The Impact of Contemporary European Debt Crisis on the British Economy

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Abstract: The objective of the study is to discuss the impact of current European debt crisis on the British economy. The study is based on different theoretically and descriptive data collected from different sources based on the crisis and on the economy of the British. Review of the literature was carried out for the data collection. The data was then analyzed by using the scanning and observation technique and all relevant data was selected for this study. All the findings were collected in a proper way to get the accurate results and conclude the study. The result demonstrates that in spite of the reality that the European crises have a negative impact on the United Kingdom's (UK) economy the European Union (EU) membership also has certain benefits for UK. 50 % of overall trade of UK is with EU and if crisis hit Europe, it will ultimately have an impact on the economic activities within UK. Inflation rate has raised, exports have dropped and the global competitiveness of the exporters has negatively impacted due to these crises. Euro zone crises are creating huge uncertainty which has reduce the public spending in euro-zone resulting in dropping the sales in UK. Furthermore the knockout effect will affect not only the companies with direct exposure in European market but also the SMEs and other larger businesses with no direct exposure to the Euro-zone. Modeling composting processes is the prerequisite to realize the process control of composting.

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1. Introduction

It evident from various financial and statistical data sources that UK carries about 50 percent of its trade activities with different European countries (S., Booth, C., Howarth, 2012) and hence, any default or crisis in European economy will ultimately have an impact on the economy of UK. This research is mainly about the impacts of currents European debt crisis on the economy of UK. For the purpose we will have to look different aspects in which both the UK and other European countries are interrelated and the extent to which they rely on each other. Further we will have to investigate the past agreement in order to develop future prediction about how far UK and European countries can go on parallel to each other.

1.1 Role of Finance in the Current World Market

There are mainly two main points of views about the role of finance in economic growth; the neo-classical point of view and the endogenous approach. (B., W., Ickes, 1996; P, Aghion and P., Howitt, n.d; C., McMahon, 2012) From the neo-classical point of view, "economic growth is entirely driven by the accumulation of input factors and technical progress, with the potential role of finance restricted to assistance in the accumulation of capital." (Michael Thiel, 2001, p.6)On the other hand the endogenous growth approaches "stress the role of entrepreneurship and innovation, which allows some leeway for finance to direct incentives to research and innovation or rent-seeking."(Michael Thiel, 2001, p.6)

The moderate thinkers who are not affiliated to either school of thought have doubt about the financial system as to whether it is beneficial for economic growth or harmful.(Michael Thiel, 2001)There are mainly two concerns about this. One is that whether finance help in economic growth on its own or the economic development too is necessary along with it to help the economy to grow. The other is that at what stage of economic development is the finance helpful. Using finance without taking care of these two concerns leads the economy to what is happening in Europe. European countries took loans and use them all in research and development and welfare works and ignored the economic growth. This led them to serious consequences. The debt toll rise and it become difficult to take further debts. Since, there was no economic growth so, it become difficult to payback the debts and ultimately exacerbated a pandemic crisis in Europe. (Michael Thiel, 2001)

This European debt crisis is acting as an obstacle for UK to recover from recession. Finance when used effectively can help in recovery from recession but if used violently and unplanned can lead to worsen the recession. (KPMG, 2010)

1.2 A Short Background of the Current European Debt Crisis

In late 2009, as it became evident that Greece, Ireland, Portugal, Italy, and Spain are unable to repay their debts back to lenders of Euro zone; the European debt crisis took shape. Until 2008, the European financial market lent handsome amount of money to Greece, Ireland, Portugal, Italy, and Spain at the same rate at which they were lending money to stable Germany. The main reason behind this blind trust was the assumption about European countries as being as safe as the safest Germany and the faith that Euro could never break up. As a result thing get worst and some countries for instance Greece accumulated about 145% of its Gross Domestic Product (GDP) as gross debt.

While on the other hand European countries also have borrowed money from banks in Greece, Ireland, Portugal, Italy and Spain and form countries outside Europe like US and Japan. This has created an interconnected web of finance among these countries leading to develop a pandemic debt crisis in Europe because the risk of debtor countries to default reached serious level which ultimately have changed the market attitude and further borrowing has become substantially expensive for these countries. “This exacerbated the likelihood of a debt crisis in the Euro-zone as it increased the debtor countries’ chance of default and consequently the chance of insolvency of banks in creditor countries.” (SESRIC report, 2011, p.4)

1.3 A short background of the British economy and its status within the European Economy

Globally UK has the seventh largest economy if measured through nominal GDP and has eighth largest economy if measured by purchasing power parity (PPP). In Europe this rank is higher. In Europe UK has the third largest economy right after Germany and France if measured through nominal GDP and has second largest economy right after Germany if measured by purchasing power parity (PPP) (CIA, 2012).

If the economy of UK is compared with the economy of other European countries in terms of inflation, interest rates and unemployment, we can say that it is one of strongest among the European countries. The inflation, the interest rates and the unemployment all remained relatively low until the 2008–09 recessions. However, the unemployment has risen somehow since then and has reached a peak value of just under 2.5 million that is 7.8 percent. This is the highest level since the early recession of 1990s. But if we compare this unemployment rate with that of European countries, it is still relatively low. However, interest rates have lowered to shocking level of just 0.5 percent. In August 2008 the “IMF warned that the UK economic outlook had worsened due to a twin shock: financial turmoil as well as rising commodity prices.”(M. K. Tang, 2008)

Furthermore, the UK economy is also affected by the current global recession. IMF European Department have summarized the current economic climate in UK thus: (M. K. Tang, 2008)

1. Macroeconomic imbalances, compounded by global shocks, dent outlook
2. Sharp slowdown in private domestic demand set
3. Need to safeguard fiscal policy credibility via strong medium-term adjustment

Hence, for the purpose of understanding the effects and implications of these economic fluctuations and to bring effective reforms to cope with the situation there is a strong need to study the global economic market. Within this global economic market there is a need to look at how the things are going globally in general and particularly in Europe and how these conditions can impact the economy of the UK. In order to enable decision makers to implement reforms that are effective in helping UK come out of the recession and move back towards economic recovery.

2. The Impact of the European Sovereign Debt Crisis on the UK Economy: Practitioners Views

Both Europe and UK are interrelated in number of economic aspects. Europe is the largest trading partner of UK; UK does more than 50% of its total trade with the European Union which comprises about 5%-6% of UK’s overall GDP. (BBC, 2011)Thus, if reduction in any economic activity occurred in Europe due to its economic crisis, it will ultimately have an impact on the economic activities within UK. (William P., 2012)

An article published by financial info.com quoted the prediction of Tony. Duo Lefen who is the British Public Policy Institute’s chief economist that “UK economy will usher in a bleak, the risk of recession has been under siege, and trigger an economic recession.” He pointed at the debt crisis of Europe as main reason of this. He further said that the reduced spending policy adapted by European countries will inevitably damage the UK economy.(Financial Info, 2012)For example if the EU countries decide to cut expenses on vacationing in UK and focus on consumer goods due to this spending cut, this could affect the UK economy based on reduced or no income in the area of tourism from the Euro zone. Also this could affect the number of European students’ inflow to UK for education as well. And these are the two major economic boosting sectors of the UK.

