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How and why Britain might join the single currency: The role of policy failure

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ABSTRACT

Why has Britain declined to adopt the single currency? The conventional view holds that there are multiple political and economic barriers to British entry into monetary union–large fractions of public opinion, business leaders, and the Conservative party oppose entry; Britain's economic cycle is not synchronized with that of the euro-zone; adoption of the single currency would harm foreign trade and investment; British political institutions make it difficult to muster support for such a move, and so on. I argue that policy failure is a more important influence on British economic policy. Major changes occur when extant policy fails and there exists an alternative policy idea that both explains this failure persuasively and prescribes a new and more effective way forward. A British government might advocate euro membership if the current framework for policy in Britain—central bank independence with a floating exchange rate—fails, and policies pursued by the European Central Bank address the source of this failure. This combination would also lead many politicians, business leaders, and voters to see the advantages of euro membership.

KEYWORDS

Policy failure; Policy change; Euro; Monetary policy.

INTRODUCTION

Why has Britain declined to adopt the single currency? The conventional view holds that there are multiple structural barriers to British entry into monetary union. From this perspective, Britain's decision to retain sterling is over-determined – fractions of public opinion, business leaders, and the Conservative party oppose entry; Britain's economic cycle is not synchronized with that of the euro-zone; adoption of the single currency would

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harm foreign trade and investment; British political institutions make it difficult to muster support for such a move, and so on. Because most of these influences change only slowly, many are very skeptical that Britain will join the single currency in the foreseeable future.

Each of these barriers is important, but as the next section demonstrates is also more susceptible to rapid change than is often recognized. I base this conclusion on an understanding of the political process in which 'policy ideas' have a substantial influence on policy choice. Policy ideas identify goals for policy and make claims about the effects of different policies. Here I focus on how policy failure leads politicians to ignore or adopt rival policy ideas. Policy failure endangers the career prospects of politicians, and leads them to search for and consider alternative policy ideas. They select and seek to implement a rival idea, *ceteris paribus*, that identifies causal mechanisms that explain recent failure and offers an intellectually coherent and politically attractive set of policy prescriptions.

The penultimate section examines the recent pattern of British macroeconomic policy making and concludes that it is consistent with this line of thinking. Since the 1970s there have been three episodes in which policy failed, and in each case the authorities identified and implemented a new policy idea that explained the source of this failure and offered new policy prescriptions. There have also been episodes in which policy failure did *not* lead to policy change; the reason, I argue, is that there was not immediately available an alternative policy idea that could explain and remedy this failure. The theory thus accurately explains the conditions under which failure does and does not produce substantial policy change. It also helps us to understand why policy ideas rejected as unviable at one point in time are adopted at others. The reason for this is that the appeal of a policy idea depends on the form of the policy failure that precedes its consideration by politicians; an idea is more attractive after episodes of failure that it can effectively explain and rectify than after other types of failure.

In the concluding section I argue that a sharp deterioration in British economic performance, combined with the conclusion that euro membership would address the sources of this failure, could quickly make euro membership an attractive alternative to the status quo. Predicting the timing of such a policy failure is impossible, although it seems quite likely that policy will fail to generate positive macroeconomic outcomes for the indefinite future. If and when such a policy failure does occur, much of the British political elite, business leaders, and public might advocate joining the euro more quickly than most observers now believe.

BRITAIN AND THE SINGLE CURRENCY

Why is Britain the only major member-state to have retained its national currency? My argument is that the particular arrangement of social forces and institutions in contemporary Britain make policy failure the most important source of macroeconomic policy change. Other sources of change have considerably less influence. The current section seeks to justify this contention. I consider five widely-discussed sources of British government's reluctance to join the single currency. On close examination each cause of Britain's reluctance to joining the euro is weaker than often assumed.

Divergent business cycles

One often-cited reason for British reluctance to adopt the single currency is concern politicians about divergences between the British and continental European business cycles. A single currency or fixed exchange rate effectively requires that all participating countries maintain the same interest rates. British politicians have in the past been reluctant to fix the exchange rate for this reason. If Britain were to adopt the euro and divergences in business cycles with the rest of the eurozone were to re-appear, the European Central Bank would likely set interest rates at a level most appropriate for the larger continental economies, or might determine interest rates based on some average of the business cycles across the eurozone. In either case British politicians would lose the ability they now have to tailor monetary policy to the needs of the national economy. Thus, the first of the five 'tests' for entry into monetary union that the Labour government laid out in 1997 – convergence – reflect precisely this concern, and it is supported by economic evidence (see the review in Takana, 2002).

However, there is good reason to believe that such concerns are less important today than they were in the past. Differences in inflation rates between Britain and the eurozone have essentially disappeared since well before the introduction of the single currency (see Figure 1). Joining the euro in this environment would not require Britain to alter its monetary policy stance substantially in the short run. Furthermore, adopting the euro would likely influence the relationship between the British and euro-zone business cycles, as the two economies adopted the same interest rates and monetary integration promoted business cycle convergence through greater trade and investment (see Frankel and Rose, 1998).

International trade and investment

Until the 1980s Britain's trade and investment links with the rest of the world differed from those of other member states. Britain traded and invested more intensively with North America and with former colonies, while the trade and investment of other member states was concentrated

