Should Britain Join the Euro: A Lesson from History

The scale and nature of the recent crash in the financial markets is leading to a rethink of the present model of economics and regulation. Can it really be tolerable, people are asking, for such risks to be taken by a banking system that, if those risks go bad, cannot possibly make good the losses itself?

Those few voices that asked that question during the recent period of growth have been joined by many more now that those risks have visibly started to go wrong. It is too early to say precisely what new regulatory framework might be established in place of the

discredited old model, but the changes are likely to be far-reaching. The failure of the present model has been so comprehensive.

This is a question that will be asked around the world, but there is another question that needs to be asked in the United Kingdom. For the UK has seen not merely a failure of its economic regulation, but of its whole national economic strategy.

For while the crash may have started in America and while it may have spread around the world, its effects have not been felt equally everywhere. The British economy has been much more badly hit than most.

For evidence of this, one need look no further than the exchange rate. Since the problems of the American mortgage market first started to emerge in August 2007, the pound has sharply lost nearly 30 per cent of its value against the Euro (falling from 1.48 to 1.12). This is a devaluation on an almost unprecedented scale. (There is a single example of a sterling devaluation greater than this, to which we will return). And devaluations matter.

Traditional economic theory tells us that the exchange rate should vary according to the balance of payments, so that a country that imports more than it exports should see its exchange rate fall so as to offset the value. In an era of floating exchange rates, this process should happen gradually and seamlessly. Instead, we have seen a sudden and dramatic loss of value, which must have a cause other than simply the balance of payments.

That cause is the failure of Britain's economic strategy.

Britain's economic strategy has been to stand aside from the main project of European integration, namely the Euro, and its notions of modestly balanced budgets and prudent financial regulation, and instead to cast itself as an offshore commercial paradise, founded on a mountain of unsustainable debt.

Regulations and business costs were kept low; the exchange rate and disposable incomes were high. House prices became the measure of economic success. The regulators did not care that for every family that benefited from an increase in the value of the home they lived in, another family could not make even the first rung on the housing ladder. Personal indebtedness rose to record levels to fund more and more extravagant lifestyles. It was an economic strategy that felt like success.

But eventually, as bubbles will, that bubble burst. We can now see that those indications of prosperity were like the thirteenth strike of the clock. Not only do we not believe it, we now realise that the clock was faulty during its previous twelve strikes.

We should reject the assertion that the British economic model did well during the past 10 years up until the crash. The European balance of power kept the peace very well until June 1914, after all.

No, it is not possible to separate the good times from the bad times that those good times subsequently caused. It is not wise to make a car faster by removing its brakes.

It cannot be coincidence that the British recession is so bad compared to those of the Germans or the French: it derives directly from the way we have viewed the world and our place in it. Our national strategy has let us down.

We have been here before.

In the late 1940s, Britain laboured under the delusion that, having been a victorious power in the Second World War, it could now separate itself from the fate of the rest of Europe. It imagined that its place as one of the Big Three at the wartime conferences could be continued in perpetuity, but of course it could not.

In a vain bid to remain a superpower, Britain maintained its military spending and overseas deployments at levels far in excess of what it could afford and out of all proportion to the threats it really faced. Hundreds of thousands of soldiers were deployed in the Middle East

and in South East Asia. Britain was even preparing for possible war with the Soviet Union without reference to what the Americans might do.

The military delusion was matched by an economic one. It was hoped that sterling could continue to play a role as a reserve currency, but that would require Britain to act as importer of last resort for the countries in the sterling area. For a country that was struggling even to pay for its own imports, to intervene on behalf of other countries was too much to hope for.

A loan obtained from the Americans of $3.75 billion and later Marshall Aid of $2.7 billion were not enough to solve the problem, merely postpone it.

Such a national strategy could be paid for only by a substantial growth in UK foreign debts and, ultimately, it led to devaluation on an unprecedented scale in 1949, when the pound was reduced from $4.03 to $2.80. This fall of 30.5 per cent has not been matched since then, except – ominously – today.

As with the 1940s, there has been a mismatch between Britain's national strategy and Britain's underlying resources. A common thread was the mistaken belief that our economic health and our place in the world could somehow be separated from those of our European neighbours.

Unlike in the 1940s, we cannot look to the Americans for a financial bail-out. They have been labouring under equivalent economic and strategic misjudgements of their own. We have to strike out on a new course, and join the Euro.

The bad news is that a recession is the wrong time to join a new currency bloc. It is necessary to find an exchange rate between the pound and the Euro that can be sustained forever, and there is far too much uncertainty in the markets to be able to that with confidence. The European treaties require a minimum of two years before such an exchange rate can be settled upon: two years' hence Britain will still be in recession, so the process of joining will not be quick.

Furthermore, it will be hard to keep the public deficit below the stipulated level of 3 per cent of GDP. The government's forecasts predict that that figure will be exceeded for every year between now and 2013, and let us hope that they are not overoptimistic.

But the economic questions of convergence can be solved, if the political decision is taken. And it is indeed a political decision. Joining the Euro is not a simple matter of economic policy, but a choice of national strategy. There is more to it than simply reprinting the banknotes. It requires a new approach to the global economy and Britain's place in it. It leaves behind the delusions and mismanagements of the past, and offers instead the consolidation of British economic interests into an effective financial framework.

To joining the Euro will take a number of years to achieve, but the time for political preparation is now.

The government failed to fix the roof while the sun was shining, but that does not mean that the country should simply accept the rain. There is an umbrella under which Britain can shelter: it is called the Euro.

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