A research report powered by TNS research (2011; p.1) on the impacts of European debt crisis on UK international trade mentioned that inflation threat and weak pound concern UK businesses trading internationally. Seven in 10 exporters are concerned that inflation will affect their competitiveness overseas. Almost two thirds of importers hit by weak UK economic conditions. The report has also mentioned some downturns in UK international business statistics and confidence in future trading conditions has lowered as a 12% decrease in the number of UK businesses who were confident that international trade conditions will improve over the next 12 months was seen and record 20% fall in the number of businesses who believe in an export-led economic recovery. (TNS research, 2011; p.1)

David Sear (2011), Global Managing Director at Travelex Global Business Payments says:"The fall in trade confidence, evident from June's index, has been largely impacted by rising UK inflation and the debt crisis we are witnessing in Europe; the UK's main trading partner." (TNS Research, 2011, p.1) Currently, UK businesses with the European countries are not profitable because of the continuous pressure on margins and bottom line, and are now anticipating further struggles. The expectation of the importers and exporter have dropped and are expected to remain same for next six months to one year because the threat of default and collapsing across the channel. There is a continuous rise in the inflation in UK and has rise about 2 percent from the targeted rate since 2009. This is alarming factor as this condition is against export-led recovery and has negative impact on the global competiveness of the exporters. (TNS Research, 2011)

A research report by ICAEW (2012) on the impacts of the Euro zone crisis on UK's business mentioned that a worsening of the Euro zone crisis is expected to have a negative impact extending beyond those with direct business contact with the Euro zone. Their latest research among senior finance professionals in the UK suggests that many expect a continued worsening of the Euro zone crisis to have a detrimental impact on the turnover of their business over the next 12 months. Those in larger companies (250+ FTEs) with direct interactions with the Euro zone are most likely to be negative. This is unsurprising given that they are more likely than their counterparts in SMEs (1-249 FTEs) to have a range of channels through which they have contact with Euro zone, in the form of customers, suppliers, business functions, outsourcing or debt finance with Euro zone based banks. The impact of the level of direct exposure to the Euro zone is further evidenced when looking at the proportion of turnover which comes from customers in the Euro zone: those with 6% or more of their turnover stemming from these customers are more likely to be negative. What's happening in the Euro zone is creating huge uncertainty, which is leading to reluctance for Euro zone customers to spend if they don't have to, which is restricting growth. There are lots of customers in the Euro zone and if there is economic meltdown the sales in UK will drop significantly. It will lead to a massive decrease in turnover due to reduced customer confidence and spending. It is possible the supplier costs (the cost of freight) will increase and UK may face bad/slow payment issues with some of its smaller customers.'(ICAEW, 2012)

An analysis report on the European debt crisis, its potential resolution and its impact on the UK market prepared by Investment Insight (2012) mentioned three broad scenarios in which the European debt crisis can impact the UK's economy. First scenario is the 'base scenario' where "politicians muddle through which ultimately leads to fiscal union."If this happened, economic conditions in UK will turn to a condition where gilt yields are expected to remain low because UK being viewed as safe-haven relative to the economic turmoil all over Europe. Long end yield are expected to trade within a range of 2-4 percent. However, with the development of coherent solutions and the diversion of investor's attention towards analyzing of UK's debt problems, this condition can significantly change. But still, the pressure of the macroeconomic conditions may not allow higher economic growth and it seems very difficult that the rise in rates will reach the past level of 5 percent. Investment decision may become dependent on risk assets as sentiment rather than on the fundamental analysis. Hence the expected outcomes of the market will oscillate between the two extremes that are either very low or very high. Under the base scenario, there is also a chance that mass global deleveraging takes place. In such a condition the low-growth environment is likely to persist in the UK. This scenario may also result in limited role of UK government in European decision making. However, if pro-Europe Labor government comes in to power before full fiscal union is achieved; the conditions are likely to be different. Under this scenario, the concern due to the contagion within the global banking sector will continue but will have special impacts on the weaker banks that who has weak balance sheet and are unable to cope with the economic crisis they are facing. (Insight Investment, 2012, p.6)

The second scenario described by the report is the 'positive scenario' where "orderly Greek default and coherent flight plan to fiscal union." If this happened, economic conditions in UK will turn to a condition where gilt yield may rise because Europe is gradually resolving its debt problems which results in fading of the UK's image of being safe-haven. Under this scenario any major movement in currency is not expected however, sterling may drop a little following the positive sentiment that is developing relating to the Euro zone. (Insight Investment, 2012, p.7)

Another impact of this scenario might be UK will suffer from debt problems and they will need to reduce this problem through deleveraging process. The impact of this deleveraging process will be that low-growth environment in the UK will persist. However, the deflationary period depends on the depth of economic recession in Europe. If it's low or normal the deflationary period can be avoided but its high, the deflationary period cannot be avoided. This scenario can slightly increase the demand of the risk assets that can be considered as relief rally leading to normalize the credit spreads. With the contribution of central banks that are working together to liquidate the market along with the decline in fear in the system would probably improve liquidity. If the fiscal union developed in Europe, it will ultimately sideline the participation of UK in major European decision making related to the future of the euro economic zone. However, beside this fact, it should be kept in mind that development of fiscal union will be a long-term and gradual process because institutions in Europe are not based on European monetary union rather they are based on European Union. (Insight Investment, 2012, p.7)

The third scenario mentioned in the report is the 'negative scenario' where "a disorderly Greek default and leads to euro break-up." If this happened, economic conditions in UK will turn to a condition where the emergence of new Euro-zone currencies would result in strengthening of the sterling in general however; this would not possibly be against a new Deutsche Mark. According to the report study, if such thing happened the devaluation of affected currencies will overshoot by 2.5 times before it round back to its neutral level. So, under this scenario, the currency volatility is expected to be too high. During the process of disintegration of European monetary union, UK is expected to be viewed as safe-haven which probably will allow the flow of money into the UK. (Insight Investment, 2012, p.7)

BBC news (2011) commented on the agreement of the European's make-or-break summit that as the outlines of an agreement emerge from the European Union's make-or-break summit to save the euro, there is one point that is now certain: The UK will not be part of it. Another point that the agreement mentioned is that the political stakes for UK may have become starkly clear but the economic and financial stakes still remained wide open. This have led the UK stands to gain or lose enormously totally dependable on the success or failure of euro. But the major problem that has appeared from this agreement is that UK has no more control or any influence on the outcome about the success or failure of euro. They just have to watch and wait until the results come.

Some of the proposed effects of euro agreement on UK are that it will have very small scale direct effects on UK because of the reason that UK has been excluded from the treaty. With this any proposals about any new rules or any modification in the existing rules on government borrowing and any possible harmonization of corporate tax rates will only affect the countries in euro-zone and UK will not be affected by them.

The distance between UK and Euro-zone keep on increasing as the UK takes more and more disputed or independent steps to recover from recession. When David Cameron lower the tax on financial transactions in order save the London's global competitiveness as a financial centre, it ultimately will irate France and Germany as this tax was pushed by them as "Tobin tax" or "Robin Hood tax". David Cameron argued that this tax will only help UK if and only if U.S and other countries of the world adapt it or it will damage the City's global competitiveness as a financial centre.

UK also did not contribute in the European summits which were aimed to boost the size of one bailout fund. Both the summits that are European Financial Stability Facility (EFSF) and the European Stabilization Mechanism (ESM) were ignored by UK and did not will to pay any more in bailouts. UK also did no contribution in European Central Bank (ECB) as the summit tried to pave the way for ECB "to step up its purchases of Italian and Spanish government debt - a back-door way of reducing those countries' currently punitive costs of borrowing."