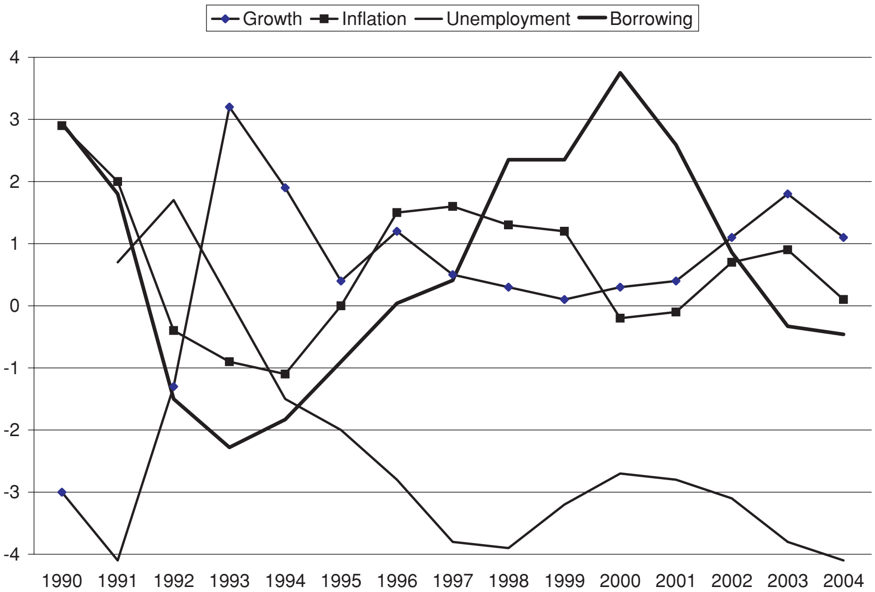

Figure 1 British and eurozone macroeconomic performance. *Note:* Time series calculated as British performance minus eurozone performance. Data before 1999 include indicators from the 12 countries participating in the eurozone in 2002. Growth is annual percentage change in gross domestic product. Inflation is annual percentage change in the consumer price index. Unemployment is a percentage of the labor market. Borrowing is annual public sector borrowing as a percentage of gross domestic product.

on Europe. This meant that British export-oriented producers and overseas investors would secure fewer economic advantages from stabilizing sterling against other European Union currencies (Frieden, 2002). Most of these differences have disappeared in the last two decades. Trade with former colonies has declined to low levels, and membership in the European Union has led to significant growth of British trade with other member states (see the figures discussed in Walsh, 2000). British firms are still more likely to invest outside of Europe than are firms in France, Germany, and Italy, but now also invest heavily in the European Union as well. Indeed, there is evidence that the euro has stimulated trade not only among the countries that have adopted the single currency but also between the euro-zone and Britain (the evidence on foreign direct investment is more mixed; see Begg *et al.*, 2003: 14–29). Euro membership would provide substantial benefits the large and growing number of firms and investors that trade with and invest in the rest of the Union.

Social institutions

The economic sector most interested in fixed exchange rates and a single currency is producers of tradable goods, such as manufactured goods. Exchange rate stability eliminates an important source of the economic uncertainty that manufacturing firms face (Frieden, 1991). Manufacturing firms in continental countries have close ties to banks. They rely on banks rather than the stock market to finance most of their investment. These banks have powerful incentives to ensure that their industrial clients prosper. They therefore join industry in lobbying governments for policies that will produce stable exchange rates (Henning, 1994). The social institutions linking banks and industry in Britain are much weaker. Here industrial firms rely more heavily on the stock and bond markets to raise funds for investment. Banks concentrate more on trading financial instruments and on international activities. The political coalition favoring stable exchange rates is thus less influential than in continental Europe; while industry lobbies for stable exchange rates, banks either do not care much about this issue or prefer policies that will keep inflation low (Walsh, 2000).

This means that the British government faces substantially less political pressure to stabilize the currency than do other member states with close bank-industry ties, such as Germany and Italy. British governments do not face such pressures, but they also get few consistent signals from society about external monetary policy. This may be one reason why the goals and frameworks of British monetary and exchange rate policy have changed so frequently over the last two decades. Governments develop and abandon new goals and frameworks with relative ease since they lack a domestic political anchor that consistently pulls them towards a single objective. In any event, while there is at present no strong coalition in society favoring adoption of the euro, there is also no strong, institutionalized social coalition opposing such a step.

Political institutions

British politics is dominated by two large catch-all parties, Labour and Conservative. This is in part a function of the first-past-the-post electoral system, which tends to deliver more parliamentary seats to the two largest parties and punishes smaller parties with fewer seats. Most other European democracies use some sort of proportional representation electoral system, which produces more and smaller parties that govern in coalitions. One result of this is that both major parties are large and diverse in their membership, and have strong divisions among their members on the merits of the European Union. In recent years, for example, a few prominent Conservative party leaders, including Kenneth Clarke and Michael Heseltine, have supported euro membership, while most others have strongly opposed such a move. There are frequent reports of strong divisions among leaders of the Labour party on this question as well, although these have not played out as publicly. These differences have made it difficult for both Labour and Conservative governments to advocate membership in the euro, since a substantial number of their own supporters oppose such a step (Aspinwall, 2004). The flip side of this is that there are also substantial numbers of Labour MPs (less so Conservative) that support monetary union. There are also likely a large number of MPs that do not hold strong preferences on the single currency in the abstract, but would support joining it they perceived that doing so was popular with the voters our would allow the government to pursue more successful economic policies that would ensure its re-election.

Public opinion

The attitude of the public is very important since both parties have promised to hold a referendum before joining euro. Polls consistently show that at most 40 percent of respondents favor such a step. The Blair government has been deterred from advocating adoption of the euro in part because it fears a humiliating loss in a referendum. But public opinion can change, especially when confronted with a real choice rather than a poll. Polling majorities against joining the European Union quickly turned into a majority in favor once the question was put to a vote in the 1975 referendum. The key issue, then, is not the opinions that voters express now, but those they are likely to express in the voting booth if and when a referendum is scheduled.

A referendum will ask voters to respond with a simple yes or no to the question should Britain adopt the single currency. And all reputable polls conducted over the last decade have shown that a decisive majority would vote no. More nuanced gauges of public opinion towards the euro measure respondents' commitment to voting for or against entry. Just under half of all voters are 'euro waverers' who respond that their opinions are not set (Mortimore and Atkinson, 2003). Persuading a substantial part of these waverers to support the euro would allow the government to win a referendum. Other research shows that political leaders influence voters' choices in important ways. Gabel and Hix (2005), for example, show that many potential predictors of individual support or opposition to the single currency do not actually explain responses. Important here is the fact that partisan identification does seem to influence choice – voters identifying with the Conservative party are more likely to oppose joining the single currency and those identifying with Labour are more likely to favor it. This indicates that a governing party that takes a strong stand on the currency question in a referendum could influence voters (see also Howarth, 2007, for a detailed discussion of this issue). An important prior question, then, is what would lead the government to advocate membership in the euro? The developments that lead a British government to change its policy towards one of supporting membership likely would influence at least some of the public to shift their preferences in the same direction.

