLC in September 2007. This event served as a wake-up call to regulators, because no mechanisms were set up to handle such an event for a

100 [?] Doughtery, *European Banks Confront Economic Slowdown,* 2008

bank with significant cross-border business.[101] Thus far, the European Commission has already opened a formal investigation into the Bank of England's bailout of Northern Rock. This oversight process is expected to set a new precedent on governmental aid within the EU, which could even result in the Commission ordering Northern Rock to return the estimated £55 billion it received in loans and guarantees from the Bank of England.[102] As a result, recent events suggest that the UK is being increasingly propelled into closer financial dealings with the EMU, and will have to hold its own financial and monetary actions subject to European Commission oversight. These observations suggest that more than ever, the UK could benefit from accepting a more integral role in the European Union through EMU membership in order to guarantee that they have a place at the bargaining table during future negotiations on these issues. Furthermore, EMU membership may become an economic necessity as coordination between central bankers and financial regulators in England and the EMU becomes a more effective way to regulate financial markets.

The prospects of joining the EMU to maintain the strength of Britain's financial services appears more plausible when evaluating how the city of London's economy has already contracted since the recent credit crisis. The sectors that have grown the fastest in the last decade —hedge funds, wholesale finance, and international securitization—are the most threatened by the recent meltdown.[103] According to the Center for Economics and Business Research (CEBR), which specializes in tracking British financial trends, around 16 percent of the growth in the British economy over the past four years has been driven by the strength of these sectors.[104] But much of this economic stimulus will be lost in the coming year. The CEBR forecasts that merger and acquisition activity will fall by 26 percent in 2008, while trading volumes on the London

101 ? MacDonald, *Credit Crisis May Advance European Cross-Border Bank Rules*, 2008
102 ? Castle, European *Union to Review Britain's Rescue of Bank*, 2008
103 ? Kaletsky, *The Storm to Come*, 2008
104 ? Westacott, *CEBR*

Stock Exchange as a whole will drop by 36 percent.[105] Additionally, the City bonuses which have powered the London housing market and consumer economy are likely to fall by 30 percent over two years—to £6.2 billion ($12.4 billion) in 2008, compared to £8.8 billion in 2006.[106] As the hedge funds and investment banks start firing staff and reducing bonuses, the London economy, which represents roughly 20% of national GDP, will suffer a significant loss of income.[107] Due to the total value added to the economy by London financiers, combined with the economic ripple effects of falling incomes and bonuses among those employed in the financial sector, it will be vital to British citizens, politicians, and bankers to keep London atop the financial services heap despite the current global credit crunch. Without the hubris of an unbeatable financial industry behind it, UK leadership has the potential to realize the benefits of accepting EMU membership in order to guarantee a place at the bargaining table during future negotiations over financial and monetary issues. Furthermore, the likelihood that the national economy will significantly contract due to the multiplier effects of a financial downturn is an economic incentive for Euroskeptic voters to break free from their isolationist tendencies.

Based on this evidence, the future of London's financial services sector appears to be at a tipping point. While still enjoying relative financial dominance, a number of forces could dramatically shift the economic and political incentives for British EMU membership. From the growing inter-state bank regulation as a result of Northern Rock, to the increasingly palatability of EMU and Bank of England monetary policy coordination in the wake of the current credit crisis, closer relations with the EU would strengthen the UK's bargaining position. The current contraction in London's financial sector demonstrates that despite its strength, the City is still vulnerable to international forces. This revelation makes "going it alone" less of an advisable

105 ? Ibid.
106 ? Ibid.
107 ? Kaletsky, 2008.

policy both economically and politically. While at this moment in time it is not possible to predict what position London's financial services will be in the next ten years, it is clear that changes in this sector have the potential to change the political calculus of EMU membership for the Britain. Thus far, economic incentives based on the Treasury's Five Tests have proved to be more of a justification, rather than a guide, for EMU policy. At the same time, the political composition of British elites combined with Euroskeptic voters has produced a political stalemate on single currency policy. In contrast, the potential changes in the financial sector have the potential to break this stalemate in British EMU policy by bringing new economic and political incentives to the bargaining table.

Conclusion

From Margaret Thatcher to Tony Blair, no British leader has resolved the issue of whether or not their country should join the European Monetary Union. While relying on economic indicators seemed like the best solution based on past experience with exchange rate coordination, evaluating EMU membership based on the Treasury's Five Tests has only justified the UK's ambivalence towards membership. The mixed signals from analysis of the Five Tests has made brokering a political solution necessary, but due to shifting party platforms, heterogeneous party preferences, and the First Past the Post electoral system, British political leaders have failed to broker an agreement on EMU policy. This lack of leadership has resulted in the devolution of power away from political elites, and through a national referendum, into the hands of the famously Euroskeptic British public. Without the ability of elites to overrule the skepticism of their constituents, the result has been a lack of definitive euro policy. But as the sub-prime market's international effects on liquidity and financial stability have made the need for central bank coordination more apparent, closer relations with the European Central Bank, and EMU membership, could become a more viable policy option in the future. While public opinion polling usually suggests that EMU membership is a distant prospect in the hands of the British public, a 2003 poll by the Guardian newspapers found that although 63 percent of British voters *opposed* becoming part of the euro zone, 71 percent also thought it likely that the euro would be adopted in the next ten years.[108] On one hand, this result may simply be further evidence of the Brits' famously sardonic attitudes. But at the same time, this polling data also suggests that as economic and political functions become increasingly intertwined across borders, even the Brits' skepticism about European integration may not be enough to keep them from participating in the EMU's grand economic experiment.

[108] Artis, *Economic Theory as a Decision Tool*, 45.

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