However it will be a good thing for UK if they contribute in financing the future bailouts of Europe because if the euro-zone collapses, the disaster will not only affect the euro-zone countries but also the UK. It isn't a new experience for UK as they have done so in the case of the Irish Republic late last year.

In other case if the euro-zone took more time to recover from its financial crisis or collapses, the UK will be affected in two broad sectors.

The banking crisis: it is becoming difficult day by day for the banks of euro- zone to borrow money and the case become more intense when they need to borrow money in foreign currencies such as the US dollar.

The government debt crisis: the borrowing cost of Southern European governments has been sharply increasing day by day.

Both of these crises could probably spill over into the UK if the financial crisis of euro-zone last further long. The banks of UK are therefore under huge risk and if the bank crisis hits UK it could ultimately provoke a global financial crisis, and as a result it will place huge strains on the City of London. According to the studies of 2008-09, UK is the most dependent countries on its banks as compare to any other country in the world. They contributes in the financing of mortgages, keeping the flow of cash through the economy, help in raising the employment rate by providing employing tens of thousands of people and pay a big chunk of the Treasury's tax revenues. All these contributions to the economy through banks are at risk and the thing to worry more is that the governments currently have much less capacity to bail the financial system out. (BBC, 2011)

The Financial Info (2012) have mentioned in their article on the challenges faced by British due to European debt crisis that the Confederation of British Industry has been optimistic about the UK economy had lowered the forecast for British economic growth, expected 2012 British economic growth was only 0.9%, and 2011 forecast growth of 1.2%. According to John Kerry Teresa the Director-General of the Federation the current economic situation is bleak; the economic recovery of UK depends on the crises of debt in Europe. It can be successfully resolved. Moody's this down the UK credit rating outlook, which indicates not only the concerns of Britain's future financial condition and economic growth is weak, and that the prospects for Europe's debt crisis and its negative impact on the economies outside worries. The results of the rating, the British Chancellor of the Exchequer Osborne said in the current international situation; the United Kingdom could not be spared of the debt problem.

The face of the impact of the debt crisis in Europe, the British hands still prescribe a "firewall". First, the United Kingdom for the EU countries, but did not join the euro, the pound is still the existence of currency in circulation, monetary sovereignty, can be taken to deal with the debt crisis in Europe for greater flexibility in monetary policy. In fact, with the European debt crisis, many British people and even the British did not join the euro thankful. The second is the British Government's intention to distance themselves from other European countries, to avoid a crisis more spread itself. 12, British Prime Minister David Cameron on the EU summit in Brussels, strongly rejected the proposal to modify the EU treaty. Cameron at the open sin France, Germany and other European powers of the proposal say their motive is to protect the UK financial sector to avoid the UK economy is dragged down by the case of the credit crunch worsened in Europe. Britain also strongly opposed to the taxation of financial transactions, the UK is to stay out of other initiatives to rescue the European debt.

Nevertheless, the "firewall" seems still difficult to stop the increasingly strong shock wave of European debt. On the one hand, Britain's foreign trade structure has the obvious vulnerability. England more than half of the import and export trade with other EU countries. Some EU countries have adopted a policy tightening, reduce the demand for public consumption, British exports therefore decline sharply. The other hand, as the financial sector of the British pillar industries affected by the European debt crisis, the downturn occur in investor confidence, fears filled the air, and then bring a direct negative impact on the UK financial industry. From recent UK financial institutions have been massive layoffs can be seen, the debt crisis in Europe the impact of the pillar industries of the United Kingdom should not be overlooked.

Analysts here pointed out, in the environment of economic integration, with the continued deterioration and the spread of the debt crisis in Europe, the United Kingdom not sit idly by. The assessment report recently released by the British think tank even believe that once the euro-zone crash, 2012 UK gross domestic product decreased by 2.3%, the proportion of the budget deficit to gross domestic product will return to a high of about 10%. (Financial Info, 2012)

Damien Gayle mentioned in article "UK 'back in recession' and EU crisis means we won't see growth until the summer, says Item Club" that Britain is once again suffering a recession and this year unemployment risk is three million, (forecaster reports). Europe's debt crisis has paralyzed the UK's economic recovery, the GDP growth forecast is from 1.5 per cent to 0.2 per cent (Ernst & Young Item club).The nine European countries - including France – had downgraded credit ratings have plunged world stock markets into turmoil.

Economists expect that economy will be powered by exports and business investment this year, with public spending as well as consumer spending is still in the dejection. More than 40 per cent of British trade is in Europe. Business confidence has decreased by uncertainty about the future of the single currency and also the continent. The Telegraph of Sunday quoted Professor Peter Spencer, chief economist at the Item Club, as saying: "Figures for the last quarter of 2011 and the first quarter of this year are likely to show that we are back in recession, and we are going to have to wait until the summer before there are signs of improvement."

Predictions of Item Club's were based on the positive assumptions. European policymakers' has ability to keep the Euro zone safe (Professor Spencer). He added: "The longer the uncertainty continues, the more debilitating the impact will be on the UK's economic prospects."

European Commission vice-president for economic affairs, Olli Rehn said that Standard & Poor's has slashed the credit ratings of the European countries. The downgrades were not in agreement and it claimed that the action of Euro zone was decisive over the economic crisis. France and Austria has no more AAA statuses, while the Italy, Spain, Slovakia and Slovenia also had also lowered rating. The Centre for Economic Business Research think-tank has revised down its forecast for 2012 growth from 0.7 per cent last October to 0.4 per cent including a risk of a more serious decline of 1.1 per cent if developments in the Euro zone become more ambiguous (Damien Gayle, 2012).

Douglas McWilliams, one of the report's authors and chief executive of Cebr, said: “We take no pleasure in outlining such a bleak forecast. But the world is going through a fundamental change where previously poor economies are industrializing fast.” (Damien Gayle, 2012)

An article “Euro zone debt crisis: Banks cutting lifelines to struggling UK companies” in international business sections of The Economic Times (2011) mentioned that since the credit crunch of 2008, the equity stakes of UK banks are accumulating day by day in 100s of ailing company to whom UK banks have lent money. This trend is a serious threat to many businesses and can cause disastrous consequences for these businesses. As the economic conditions get worse in Europe, banks are lowering the extent of their support to the struggling companies. Consequently these struggling companies are put in more risky conditions related to administration and this is not only limited to suffer the struggling companies only but the leaving lenders too are facing hefty losses on loans that they have lend to these struggling companies. Paul Daccus, who is the principal at private equity group Sun European Partners, said that “They would rather put the businesses into administration and get back what they can. One year ago they might have taken a punt on the equity.”It can be evident from the forced sale of Luminar which is the former London-listed night clubs group. Other example includes the Oceana and Lava & Ignite clubs whose owners were put into administration in October because of the cutting of credit lines from them by some of their large lenders banks including Barclays, Lloyds Banking Group and Royal Bank of Scotland. It was done because the last week sales of these companies were so low that they were only able to recover just a fraction of their loans. About handling of the distressed companies some at the banks argue their approach to handling distressed companies hasn't changed; it's just the economic conditions that are gloomier.

“If we can see a route back to value we will always back ourselves to do that. That hasn't changed. What has changed is that we are in a very uncertain business environment which makes forecasting with any accuracy extremely difficult,” said the head Graham Rusling. With the longer and trickier path of recovery banks are running the risk of holding companies for long. Banks find it difficult to take control due to higher costs for holding equity severe discouragement that will come under Basel III regulations. It is all strengthening the argument for banks to get out earlier if they can. The number of equity stakes lenders hold has ballooned since the early days of the credit crisis, with many lenders beefing up their so-called "workout teams" to handle distressed deals. They now control a swathe of mid-sized companies across Britain, including window maker Anglian and retailer Garden Centre Group.