POLICY FAILURE AND POLICY CHANGE

As this short review makes clear, British governments have faced few strong domestic advocates of joining monetary union. But they also do not face as many committed opponents of this move as is often believed. British governments get few clear signals from important constituents, including the public, business leaders, the financial sector, and political elites, about their preferred frameworks for external monetary policy. The consequence of this arrangement of social forces and institutions is that decisions are driven largely by recent policy's success or failure in allowing the government of the day to achieve its political objectives. Policies perceived by those in power as successful create few pressures for change. Policy failure does create such pressure, leading politicians to consider seriously the costs and benefits of alternative approaches. But not all episodes of policy failure are followed by a fundamental change in the objectives and tools of policy. Instead, policy failure only leads to change when there exists an alternative policy idea whose causal logic both explains the past failure and offers a new set of prescriptions that promise to produce more successful outcomes. The explanation of changes in British monetary policy that I offer thus relies heavily on the role of ideas, rather than material interests or institutions alone. It differs from other ideational accounts in emphasizing how the *content* of rival policy ideas, combined with the failure of current policy, helps explain why politicians find some ideas useful guides to action but ignore others.

Hall (1993: 279) defines a policy idea, or what he terms a policy paradigm, as 'a framework . . . that specifies not only the goals of policy and the kind of instruments that can be used to attain them, but also the very nature of the problems they are meant to be addressing'. Policy ideas differ from more general ideologies and world-views because they have a programmatic element that indicates how to achieve a desired outcome (Berman, 1998: 21). In other words, policy ideas identify not only the appropriate objectives of government action, but also specify specific causal mechanism or mechanisms that explains how and why these actions allow authorities to achieve these objectives. Ideas reduce uncertainty about how the social world operates by providing decision-makers with simplified models of reality in the form of causal mechanisms that explain how policy influences outcomes (see especially Blyth, 2002). These are particularly useful to politicians, who often lack professional expertise in the policy areas that they supervise, and whose time and resources may be stretched across many political and policy domains, and who seek well-crafted proposals that can be more easily communicated to others.

Policy failure is an important reason why politicians seek out and evaluate alternative policy ideas. Politicians are never certain about the true relationships between the policy options available to them and the outcomes each will produce. When extant policy produces desirable outcomes, politicians have little reason to question its usefulness. Undesirable outcomes undermine politicians' confidence in their estimates of the relationship between actions and outcomes and create pressure to consider alternative policy ideas. More specifically, it is *unexpected* policy failure that influences the likelihood of change. As Legro puts it, '[i]deational prescriptions carry a set of social expectations of what should or should not result from group action. When expectations of what should happen are not matched by the consequences of experienced events, there is pressure for collective reflection and reassessment' (Legro, 2000: 424–5).

There is empirical support across a wide array of issue areas that failure leads politicians to consider new policy ideas. Many works on foreign policy explore this connection. Policy failure figures prominently in Jervis' psychological model of policy learning (Jervis, 1976: 275–9). Levy's (1994) review of the literature of learning and foreign policy accords a key role to policy failure, often in combination with other variables, in prompting change. Checkel (1997) shows how the failure of many the Soviet Union's foreign and domestic policies led Mikhail Gorbachev to consider seriously and then attempt to implement a wide array of alternatives grouped under the term 'new thinking'. Reiter (1996) argues that the success or failure of a state's choice between alliance or neutrality in one period has a decisive impact on alliance policy in subsequent periods. Others working on the role of ideas in domestic policy reach similar conclusions. McNamara (1998) holds that the failure of monetary and fiscal expansion in western Europe in the 1970s to produce acceptable economic outcomes led to the diffusion of new policy ideas that supported tightening monetary policy, granting independence to national central banks, and cooperating more closely to stabilize exchange rates in the 1980s. Hall (1993) shows that policy failure led to a fundamental rethinking of the goals and tools of macroeconomic policy in Britain during the 1970s. Heclo's influential study of the development of the welfare state in Britain and Sweden in the twentieth century demonstrates that politicians in each country responded to negative experiences when developing new policies (Heclo, 1974, especially pp. 315–8). In his study of the diffusion of policies across polities, Rose (1993: 50–76) attaches much importance to how failure in one polity leads its politicians to investigate the policies pursued in other polities.

There is thus good reason to believe that failure prompts politicians to search for and to evaluate new policy ideas. But how do they select among rival ideas? Which rival idea, if any, will they find most persuasive and useful? And why do politicians sometimes continue to implement failed policies when rival ideas' policy prescriptions are available? The existing literature offers unsatisfactory answers to these questions. Many of the empirical studies of policy failure cited earlier do not explain in detail why politicians found one new idea more useful than others after experiencing failure, or select cases in which only a single rival policy was considered seriously. Legro (2000: 429–30) argues on theoretical grounds that there is often only one alternative idea:

> Such [ideational] structures seem to frequently take a binary form with a dominant idea that guides societal action and an alternative idea that exists in opposition-be it containment-engagement, free trade-protectionism, isolationism-internationalism, Keynsianism-monetarism, or offense-defense. When an old orthodoxy collapses, an oppositional idea with preexisting social support that appears to coincide with socially desired results (whether it actually caused such results is irrelevant) is likely to be the new focal point of consolidation and institutionalization.

It may be true that in some cases there is really only one realistic alternative to the status quo. But it seems likely that there are as many or more cases where there are multiple plausible alternatives. Government departments, independent agencies, research institutes, political parties, interest groups, universities, international organizations, and political leaders themselves are in the business of creating, evaluating, and lobbying for policy ideas. Very often the difficulty that politicians face is not the paucity of new policy ideas but the plethora of them, for this raises the issue of how do politicians rank these ideas? Consider contemporary monetary policy. The policy literature focuses on the strategic interactions between politicians' goals and the inflation expectations of the private sector.[1] This assumes that attempts to reduce unemployment with an expansionary monetary policy are effective only in the short run. In the long run, such policies result in higher inflation and unemployment reverts to the natural rate. But politicians face a 'time inconsistency problem': they are tempted to promise not to try to push unemployment below the natural rate but then to renege on this promise, since the unexpected inflation this generates will not influence private sector behavior immediately. The private sector eventually catches on to this and adjusts its behavior to politicians' previous reneging. The solution is to create rules that constrain politicians' ability to try to spring inflation surprises on the public. Abiding by clearly-specified rules for the conduct of monetary policy both constrains politicians' choices and allows them to build up the credibility of their promises to manage the economy responsibly.