RBS, 83 percent owned by British taxpayers, holds equity stakes in some 300 companies. That's nearly three times the number owned by British private equity firm 3i Group. Barclays has a much more modest 30 or so equity positions - a similar number to Bridge point. Neither bank lists these equity stakes nor do the precise details remain private. According to some analysts, banks sometimes turn too bureaucratic to take certain types of tough decision about restructuring companies under certain conditions because their teams may already have swamped they are not able to take on more businesses.

"Banks are not natural owners of companies," said Matthias Allgaier, managing director at HIG Capital, who already sees an increased flow of new deals from banks. "The requirement of new money makes a lot of banks very hesitant and they would rather cut their losses and sell the company than put in equity," Allgaier said. Despite resistance from many lenders to taking equity, some point to successes. "Banks are not commercially inclined to get involved in equity. But if you convert enough debt, and provided the business is right, you will get a faster recovery of your money," said Derek Sach, head of RBS's global restructuring group. When CVC's suitcase maker Samsonite got into trouble, RBS swapped debt for equity and ended up with a 30 percent stake. The company floated earlier this year in Hong Kong and RBS got back much of its money, and could still recoup it all if remaining shares trade well. (The Economic Times, 2011)

An article “King: European debt crisis or threat to British economic recovery” published by finance-ol.com have mentioned that Bank of England (BOE) governor Mervyn King on Wednesday, King (516), the UK economy remains slow recovery, but the euro zone turmoil bring a certain amount of risk to the UK economy. King Wednesday, said: “We do not know when it will eliminate the turmoil of the Europe Bureau, but we have reason to believe that the British economy will continue to maintain recovery momentum, British inflation will fall.”

King also pointed out that: “in the foreseeable future, the United Kingdom’s economy will continue to be the impact of the debt crisis in Europe, the major British companies, especially the balance sheet of euro area financial enterprises there is a certain potential risks , which means that the process of economic recovery will slow, and has some uncertainty. “

The inflation front, the King said, the level of UK inflation in the next one may remain to more than 2 percent, while economic growth will likely slow down due to the European debt crisis to contain. The British central bank’s projections indicate that the lower inflation rate than the previous three expected slowdown in economic growth prospects are worse than before. (Finance Online, 2012)

European economic review mentioned following impacts of European debt crisis on UK economy:

The U.K. economy continues to be troubled by surging inflation and weakening consumer demand. January's measure of price rise in the country touched 4%, which is double the Bank of England's target of 2%. However, the central bank has refrained from making any decision on raising interest rates. Given that the U.K. economy contracted 0.5% in the fourth quarter of 2010, such a decision is likely to be kept on hold for an extended period. Meanwhile, consumers in the country seem to be growing more cautious about spending.

A monthly survey that measures sales volumes indicated that in February, the number of retailers reporting higher sales grew only 6% compared to last year. The rate of growth was expected to be 25%. The survey also found out that the number of retailers expecting sales volumes to decline over the next three months was the same as the number that anticipated volumes to rise. Given the Value-Added Tax (VAT) hike in January and the rise in raw material costs, shopkeepers are struggling to keep prices attractive for consumers. Hence, many households are postponing the purchase of big-ticket items.

On a positive note, though, the country's crucial services sector recorded its fastest pace of growth since May 2010 in January 2011, as businesses normalized their operations after December's snow disruption. Further, the purchasing managers' index for manufacturing showed a record jump in January, while another purchasing managers' survey indicated renewed momentum in construction activity. (Thomas White, 2011)

European debt crisis is one of the biggest obstacles in UK's recovery from economic crisis. United Kingdom Economy (2012) mentioned about the UK that it is a leading trading power and financial centre of Europe and ranks third among the largest economies of Europe after Germany and France. It has adapted the austerity policy and the government of UK has greatly reduced public ownership and number of social welfare programs has been contained. Agriculture of Europe is highly mechanized and intensive and has adapted the European standards which have led it to produce about 60 percent of food needs by using only about 2 percent of the total labor force. Until now UK has rich resources of oil, coal and natural gas but unfortunately its oil and natural gas reserves are declining and it is estimated in a report in 2005 that UK has become a net importer of the these energy resources. Banking, insurance and other business services means a lot to UK in terms of its overall GDP growth but a declining trend can be seen in this industry too. The economy of UK was hit by recession in 1992 but when it recovered from that recession UK enjoyed the longest period of expansion on record. During this period the time growth of UK outpaced most of the other European countries. But after sixteen years of fertility the land of economy barrens once again when in 2008 global financial crisis hit the economy of UK. This financial crisis hit the UK's economy particularly hard because of the role of financial sector being the most important in UK's economy. As a result, home prices declined sharply, consumer debt raised and UK suffered economic problems due to slow global economic growth. All these factors led the UK towards recession once again in late 2008. Aftermath of the recession turns the BROWN government of UK to implement austerity policy and number of other measures to stimulate the economy and stabilize the financial markets including nationalizing parts of the banking system, cutting taxes, suspending public sector borrowing rules, and moving forward public spending on capital projects etc. The austerity policy was actually adapted in 2010 by the then Cameron Government in because of the burgeoning public deficits and debt levels. Its aim was to reduce the London's budget deficit from over 10% of GDP in 2010 to nearly 1% by 2015. In continuation Chancellor of the Exchequer George OSBORNE revise the applied austerity policy and some more austerity measures were added with time span expanding from 2015 to 2017. He took this decision because of two reasons. One is the slower-than-expected economic growth and the other is the one which we are trying to investigate though this research is the impact of the euro-zone debt crisis. "The Bank of England periodically coordinates interest rate moves with the European Central Bank, but Britain remains outside the European Economic and Monetary Union (EMU)." (Theodora, 2012)

Matthew Lynn (2011) in his article "U.K. is not immune to euro zone crisis" published in 'The Wall Street Journal' mentioned that "U.K. economy right now is dire." The GDP growth of UK is flat, unemployment is mounting, exports are decreasing, and the deficit is more than about 10 percent of the GDP and the chances to reduce this rising budget deficit looks set to be missed. All these factors can probably lead the UK's economy into recession again in 2012.

The article predicted that UK though till now UK economy has escaped from the harmful impacts of the euro-zone crisis but in near future it will suffer a big hit. The crisis will have an impact on gilts, sterling and the U.K.'s key benchmark index, the FTSE 100 (UK: UKX). From summer 2011 the situation changed. European countries become aware of the weak economic conditions of UK. This resulted in further lowering of the growth in UK as the trust of companies in Euro-zone distracted. Prime Minister David Cameron like the Prime Ministers of other European countries too has to work on cutting the expenses and ignore looking around for the phone number of the International Monetary Fund. As said, “Low growth is one thing. Going broke, and having to be bailed out is another.” (Matthew Lynn, 2011)

The situation of UK and European debt crisis is same as of the one whose neighboring house is on fire but he is lucky enough to escape the conflagration. But for long he may escape. So, he has to worry about it. Same is the case of UK. UK although till now have escape the conflagration of debt crisis in Europe but for how long it may remain safe. There are mainly three enormous challenges that UK has been facing, and adding them together can help the threat to end up in meltdown.