The difficulty is that there are many plausible rules that are potential solutions to the time inconsistency problem. Setting targets for the rate of growth of the money supply or inflation, creating a politically independent central bank, fixing the exchange rate, entering monetary union, and so on are all examples of such rules.[2] Central bank independence, a fixed exchange rate, inflation targets, and so on share the basic principle that macroeconomic outcomes will be superior when politicians are constrained by a rule. But each offers a different solution to the same basic problem (Verdun, 2000). How are politicians, most of whom lack expert knowledge of these rules' intellectual underpinnings and economic effects, to select among them? The analytic content of a policy idea is an important source of influence. Research on ideas and politics focuses a surprisingly small amount of attention on the degree to which what an idea says makes it more or less important in policy debates. Instead, much of the debate has been about how policy ideas can compliment explanations of political outcomes that focus most of their attention on actors' material interests or institutional arrangements (see Blyth, 1997 for this point; two important works that draw attention to the content of ideas are Hall, 1993, and Legro, 2000). Politicians are attracted to policy ideas whose causal mechanisms can both persuasively explain why failure occurred in the past and draw on this explanation to provide new prescriptions for more successful policy in the future. Both of these elements are important for understanding why politicians will express interest in some policy ideas but dismiss others. Policy ideas whose causal mechanisms can explain recent past failure are immediately more plausible to politicians. Political decision makers are oriented towards practical steps and outcomes, not epistemology. This means that they are more interested in policy ideas whose causal mechanisms can explain the cause of the policy failure that they face right now. The ability (or inability) of the policy idea to persuasively explain episodes of policy failure in the more distant past, or in different empirical contexts, is less important to politicians when they evaluate an idea's utility. The ability to explain recent failure also has the advantage allowing politicians to draw on the idea to justify and explain persuasively their diagnosis of the problems they face to other political leaders, interested elites, and the public.

Politicians favor policy ideas whose causal mechanisms also identify new policy tools and settings that have the promise of generating more successful outcomes. Recall that policy failure makes politicians and other interested parties less certain of which tools and settings will produce desirable outcomes. The ideational component of a policy – the causal connections it draws between various policy actions and outcomes – is an important source of its influence because it reduces uncertainty in the minds of politicians about the range of options available to them and the consequences that would result from the implementation of these options. Unexpected policy failure leads politicians to listen seriously to advocates of rival ideas inside and outside of the government. Politicians favor those

Has extant policy failed?	**Does policy idea exist that explains failure and provides prescriptions?** No	Yes
No	No Policy Change *Central Bank Independence and Floating Exchange Rate, 1997–Present*	No Policy Change
Yes	Policy Drift *MTFS (1983–1988), EMS (1992)*	Policy Change *MTFS (1979–1982), EMS (1990–1991), Central Bank Independence and Floating Exchange Rate (1993–1996)*

Figure 2 Policy failure and policy change.

ideas that persuasively might mitigate their now-heightened uncertainty and that provide coherent and comprehensive packages of policy changes that can be explained to bureaucratic and public audiences.

It is not only the causal mechanisms upon which a policy idea is based that make it more attractive to politicians. Instead, a specific policy idea is more persuasive only if it 'fits' with an episode of recent policy failure in the sense that it can explain this specific failure and offer novel prescriptions for reversing it. The political value of policy ideas is not absolute, but depends on the *context* in which it is discussed and considered by political leaders. The chance that a given policy idea will be adopted is thus path-dependent; a particular idea might be very interesting to politicians after one type of policy failure, but marginalized in policymaking circles after another type of failure. Figure 2 illustrates this interaction between policy failure and the content of rival ideas. The absence of policy failure creates few pressures for change, and makes politicians reluctant to seriously address the advantages and disadvantages of alternatives. So even ideas whose intellectual content is judged superior to the status quo face an uphill struggle in attracting the attention of politicians in the absence of policy failure. But conversely, not all episodes of policy failure lead to the adoption of a new idea. If there does not exist an alternative idea that can explain this particular episode of failure and prescribe novel actions, policy after failure drifts in the sense that it lacks coherent intellectual links between tools and desired outcomes. This drift can take the form of continuing to implement failed policies or altering the selection and settings of policy tools in cosmetic or contradictory ways that do not address the sources of failure. It is only when there is a rival policy idea that can adequately explain the failure that politicians must address and provide them with guidance regarding superior policies that its prescriptions will be turned into action.

I am not arguing that the ability of an alternative policy to explain and to correct past failure alone explains its adoption by government leaders. The political viability of an alternative is also important to politicians. They may lack sufficient political support from powerful constituents to implement the policy proposal that they conclude best explains past failure and offers new prescriptions. These constituents may block implementation because of ideological opposition to proposed policy changes, because they want to change the government's composition, or because they will have to pay additional costs if the new policy is implemented. The identity of such constituents is likely to vary a great deal depending on the policy issue and institutional context involved. For some issues and in some institutional milieus, politicians may adopt a new idea but will have to persuade many others, such as bureau managers, legislators, interest groups, to support its implementation. This need to secure the assent of others is less salient for the topic of this analysis, monetary and exchange rate policies in Britain. This means that the dynamic relationship between policy failure, the explanatory and prescriptive power of alternative policy ideas, and policy change outlined above should exercise a powerful influence over policy choices in Britain. Here macroeconomic policy is of most interest to large constituency groups such as political parties or labor unions. The reason is that the economic effects of macroeconomic policy, especially monetary policy, cannot be easily disaggregated. Many narrower interest groups have interests in macroeconomic policy that cross-cut each other. They also face important collective action problems; smaller groups that might benefit from a particular orientation of macroeconomic policy, for example, may have few incentives to deploy their political resources to achieve this outcome if most of the benefits go to others.[3] Few interest groups and other constituency groups thus take a direct interest or lobby the government on broad issues of foreign or macroeconomic policy, such as the design or participation in European institutions, although some such groups do try to influence specific policy decisions. This arrangement of societal preferences and policymaking institutions means that the government has considerable freedom to consider and to implement new policies. Groups such as unions, employers, and rival political parties often find it difficult to develop clear preferences regarding monetary policy, and even when they do so are inhibited by collective action problems from devoting much effort to lobbying for policies consistent with these preferences.