Placing aside the comment that whether U.K. is immune to the euro’s woes or not, it can evident from different statistics that although the trade of UK with rest of the world and especially with BRIC countries namely Brazil, Russia, India and China has increased twofold but despite this fact Europe is still the major trade partner of UK. Hence any mishap that strikes the Europe will have an ultimate impact on UK. Another challenge that UK has been facing is that its bank are not off the hook. Its potential liabilities are undercover and there is no specific way to know about them. There is also no possible way to estimate the loss that UK banks will suffer in case of the meltdown in the Italian, Spanish and now French bond markets. Banking is aggressive in City of London which has number of very large banks. These banks have plenty of exposure among the banks themselves. They also have larger exposure to those with whom they do business for example the London hedge funds. All this exposure may result in easily in another expensive bail-out of the banks ahead, which will blow the deficit sky high.(Mathew Lyne, 2011)

Despite the threats to the economy of UK from the European debt crisis mentioned above, there is also some counter argument about the matter as Hamish McRae said that “The UK position is not as gloomy as is sometimes depicted”.(Martin P., 2011). He argue while wrote in The Observer that it is true that the fiscal deficit of UK is more that 9 percent but still it is to be considered as safe-haven as it has enough spare cash to control it as compared to that of US. This fact point towards the success of the approach adapted by UK and through this austerity approach UK is having benefit of low interest rates and an AAA credit rating. Martin P., (2011) further mentioned that in spite of political demand for further stimulus, UK can achieve a sustainable recovery if they keep their interest rates low and maintain their credit rating.(Martin P., 2011)

3. British Role in European Union (EU)

European Union has 27 member states and UK is its one of the important member states. Being the member state of EU, UK is subject to European Union (EU) legislation. British ministers are although involved in the decision of this legislation but they cannot accept the proposals before it has been examined by Parliament. The EU has authority to enforce the laws of England, but actually putting them into action may require Parliament to approve a new or amended legislation. (Craig, P., de Búrca, G., 2003; UK Parliament, 2012)Scrutiny Reserve Resolutions of UK bound its government ministers not to agree to any proposal that is still 'subject to scrutiny' by Parliament either in the Council of Ministers or the European Council. And if they do it on their own, they will be require explain their reasons. The British Parliament receives copies of documents from the EU along with an explanatory memorandum (EM), prepared by the relevant ministry. These documents are then well thought-out by the Scrutiny Committees in both the House of Commons and the House of Lords. In the House of Commons, the European Scrutiny Committee considers all EU documents and reports its opinion on the legal and political importance of each one. The committee may decide that no further scrutiny is required, or it may request further information from the government or recommend the document for debate in a European Legislation Committee or in the Commons chamber. The House of Lords examines proposals for EU legislation through the European Union Select Committee and there is close co-ordination with Commons committees. The Lords look at fewer EU documents but carry out detailed reviews on subjects selected for their general importance. These reviews are reported either just for information or to recommend a debate in the Lords. (DFAT, 2012, UK Parliament, 2012)

“Around 50% of significant legislation enacted in the UK that imposes burdens on businesses in UK originates from the European Union.” (Lord Macdonald, 2002; Sir D., Jones, 2005) They further mention that the number of these legislations is expected to further increase as the European competence area widens and new and different policy fields are drawn into it. Earlier European Union legislations were enacted only in the field of agriculture and fisheries but now a day the range of these legislations has covered not just the agriculture and fisheries but has implemented a single financial market and single goods and services market.

The EU is dynamic in more or less all areas of interest to business whether they are accounting standards; competition policy; contract, consumer and company law; corporate governance; employment;

environment; e-business; health and safety; international trade; intellectual property and transport. (Sir D., Jones, 2005)

Bulmer et al, (2002: p.5-6) follows an institutional approach to analysis and examined changes across four different 'dimensions' of institutions. He mentioned that: (R., Gomez, et al., 2003, p.1-2)

1. Change in the systemic dimension: affecting the constitutional rules and the framework of the state and government;

2. Change in the organizational dimension: affecting the formal structure of offices and key positions, and including the distribution of formal authority and resources of money and staff.

3. Change in the regulative dimension: affecting rules, guidelines and operating codes and also the capacity for strategic guidance (i.e. the means to ensure that tasks are fulfilled and that forward thinking is undertaken).

4. Change in the process dimension: affecting the processes whereby business is handled, information distributed and policy decisions determined; and including the networks established to fulfill these tasks.

3.1 The EU Act

The Britain's queen announced in her speech on May 2010 that the government of Britain will introduce a new legislation according to which any legislation enacted by European Union that lead to proposed transfer of power from Britain to European Union will be presented to parliament and the parliament will have an authority to review that legislation. The reason behind this legislation was to ensure that no transfer of power from Britain to European Union take place without the consensus of British people. (FCO, 2012)

This was because although the Government of Britain is committed to play a strong, active and positive role in European Union but contrary to this, the people of Britain are on opposite hand. The main reasons behind this disconnection is how the EU has developed, and the decisions that have been taken by the British Government in their name. With the promulgation of the EU Act the people of Britain will now have more control over the decision made by their government regarding the legislations of European Union. The British Government believes that by they can reconnect the people with European Union and rebuild their trust by rolling out control of these decisions to the people. (FCO, 2012)

With the promulgation of the European Union Act it will be ensured that there is a referendum lock on all those treaties enacted by European Union that moves a power or an area of policy from the Britain to the European Union that is, if any such treaty is passed by European Union, the Government will have to get the British people's consent in a national referendum before it can be agreed. (FCO, 2012)

Also with the promulgation of the European Union Act it will be ensured that before the Government can agree to the use of a ratchet clause, or passerelle (transfer power or an area of policy from the Britain to the European Union), an Act of Parliament will be required for all types of changes in European Union's treaties, which was not previously the case. (FCO, 2012)

3.2 Position of the British Government on the Common Euro Currency

More than a decade has passed since the development of the European currency union. The European Central Bank, located in Frankfurt has the responsibility of setting interest rates and controlling the issuance of euro bank notes and coins for all of the 27 member countries of the European Union. However, beside the fact that Britain is among the largest European Union member countries, it still has not the Euro as their currency rather they have retained the pound sterling as a national currency unit. With this in Britain only, the Bank of England is responsible for the supply of sterling and the setting of sterling interest rates. Although there is strong economic and financial ties between the Britain and the rest of Europe Union but this retention of the pound sterling have caused the British membership of the euro area to fallen off the domestic political agenda. C., Bowdler, (n.d) in his article assesses some of the arguments that are central to the debate over whether Britain should adopt the euro. He then focuses on how the effects of the credit crunch and global recession may impact upon this debate. (C., Bowdler, n.d)

3.3 The Economics of Monetary Union

The adaption to the single currency unit is one of the defining features of the monetary union. In case of European Monetary Union the adaption to the euro as national currency is that defining feature neglecting which may lead to incomplete monetary union. This framework of adapting to single currency has two major implications. First implication is that it eliminates the fluctuations in national exchange rates between member countries. For example "two years ago, British tourists holidaying in Spain this summer will have returned home to see hotel fees and restaurant bills paid in Euros showing up as much larger credit card bills in pounds and pence. The same is not true for their German counterparts, who pay for their time by the Med using exactly the same currency units that they receive each month as part of their pay cheque." (C., Bowdler, n.d, p.1) First implication is that monetary union entails similar interest rates for each member country. For example "in the 1990s the BancaD'Italia may have set much higher interest rates than the Banque de France, the European Central Bank now sets a single interest rate at which central banks across the Euro area make loans to commercial banks. If the interest rate in Italy were to be set higher than that in France, Italian borrowers would simply borrow Euros in France and use them to do business in Italy, rendering the higher Italian interest rate redundant." (C., Bowdler, n.d, p.1) Recent work by European Central Bank researchers indicates that the single interest rate set by the European Central Bank is related to convergence of the long-term interest rates paid on government bonds. This results in setting the cost of borrowing for many businesses and home owners.(M. Ehrmann, et al.; C., Bowdler, n.d).

Adaption to the single currency has large number of argument in its favor, which is well known. For instance, trade economists view it as a source of savings on transactions between countries. For example, tourists traveling within member countries no longer waste their money in foreign exchange and car producer of one member country working on orders for the car market of another member country no longer has to wait and see how its revenues are affected by the exchange rate at delivery date rather they can get the exact amount in that same currency which will help them to immediately grow their business. (C., Bowdler, n.d)

Economists while referring towards a loss of national monetary autonomy within a single currency area consider the combination of a fixed exchange rate and the imposition of a common interest rate between member countries. They also argue that the cost of trade has lowered in member countries of European Union due to monetary union and this has resulted in the increased trade growth between these countries. The economists, at a macroeconomic level, consider the monetary union as potential for improved policy. (C., Bowdler, n.d)

At the time when there were only sixteen member countries in the European Union, investors aggressively sold their currency believing that it has been over-valued commonly known as the prospect of currency attacks. This has forced the authorities like BancaD'Italia to make investment in large holdings of foreign currencies that could later be used to purchase Italian lira, and supports its value in the event of attacks. But as a result of the monetary union this expensive foreign currency holdings are minimized. Monetary union also reduced number of currencies vulnerable to attacks like these. When the European Central Bank was preparing the framework for the current monetary union, they have consulted experts from different individual central banks located at different member countries. For this the economists argued that "the policy errors that resulted in high inflation outcomes in southern European countries during the 1980s and 1990s will be avoided under the new policy framework." (C., Bowdler, n.d, p.2)

Another benefit of the monetary union is that it has expanded the domestic market place for companies of the member countries for example, "BMW or Siemens has expanded from the 80 million people of Germany to the 328 million people of the Euro area." (C., Bowdler, n.d, p.2) Larger markets access allows these companies to take advantage of economies of scale, as the economies of scale helps in lowering the unit costs of the manufactured products and increases competitiveness which ultimately results in boosting long-term growth prospects as well as delivering better value for money for consumers. (C., Bowdler, n.d)

Beside the advantages there also some disadvantages associated with the monetary union. One of these disadvantages is the inability to use the instruments of monetary policy to achieve macroeconomic goals. Most common of these macroeconomic goals are stable inflation and full employment which are still under consideration as these goals have not yet been achieved by the European Union. Despite the fact that monetary union has eliminated the multiple national interest rates to a single interest rate all around the European Union but it has not yet succeed in controlling the inflation rates and unemployment rates. "This tension leads to the prospect of very inefficient macroeconomic outcomes across countries." (C., Bowdler, n.d, p.2)

There is a huge cost associated with managing the monetary union and a question arises that whether or not monetary union is enough beneficial that its benefits exceed the costs associated with managing the monetary union. This depends significantly on the extent of shortcoming in the successful implementation of single monetary policy. The Nobel Laureate Robert Mundell argued that "labor mobility may substitute for monetary policy as an adjustment mechanism following asymmetric demand shocks." (C., Bowdler, n.d, p.3) for example "If Ireland were to be hit by a macroeconomic downturn more severe than that in the Netherlands, Irish workers that remained unemployed even after the common monetary policy expansion could migrate to the Netherlands in order to achieve full employment in both countries." (C., Bowdler, n.d p.3)

3.4 Benefits of Relationship on Both Sides

There is large number of practical benefits that UK enjoys being a member of the European Union. These benefits cover almost all economic areas including the trade, employment, travel and work opportunities, lower prices and wide array of choice for consumers. UK's ability to cope with current increasingly interdependent world's global challenges has increased due to its European Union's membership. UK is able to achieve more as member of European

Union then it could have achieved on its own in coping with some of the important issues including the “climate change, energy, cross-border crime, counter terrorism and the fight against world poverty.” (Foreign and Commonwealth Office, 2007)

The European Union is the world’s largest multilateral trading bloc and has a single market residing more than 490 million people. Britain can benefit from this huge market in terms of significant opportunities for both British businesses and consumers and membership of European Union helps them in trading freely in this huge European market. It is estimated that around 50% of total UK’s trade is with the European Union. According to the statistics of 2006, UK companies have exported goods to European countries that worth nearly £150 billion (statistics from HM Revenue and Customs). This figure is approximately 62% of the total export of the UK. Not only have this but with European Union’s membership the export of UK increased 25% on the year before. The statistic also mentioned that “in 2005, British companies invested €25.8 billion (£17.3 billion) in the EU – up from €17.1 billion (£11.5 billion) the year before.” The single market encourages the competitiveness of Europe’s businesses by eliminating the barriers in line of free movement goods, services, human and other capital throughout the European Union. Not only is this but it is further strengthen by the tough competition rules of the single European market. (Foreign and Commonwealth Office, 2007)

Britain however needs to continually ensure that the European Union effectively responds to the newly emerging global economic challenges. European Union now has keep updated and always ensures that they are globally competitive enough to catch up the rapidly growing economies of the world such as India and China. For European Union will have to create and maintain conditions that will enable internationally competitive businesses to thrive, for example they have to introduce themselves with the new technologies and the innovations that are currently emerging so that they become competitive and can flourish its businesses and position them at forefront. It should also focus on the skill and opportunities of its people so that they can achieve prosperity in future. It was estimated that the trade of china is doubling after every three years and at this speed, it was expected that China will become the largest exporter of the world by 2010. In service industry, the fastest and dramatic growth is made by India.

By working through the EU, the UK increases its influence in global markets. The ‘Hampton Court’ agenda was agreed during the UK Presidency in 2005. This agenda is trying to refocus the energy of the European Union’s to cope with the 21st century’s challenges. It is also helping in taking further action on energy and climate security. It is also focusing on developing the economy of European Union in 21st century economy by means of innovation and high educational achievement. The agenda is also working on issues associated with migration and further improving the security. (Foreign and Commonwealth Office, 2007)

There are several examples that points towards the successful progress of this agenda. For instance, “European Union leaders agreed in March 2007 on a crucial package of measures on climate change and energy. A unilateral reduction in greenhouse gas emissions of 20% by 2020 – rising to 30% in the context of an international agreement – demonstrates that the EU is serious about tackling climate change.” (Foreign and Commonwealth Office, 2007) With the help of this agreement, the European Union is setting itself on right track that will lead them to become the world’s first competitive, energy-secure, low carbon economy. Global efforts are being made in order to take effective measures to tackle climate change and energy security and this agenda will also help European Union to continue to lead these global efforts. There are several evidences that prove that when the European Union acts together and Britain play a leading role for them, they both can take the right decisions to shape their future. For example, the European Union Emissions Trading Scheme (EUETS) and the deployment of low carbon technologies in future including the Carbon Capture and Storage are further evidence that when the EU acts together, with Britain playing a leading role, we can take the right decisions to shape our future. (Foreign and Commonwealth Office, 2007)

Another benefit that Britain is enjoying through the membership of European Union is the significant increase in their both inward and outward FDI. However, the extent to which this membership has played its role in this increase in FDI is very complicated to determine as there are many other factor associated with this increase for example the global surge in FDI. The stylized facts help in determining this extent by supporting the theory that with the help of European Union’s membership, investments in UK have increased. These facts have also demonstrated the importance of these investments in the UK’s economical growth.