APPLYING THE ARGUMENT

This understanding of the relationships between failure and policy change accounts for the major changes in British monetary policy since the 1970s. It also accounts for those cases in which policy failure occurred but was not followed by the adoption of a new policy idea. Three such changes have taken place: the adoption of strict monetary targeting by the Thatcher government in 1979, known as the Medium-Term Financial Strategy (MTFS), the informal targeting of the exchange rate in the mid-1980s culminating in the entry into the European Monetary System (EMS) in 1990, and the exit from the EMS and subsequent creation of an independent central bank combined with a floating exchange rate. During periods in which the authorities judged policy to be producing successful outcomes, they devoted little attention to alterative policy ideas and focused on marginal improvements to the status quo; examples include the early membership in the EMS in 1990 and 1991, and central bank independence after 1997. All three episodes of major change – the introduction of the MTFS, entry into the EMS, and granting the Bank of England independence – were preceded by the failure of extant policy to achieve the government's goals, and each of the new policies was backed by an ideational component that explained past failure and suggested new actions. Other cases of policy failure in which such an alternative idea was not available – such as between the failure of the MTFS and entry into the EMS–were characterized by subsequent drift in policy.

Monetary targeting and the MTFS

Conservative and Labour governments encountered serious economic problems in the 1970s. Particularly difficult was the simultaneous occurrence of higher inflation and higher unemployment. This 'stagflation' was unexpected by what was arguably the dominant understanding of the macroeconomy at the time, which held that there was a trade off between inflation and unemployment. It convinced many politicians in both parties that the status quo policies based on this trade off had failed, and led them to search for alternative frameworks for economic policy. They found that many such alternatives were circulating among professional economists and in the economic policy community. These included granting independence to the central bank, a policy which seemed to be containing inflation without sacrificing growth in Germany, participating in the new European exchange rate system, which promised to provide an external anchor for monetary policy and halt the large currency depreciations that occurred in the 1970s, strict rules for minimizing budget deficits, which would reduce inflationary pressures, actively coordinating wage demands and increases with employers and unions as occurred in many continental countries, as well as targeting the rate of growth of the money supply, which some economists believed had a direct and positive influence on the inflation rate.

Why did politicians find monetary targeting more attractive than the alternatives? The decisions involved have been subjected to a great deal of scholarly scrutiny, and addressing these questions fully could consume an entire article or book. Here I will simply note that the outcome is consistent with the analysis of policy failure and change advanced here. A crucial ingredient was that targeting offered a coherent explanation of the economic problems of time (see especially Hall, 1993). All of the other alternatives either had been tried in the recent past and failed (such as fixing the exchange rate or wage concertation) or offered only theoretical promises of improved policy without directly addressing recent sources of failure (such as central bank independence). The Labour government of James Callaghan first introduced targets for the rate of growth of the money supplyin the mid-1970s as a guide for monetary policy. The Conservative Thatcher government elected in 1979 made such targets the centerpiece of its economic policy in the form of the Medium Term Financial Strategy (MTFS). The idea of monetary targeting had circulated among professional economists for many years. But it was only in the context of the high inflation, unemployment, and slow economic growth of the 1970s that it gained any political attention. Politicians were attracted to monetary targeting because it provided both a coherent explanation for the failure of contemporary policy and a guide to policies that would be successful in reversing these failures. In terms of explaining past failures, the argument for monetary targeting had two advantages. First, it boiled down to a simple positive relationship between the amount of money in circulation and changes in prices that could be explained to non-expert audiences and that posited a general relationship that could explain with one causal mechanism many of the economic problems of the day. Second, monetarist economists such as Terry Burns and Alan Budd produced empirical studies that showed a close relationship between increases in the money supply and in subsequent prices changes during the 1970s. The theoretical argument linking these two variables, then, seemed confirmed by recent experience. The prescriptions of monetary targeting were also more appealing to politicians. The policy idea held that the authorities only had to control the rate of growth of the money supply in order to contain inflation. This prescription seemed far simpler and easier to grasp than some alternatives, whose prescriptions would be politically difficult to implement (such as negotiating comprehensive wage restraint with employers and unions), had failed in the recent past (such as a fixed exchange rate), or which promised that institutional changes would in a not very well-defined way translate into superior economic outcomes (such as central bank independence). Monetary targeting, in comparison, had the advantage that if had never been fully implemented in the past, which meant that it had never failed, and of offering a seemingly straightforward way to measure and control the money supply and thus inflation.

Monetary targeting also delivered political advantages to the new Conservative government elected in 1979. The Conservatives were elected on a platform promising to 'solve' the inflation problem, and the government's leaders understood that their credibility with voters and capital markets depended on reducing inflation sharply well before the next general election. Monetary targeting made achieving this goal easier than alternative policy ideas. The government was able to use monetary targets to justify very sharp increases in short-term interest rates. This in turn led to a rapid appreciation of sterling against most other currencies. Appreciation placed downward pressure on inflation by reducing the sterling price of imports and exposing British producers of tradable goods to sharper international competition in domestic and foreign markets. The government recognized that many of the costs of high interest rates and fiercer international competition fell on industrial firms and labor unions. While the complaints of industrial firms, which naturally supported the Conservatives, did create some political problems for the government, this was balanced against the advantages of being able to weaken organize labor and to blame the trade unions, which of course supported the opposition Labour party, for many of Britain's economic troubles (Lawson, 1993: 59; Moravcsik, 1998; Talani, 2000).