European Union’s membership has reduced the access costs to a larger market for UK which resulted in FDI growth in the UK. It has enabled greater economies of scale and returns on investment, increasing competition and facilitating agglomeration. Among the total FDI inflow in the European Union, the UK has been its major beneficiary. Not only this, but the European Union’s membership also allow

UK's growth in outward FDI to EU countries, and increasing returns on this investment. More and more important potential future FDI gains are expected as the UK participates more in the European Union especially through the successful liberalization of services industries. The long-term FDI cost of withdrawal would be significant. (Her Majesty's Treasury, 2012)

Another benefit for UK associated with European Union membership is in the field of Justice and Home Affairs. The security of the British citizens have improved can there is a real opportunity that this will improve further if the Britain continue to work with the European union on issues like terrorism, illegal migration and organized. As an example, "the European Arrest Warrant, agreed in 2004, was used to extradite Hussain Osman, one of the attempted London." And during 2004 and 2005 seventy-five suspects were returned to the UK under the arrest warrant. (Foreign and Commonwealth Office, 2007)

Eurodac database have introduced The Dublin System that have helped the immigration system of UK to spot those asylum seekers who have already lodged a claim in another European Union country and are now seeking it in UK too. Through this UK is now able to return these asylum seekers to their respective country. "The UK removes on average around 130 asylum seekers per month to other States under the Dublin arrangements." (Foreign and Commonwealth Office, 2007) The UK and the European Union has also recently agreed on increased cooperation and more effective information sharing between their police forces. This will certainly help both the UK and the European Union to control the organized crime and terrorism. (Foreign and Commonwealth Office, 2007)

In broad scenario, UK in global perspective has significant role and global interests. It is a permanent member of the UN Security Council and is also a member of the G8. Its role is significant enough that it can and it often does most of the acts that are of their concern alone. However, regarding the issues related to foreign policy, UK certainly needs the help of the European Union. As said "in many situations, 27 voices are louder than one, and when we speak in concert with our EU partners, our demands have a greater chance of being heard." (Foreign and Commonwealth Office, 2007) The Common Foreign and Security Policy (CFSP) between the UK and the European Union now make a significant contribution to peace and security throughout the world. (Foreign and Commonwealth Office, 2007)

European Union membership also benefit UK in its external trade that is while negotiating its external trade agreements, it has the support of European Union and this support is very significant as the European Union is largest trading bloc of the world and it also play a leading role in the current round of World Trade Organization negotiations. So, negotiating alone as compared to negotiating with single voice by all European Union's member countries will certainly be less fruitful compared to the later one. In short we can say the membership of European Union is crucial for UK in its future prospects. This membership helps UK to access open markets, combat crime and tackle pollution. (Foreign and Commonwealth Office, 2007)

4. The Impact of the European crisis on UK's Financial Sector

Currently the economy of the world is passing through most crucial stages as it is facing some of the most challenging circumstances. In the beginning of 2007 a credit crunch started and has now last for than 4 years resulting in number of urgent calls to bring changes in the global financial architecture. The macroeconomic frameworks as credited for its significance and effectiveness in bringing stability in 1990s and in the previous decade has now been exposed to the recession that has subsequently taken hold and has poses major challenges to that macroeconomic frameworks. (C., Bowdler, n.d)

C., Bowdler, (n.d) has presented some of his observations about the origin of these global crisis, responses to the crisis and their implications for potential UK entry into European Monetary Union which are as follows.

1. His first observation was that the crisis illustrates the potential for asymmetric shocks across the euro area and UK economies. The origin of these crises is traced out from the problems that came in the US sub-prime mortgage market. Sub-prime borrowers in US were at certain conditions able to cover their mortgage costs. These conditions were that the mortgage interest rates must remain low and their own labor income remained intact. When these condition failed that is the mortgage interest rate rose and their own labor income lowered the borrowers in US defaulted on their loan payments and ultimately the banks were left with no choice but to write-off the value of the funds invested in those loans. With this, the banks all around the globe bears severe losses which resulted in threatening the viability of these banks and they were again left with no choice but to contract their lending to both prime borrowers and sub-prime borrowers. (C., Bowdler, n.d) This in turn affects the budget of the households and businesses and they were forced to trim their budget leading to sharp fall in the consumer's demand and as a result inducing the global recession.

UK was most immediately and more pronouncedly exposed to these problems as compared to many of the other European Union's member countries. There are mainly three reasons behind this view. First there is a close resemblance between the mortgage market of the UK and the liberal US model so UK has to face both the global crises as well as its own version of the sub-prime problem. The second reason is that the investors in UK have invested a lot of funds in American Banks and since there is a strong economic and financial linkage between both the regions, so, UK investors to lose a great deal from these bad loans that emanate from the US sub-prime mortgage sector. The third reason is the heavy reliance of the British banks on global capital markets. Compared to rest of the European banks, UK banks are most heavily funding loans to firms and households. This is so because most of the European banks rely on more traditional sources of funds for example deposits from savers. "When the losses from the sub-prime crisis caused funds to be diverted away from global capital markets, British banks were forced to pass on reductions in loan supply to others in the private sector much more quickly." (C., Bowdler, n.d, p.4)

2. The second observation made by Bowdler is that in order to cope with the recent crises, UK has fully utilized its monetary autonomy leaving the single currency area outside. There are mainly three ways to view this aspect which are as follows. (C., Bowdler, n.d, p.4)

1. Firstly, since the onset of the financial crisis the pound sterling has depreciated significantly against the Euro. During summer 2007 one pound purchased as much as 1.50 Euros, compared to a current rate of approximately 1.15. The resulting fall in the price of British goods exported to the Euro area has provided a much needed boost to the sales of the UK manufacturing sector.

2. Additionally, by increasing the price of goods imported from the Euro area to the UK, the depreciation of sterling has prevented consumer price deflation. Policy-makers are particularly keen to avoid such a scenario because declining prices encourage households to delay spending in the hope of better value for money.

3. All of these factors contributed to the view that the UK was more vulnerable to the credit crunch and global recession that originated in the US than was the Euro area, and would therefore face a relatively large leftward shift of AD and require a larger interest rate reduction.

The learning outcomes that emerge from the asymmetric responses of the Britain and the other European Union countries to certain factors such as the credit crunch is different monetary policy reactions along with separate currencies plays a vital role in the efficiency of the macroeconomic management.