Targeting the exchange rate

While monetary targeting reduced inflation quickly, it soon encountered substantial problems of its own as a guide to policy. Two difficulties were particularly important. First, changes in the financial system made the behavior of the monetary aggregates more difficult to predict and target. The government's removal of capital controls shortly after taking office, substantial growth and reform of major markets in the City, as well as technical disagreements about which measure of the money supply best reflected underlying economic activity, made it impossible to base interest rate policy on the movements of the money supply alone. The second difficulty with monetary targeting was the exchange rate. Sharp sterling appreciation after 1979 helped reduce domestic inflation. But sterling was by 1981 at an unsustainably high level and began to depreciate. Monetary targeting was little use as a guide to policy in this environment. In principle, monetary aggregates would eventually respond to exchange rate depreciation, but in practice the relationship between the aggregates and the exchange rate was characterized by lags of uncertain duration. Furthermore, politicians worried that sterling would depreciate as quickly and sharply as it had appreciated. This would require an immediate reaction in terms of interest rate policy and would undermine the government's economic credentials with the public.[4]

The failure of monetary targeting to develop a consistent relationship between the money supply and economic outcomes, and to provide a guide for exchange rate policy, meant that by about late 1982 the conduct of monetary policy was divorced from changes in monetary aggregates. While the government continued to justify such changes to the public and the financial markets in terms of controlling the rate of growth of the money supply, in reality the authorities changed interest rates largely in response to changes in the exchange rate, cutting rates as sterling appreciated and, more often, raising rates as the currency fell.

This failure of the MTFS prompted ministers and senior officials to search for alternative frameworks beginning in 1982. Policy would drift until they decided to prioritize the exchange rate later in the decade. They seriously considered two rival policy ideas. One was to grant the Bank of England the independent authority to set interest rates. Under the direction of the Chancellor, Nigel Lawson, a team of Treasury officials drew up a proposal for an independent central bank in the summer and autumn of 1988. The proposal argued that the advantage of an independent Bank of England was that it would provide 'an alternative way of entrenching the commitment to stable prices' that would not be prey to the difficulties that monetary targeting had encountered. This was because it would be 'locking a permanent anti-inflationary force into the system, as a counterweight to the strong inflationary pressures which are always lurking' (Lawson, 1993: 868). Monetary targeting, of course, had been developed with the same idea of creating a rule for governing monetary policy. Central bank independence, in contrast, was an institutional rather than a direct policy solution, and so would be more adaptable to changing and unforeseen circumstances. This would provide the central bank with the credibility that a government could not achieve.

Many inside and outside of the government concluded that a formal target for the exchange rate by joining the European Monetary System would provide a superior framework for policy. Chancellor Nigel Lawson himself preferred this step to that of creating an independent central bank, although he argued that both would be superior to the status quo. He argued, first in private and then in public, that directly targeting the exchange rate would eliminate most of the short-term depreciation pressure that sterling encountered in the early 1980s and would provide a clearly visible public expectation for the goals of policy. The European Monetary System, created in 1979, had a proven low-inflation 'anchor' in the form of the German central bank, the Bundesbank, and joining the system would allow the British authorities to import some of their German counterparts' credibility with financial markets (Lawson, 1993: 461–9; Smith, 1979: 50–1; Thatcher, 1993: 694).

The Prime Minister, Margaret Thatcher, initially rejected joining the EMS, largely out of concerns that this would effectively remove her influence over monetary policy and because of her personal opposition to European integration (Moravcsik, 1998). But the government did in effect join the EMS by adopting an informal target for the sterling-mark exchange rate, and adjusting interest rate policy to stabilize this rate (Lawson, 1993: 731–49; Smith, 1992: 118–9). Thatcher's successor, John Major, did take sterling into the EMS in late 1990 (Thatcher had reluctantly agreed to this move in principle 'when the time is right' but did not authorize membership before leaving office). EMS entry addressed the government's short-term economic problems. By late 1989 Britain faced high inflation, already high interest rates, and the beginnings of what would become a deep recession. Major concluded while still Chancellor of the Exchequer that EMS entry would be the best way to address these problems, and brought sterling in soon after he replaced Thatcher. The move was based on the consensus in the government and outside it that exchange rate stabilization was the most effective rule for monetary policy. It thus built on the arguments made earlier by Lawson and others that a currency target was the best way to enhance the authorities' credibility (Financial Times, 24 February 1990; Independent, 12 March 1990: 22). EMS entry also had a powerful political logic. The key difficulty that the government faced was high inflation combined with already-high interest rates. Raising interest rates further would contain inflation but would slow stagnant economic growth and reduce the government's popularity before the next general election, due by 1992 at the latest. Joining the EMS, and in effect formally pegging sterling to the low-inflation German mark, would allow the British authorities to import the credibility of their German counterparts. The key cost of such a move would be that the Bank of England would have to match changes in German interest rates. But this posed no political problem in the short-run, as interest rates in Germany were lower than those in Britain; indeed, the government cut interest rates immediately upon entry in late 1990 and continued to do so until mid-1992 (Financial Times, 6 October 1990; Independent, 17 June 1990; Thatcher 1993: 722–3).

Why did the authorities eventually endorse the policy idea that called for fixing the exchange rate rather than the idea that advocated an independent central bank? An important reason was that fixing the currency directly addressed an important cause of the failure of the MTFS. Politicians understood that responding to downward movements of sterling was the immediate problem that they faced by 1982. An exchange rate target was a simple and straightforward solution to this problem. Entry into the EMS, then, addressed what politicians identified as a major cause of the failure of the MTFS and offered a solution that would avoid such failure in the future. The alternative policy idea, central bank independence, addressed these issues in a much less satisfying way. It did not deal directly with the problem of exchange rate instability, as a politically independent Bank of England would face the same between higher interest rates and higher inflation that the government faced when sterling depreciated. And it was more difficult for politicians to envision how an independent monetary authority could be created or how it would behave. Ministers, officials, and commentators expressed more and earlier interest in an exchange rate target than in central bank independence. Serious and public debate about entering the EMS started in 1985 and became a regular feature of the public debate about monetary policy for the next five years. Lawson kept his proposal for an independent central bank secret until he resigned from office in 1989. But even after this widely-publicized revelation, the idea behind central bank independence did not gain much traction. The Labour party, then out of power, opposed the idea. The ruling Conservative party never endorsed the proposal, although one senior party member – Michael Heseltine – did adopt it when he campaigned unsuccessfully to succeed Margaret Thatcher as prime minister in late 1990. It is true that the Major government carefully managed and timed its entry into the EMS so that it received maximum short-run political benefit from the move. This interest in shoring up its political support help us to understand the choice of when to enter the system and the exchange rate chosen when doing so. But it does not help very much in explaining why interest in a fixed exchange rate was seriously debated consistently after 1985, nor why the government chose this option rather than others such as simply changing interest rates in response to immediate economic or political developments. But the framework introduced here does address these issues, as it shows how the specific cause of an episode of failure makes some alternatives more attractive and plausible than others.

Creating an independent Bank of England

Sacrificing monetary policy autonomy by joining the EMS soon imposed substantial costs on the government. The Bundesbank raised interest rates through early 1992 to counter domestic inflation. Inflation in Britain fell in the early 1990s but growth and employment remained low, calling for further interest rate cuts (see Figure 1). But EMS membership placed a floor under British interest rates. By mid-1992 the government faced a serious dilemma – maintaining sterling's peg in the EMS would choke economic growth and reduce the government's popularity with voters and MPs, but exiting the EMS would undermine the credibility of the government's policy promises.

External developments resolved this drift in policy. The combination of a the rejection of the Treaty of European Union by Danish voters in a referendum in June 1992 and increases in German interest rates in July led sterling and other European currencies to depreciate against the mark.

The government intervened heavily on the foreign exchange market to maintain the peg, then unsuccessfully pressed German authorities to cut interest rates, and on 'Black Wednesday', September 16, gave up the battle by pulling sterling from the EMS and allowing the currency to float (Cameron, 1993).

Black Wednesday destroyed the Major government's credibility with voters and investors. Ministers and officials spent most of late 1992 and 1993 considering alternative policy ideas. Any idea that prioritized exchange rate stability – such as rejoining the EMS or negotiating a more global monetary agreement – received little consideration. This was despite the fact sustaining an exchange rate peg may very well have been much easier after Black Wednesday for two reasons. First, sterling could have reentered the system at a more sustainable parity. Second, after the summer of 1993 the other members of the EMS widened its fluctuation bands from ± 2.25 to ± 15 percent around central parities. This reduced expectations of devaluations and created less tension in the EMS. But the analytical ideas behind proposals for exchange rate stability had been discredited in the eyes of British leaders by their humiliating exit from the EMS. They focused most attention on policy ideas that would give precedence to domestic macroeconomic stability and would promise to restore the authorities' credibility with the financial markets. Such ideas were avoided the problems that exchange rate stabilization had created. They also would serve the useful political function of allowing the government to give priority to creating economic conditions preferred by voters and potential rebels in the Conservative party in Parliament. And they would address the fact that the government lacked credibility, which made it much more difficult to influence private-sector economic activity and expectations.

Two such ideas were considered and debated. The first was inflation targeting, in which the authorities declare a public target for the inflation rate and pledge to adjust interest rates to achieve this target. In the post-Black Wednesday context, inflation targeting has three principal advantages. First, it prioritized the domestic objective of low inflation. Second, it gives the authorities the flexibility to respond to unforeseen developments that influence the inflation rate. This was a considerable advantage over the EMS experience, when unexpected sterling depreciation forced the government to maintain high interest rates at a time of slow economic growth. Third, the fact that an inflation target is public is intended to increase the credibility of the government's promise to achieve it. Governments know that they will be criticized for exceeding their inflation target if it has been announced in advance, and thus will work harder to avoid this outcome, a conclusion supported by some recent academic research (see, for example, Fischer, 1995).

The Major government adopted this policy idea, and announced inflation targets beginning in 1993. But they soon decided that inflation targeting alone was not an adequate solution to the policy failure of Black Wednesday. While inflation targeting usefully focused on the domestic economy, it did too little to augment the government's credibility. The reason was that inflation targets amounted to a promise of the outcomes the government wanted to achieve, but did not explain how the government would do this. So the government soon linked the inflation target to moves that gave the Bank of England greater voice over monetary policy, while continuing to allow the currency to float. Academic research produced at the time, with which many officials and advisors were familiar, concluded that central bank independence was a 'free lunch' that provided lower inflation at no cost in terms of output or employment (key works included Cukierman, 1992; Grilli *et al.*, 1991; Alesina and Summers, 1993). The key advantage that the policy idea of central bank independence had over inflation targeting was that it posited a plausible institutional and political mechanisms that would realize this goal. On the institutional side, contemporary independent central banks are typically charged with giving priority to keeping inflation low. This statutory requirement is intended to create in the bank the organizational objective of maintaining low inflation. On the political side, independent central bankers are usually selected, or become upon assuming their office, 'conservative' in the sense that they place priority on low inflation (Rogoff, 1985). Furthermore, the major force in society that interacts with, and supports the independence of, the central bank are banks and other financial firms. This private sector coalition should support the objective of low inflation and lobby other branches of government that the central bank's ability to achieve this objective be maintained (Henning, 1994).

Initial steps in the direction of central bank independence included directing the Bank to publish an independent inflation forecast, institutionalizing monthly meetings between the Chancellor and the Governor of the Bank, and releasing the minutes of these meetings with a six-week lag. While the government retained authority over interest rate changes, it did give the Bank considerable room to effectively criticize policy decisions that it thought were inflationary (Cobham, 1997; Stephens, 1996: 294–5). The Labour government elected in May 1997 took these reforms to their logical conclusion, and granted the Bank full political independence and operational authority over interest rate policy. While the government continued to set an inflation target, the Bank now had free rein to change interest rates in the manner it thought would best achieve this target. Full independence would further increase the credibility of monetary policy, and the 'new' Labour party, having been out of office for 18 years, was very keen to prove to voters and investors that it could be trusted to manage economic policy responsibly. Furthermore, the limited implementation of this policy idea by the Major government had produced successful outcomes compared to the past (see Figure 1), making it seem to the authorities quite reasonable to take the idea's prescriptions to their logical conclusion (see especially Burnham, 2001, and King, 2005).

This case also demonstrates that it is principally how the content of a policy idea relates to recent failure, rather than its content alone, that determines the extent to which it is found persuasive. The content of the policy idea of central bank independence did not change substantially between when it was first seriously injected into policy discussions by Lawson in 1988, and when it was adopted by first the Major and then the Blair governments. What had changed, however, was the context in which it was considered. The failure of the MTFS raised questions about which policy tool would provide the best rule for maintaining low inflation. Central bank independence did not create such a rule, but membership in the EMS did. After Black Wednesday, the failure of EMS membership raised the issue of how the authorities could most effectively increase their credibility. The policy idea of central bank independence directly addressed this problem, which made it much more interesting and persuasive to politicians.

HOW AND WHY BRITAIN MIGHT JOIN MONETARY UNION

To this point, I have argued that policy failure leads to the implementation of a new policy idea only if this idea can successfully explain past failure and generate plausible prescriptions for how to produce more desirable outcomes in the future. Such policy ideas existed and were implemented after the failure of demand management in the 1970s, the MTFS in the 1980s, and the EMS in the 1990s. If this understanding is correct, Britain might join the euro under the following sequence. First, the current policy framework of central bank independence with a floating exchange rate must begin to produce undesirable outcomes. While it is impossible to predict when such failure might occur, it does seem reasonable to expect failure at some point in the future. Few would argue that the innovation of central bank independence has permanently stabilized the economy, especially in the face of external shocks. And there are numerous cases in which independent central banks took steps that actually aggravated such shocks, including the Bank of England at the onset of the Great Depression, the United States Federal Reserve in the 1970s, and the German Bundesbank after German reunification.

This policy failure would create strong incentives for the government to seek out alternative ideas for monetary policy. The government might consider seriously membership in the single currency as an attractive new policy framework if joining the euro was seen as addressing the cause of recent policy failure. We can imagine two situations in which this might be the case. The first would be a rapid and sustained fall in sterling's value. This would have two negative effects. It would feed into domestic inflation, the key problem that central bank independence is intended to prevent. It also would indicate that an independent central bank alone can do little to control such depreciation. Both of these difficulties could be resolved by joining the euro. This step would impose the presumably now more credible authority of the European Central Bank, which should reduce inflation expectations in Britain. It also would remove the exchange rate problem, as Britain would no longer have a national currency or national exchange rate. A second scenario that would make euro membership attractive is a combination of high inflation and slow growth in Britain with lower inflation, reasonable economic growth, and low interest rates in the eurozone. Here joining the single currency would also reduce inflationary expectations while at the same time allowing for lower interest rates, which would spur British economic growth. Recall that this was exactly the circumstances that led the anti-monetary union, Conservative government of John Major to decide to join the European Monetary System in 1990, since doing so both shored up the government's anti-inflation credibility and allowed it to reduce interest rates. Euro membership would be less attractive after other sorts of policy failure. For example, unexpectedly higher unemployment in Britain than in the eurozone alone would not make euro membership more attractive, unless this step was consistent with an explanation for the unemployment difference and held the promise of ending it. If an episode of policy failure convinces the government of the day of the advantages of euro membership, it would then make the case to business leaders, international investors, and the voting public that euro membership will improve the state of the British economy. As we have seen, none of these groups has a solid majority committed to preventing the country from joining the euro. This means that majorities in favor of membership might materialize if the government were to make a strong and convincing case in favor. For government advocacy of monetary union to be effective, it must be able to show how the policy framework of the eurozone would solve the problems that previous national policy had created.

One might question the extent to which the policy ideas informing the current monetary policy regimes in Britain and the eurozone actually differ from each other. Central to the policy regimes in both Britain and the continent are a politically independent central bank charged with keeping inflation low. The key difference is that the eurozone is essentially a permanently fixed exchange rate regime, while the British authorities manage a floating exchange rate. Member states participating in the euro must match the monetary policy produced by the European Central Bank, which does not and is unlikely to alter its policy stance enough to offset even a serious economic problem such as recession in a single member state. In other words, adoption of the euro would mean that British authorities are abandoning the ability to revalue or devalue sterling (and thus the ability to conduct an independent monetary policy) to a supranational authority. This would mark a very substantial change in policy.

I am not arguing that this sequence of events is the most likely outcome or attempting to predict when such a sequence might occur. It is easy to imagine that events might prevent this sequence from unfolding. For example, the British economy may continue to outperform that of the eurozone in many respects. This has been the pattern for the last decade or so, during which Britain's unemployment rate has been much lower, and its inflation, growth, and borrowing rates have been about equal to or better than, those of the countries that have adopted the euro (see Figure 1). Even if the economy falters, the government in office (particularly a Conservative government, as the party remains divided on relations with the European Union) may resist pressure to advocate joining the single currency. Or the government may push for membership but have this move rejected in a public referendum. Instead, my point is that the preferences of the public and of elites, and therefore policy, may shift much more quickly and radically than structural explanations, such as trade patterns or political or social institutions, would have us think. The recent history of British monetary policy and especially of exchange-rate policy indicates that dramatic policy changes can occur in a short period of time. The reason for this is that while policy is of course influenced by slowly-changing structural factors, it is also influenced by policy ideas, which can achieve political prominence far more rapidly than structural factors change (see also Blyth, 2002).

One implication of this line of thinking is that most of the advice proffered by advocates of entry is either ineffective or counter-productive. Many favoring euro entry urge the government to emphasize the costs of exclusion for British business and British influence in the European Union (see, for example, Leonard and Arbuthnott, 2001). But it is difficult to make the case that the British economy has suffered outside of the euro. And counterfactual claims that Britain would have more influence in the European Union if it joined the single currency are difficult to substantiate in a compelling way to the public and politicians. Sadly for euro enthusiasts, British politicians, business leaders, and the public are unlikely to be convinced of the merits of joining the single currency unless the British economy begins to suffer from serious problems that cannot be addressed quickly or adequately with the current policy framework of national central bank independence. Only then might the alternative of abandoning sterling for the euro look politically and economically attractive.

NOTES

1 The key early papers are Kyland and Prescott (1977) and Barro and Gordon (1983).

2 The scholarly literature on each of these alternatives is enormous. A good introduction is (Bernhard *et al.*, 2002).

3 McNamara (1998) and Moravcsik (1998) both reach this conclusion, which is consistent with the focus on things such as partisanship, government cohesion, and electoral timing much of the comparative research on the determinants of macroeconomic policy. Others, such as Hall (1993) and Henning (1994), argue that the interests and influence of narrower interest groups depends largely on the institutional context. In the case considered here, this institutional context tends to minimize the importance of producer groups and other interest groups for the determination of macroeconomic policy for the reasons mentioned in the text.

4 Keegan (1989: 157), Riddell (1991: 18–22), Smith (1987: 90), and interviews with former minister and former director of the Bank of England.

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