Another argument presented by Bowdler in favor of UK's membership of the European Union is about the differences in the targets of monetary policy at the Bank of England the European Central Bank. The Bank of England has a long established policy of targeting inflation. In the beginning years of the 21st century interest rates in UK were set low in because at that time the inflation in UK was low and stable. They were enjoying cheap imports from China and labor costs were low because of the firm supply of labor from the Eastern Europe. (C., Bowdler, n.d) However, later this low interest policy affects the UK economy by supporting the growth in sub-prime lending. Growth in sub-prime lending is viable only in conditions were the interest rates are at historical lows. But as the interest rate goes higher and higher, the sub-prime lending starts creating problems. UK although have started sub-prime lending in era when the interest rates were very low, but later when the rose, UK suffered a lot. As said that "the prospect of UK entry into the Euro area is more distant than it was before the current crisis broke during the summer of 2007." (C., Bowdler, n.d, p.6)

In order to cope with the crises UK government has adapted a large fiscal expansion, in light of the role that a fiscal policy plays in the macroeconomic management. One big mistake made by the UK is that it has only focused on the inflation rates in its monetary policy and has ignored the growth rate of broad measures of the money supply such as M4. These money supply sources have continuously accelerated since 1990s up to the starting years of the previous decade where it has exceeded up to 10 percent. With this mistake UK become unable to cope with the constraint on its fiscal policy that is imposed under European Monetary Union. "The European Central bank stands out amongst the major central banks in specifying a reference value for broad money growth that is consistent with price stability, the first pillar of its monetary policy strategy." (C., Bowdler, n.d, p.6) If UK would have pass the responsibility of setting the interest rates in UK on the shoulders of European Central Bank in previous decade, it is expected that higher interest rates would have been implemented by the European Central Bank and as a result, UK would be able to restrict the sub-prime lending in the UK and the scale of the economic correction currently being observed in response to it. (C., Bowdler, n.d)

4.1 British Banks

The profitability of UK's financial sector is expected to reduce further in coming years following the crises in its banking system. This will severely damage the UK financial sector as financial services contribute a relatively large share of UK's overall GDP. The future prospects of these damages are that they will tend to prolong the downturns in the real economy by slowing the economic growth of the UK and causing the problems of unemployment in UK. The

Bank of England react to the crisis by lowering the interest rates by 4.5 percentage points in just five months, while in comparison to that, the European Central Bank has lowered the interest rates by only 3.25 percentage points in seven months. Besides this conventional monetary policy easing that is done through the lowering of the interest rate, another strategy adapted by the Bank of England was introducing an Asset Purchase Facility (APF) in which it has invested £125billion of newly created money mostly in acquiring government bonds. They have also spent this money in purchasing small amount of corporate bonds that are issued by those firms which were seeking to raise their liquid funds. This action carried by the APF, and its further plan to invest more in this area and raise its investment to £175billion by 2009, is what a term know as 'quantitative easing'. The main reason behind Bank of England's adapting this strategy was that it has recognized that lowering the interest rates is unable to support aggregate demand during the recession. The Bank of England charge overdraft interest rate to commercial banks when these commercial banks deal with the Bank of England. This along with the policy rate of Bank of England has both dropped to only 0.5 percent. Also most of the bank loans are funded either from investments in banks by pension funds or by other large investors, but as an aftermath of the credit crunch the supply from both of these investment sources has become limited. That is why the Bank of England has adapted the strategy of the quantitative easing as it was "intended to address this problem through increasing the share of cash in banks' total assets and thereby providing the liquid funds needed to support bank lending to firms and households." (C., Bowdler, n.d, p.5)The European Central Bank too has adapted the similar strategy of quantitative easing in July 2009, but they have invested only £50billion for all of the then sixteen countries of the European Union. Furthermore, the European Central Bank has not invested all that money at a glance rather only 10 percent of that dedicated money has been invested. So, in comparison to Bank of England, the European Central Bank is much more conservative in responding to the crisis through quantitative easing. (C., Bowdler, n.d)

4.2 Britain and Europe – We are all in it together

For instance, Europe's crisis is serving to show just how dependent upon Europe the British economy has become. In many respects George Osborne, the Eurosceptic Tory Chancellor in the coalition government, may be inadvertently playing into this theme. For political reasons he has been promulgating the idea that the major threat to the British economy has been the sovereign debt crisis of the Euro-Zone – so that, should Britain's economy worsen, he can then deflect the blame to Europe. Yet, by so elevating Europe's importance to Britain he is simply reinforcing the notion of how intertwined we are with Europe – and how we share the same fate. To coin a phrase he is cementing the view that 'we [Europeans] are all in this together'. (S., Haseler, 2012)

As indeed we are. The EU remains by far the largest market for British exports. Indeed it is a revealing fact, as recent Office of National Statistics figures show, that British exports to the 'Club Med' countries remains roughly four times the exports to China, and that over the last few months the percentage of our exports to the Euro-Zone has gone up and those into the rest of the global economy has gone down.

And then there is the role of the European Central Bank (the ECB). The fact is that this Frankfurt-based Euro-Zone central bank, though not technically Britain's central bank, has nonetheless played a major role in keeping the UK financial system afloat – certainly so since the arrival of its new Chairman, Mario Draghi. For, through its new 'Three Year Financing' operations for Euro-Zone banks (with some of this money going directly to British banks) the whole EU banking system has been stabilized. Indeed so aware is the British government of the ECB's stabilizing effect that London has become an advocate for the ECB taking a bigger, not smaller, role – and it has even called for the ECB to mutualize the Euro-Zone debt. The London government has also become a keen supporter of the Euro bailout fund – a major supranational measure that increases the role of the centre and can form the core of a future Euro-Zone Treasury.

According to Cannel 4, although the Spanish government has attempted to dampen speculation that it will request an immediate bailout from the EU to shore up its banks, many believe it will have to do so in the future. During the 2008-09 financial crises, RBS and Lloyds had to be bailed out by the British taxpayer. Since then, they and other British banks have made efforts to strengthen their "capital buffers" to withstand future shocks. They have done this by increasing the amount of money available from shareholders that can be called on if other sources of funding are under strain.

Under international rules, all banks currently have to ring-fence 4 per cent of their balance sheet to deal with a crisis. In Britain, mindful of recent history, they have gone further, typically ring-fencing 10-11 per cent. According to Britain's banks, they are well capitalized in comparison with financial institutions in the euro-zone. The British Bankers' Association says the amount of money held for emergencies has risen from 7.6 to "almost 12 per cent" of total balance sheets in the last three years. But even if they are in fitter financial shape than European banks, would British banks be able to cope with a Greek exit from the euro and/or Spanish banking implosion? “I don't think it is reasonable to say that anyone knows for certain. The key is what policy decisions are made by euro area governments to resolve this.” Michael Symonds, Daiwa

PIRC, which carries out research for institutional investors, has produced figures which suggest Britain's biggest banks are already preparing to write off a further £40bn in bad debts, with RBS and HSBC hit the hardest. But RBS told Channel 4 News: "We don't recognize the numbers quoted by PIRC. Our capital, liquidity, and funding positions are strong and we comply fully with IFRS international accounting standards."

Events in the euro-zone are intertwined with concerns over bad debts. The Bank of England and the Financial Services Authority, which regulates the banks, have been working together to ensure banks are well capitalized, while the banks have been reducing their exposure to the euro-zone and carrying out stress tests to see how they would cope if Greece leaves the euro.RBS has reduced its exposure in Greece, Spain, Italy, Portugal and Ireland and no longer lends money to the Greek government, although it is owed £0.8bn by Greek companies. In Spain, it maintains "strong relationships" with banks and companies, but it will not comment on individual firms.

According to figures from the Bank for International Settlements from Dec. 2011, British banks' exposure to Greece is small, but their business in Spain and Italy is much bigger, particularly their lending to the private sector. British banks have loaned $10.6bn to Greece: $1.8bn to the government, $1bn to banks, and $7.8bn to the private sector.

In Spain, a total of $83bn has been loaned: $4.4bn to the government, $12.9bn to banks, and $65.8bn to the private sector. In Italy, the total figure is $59.4bn: $8.4bn to the Govt., $6.9bn to banks, and $44bn to the private sector. Michael Symonds, an analyst at Japanese investment bank Daiwa, told Channel 4 News that British banks had increased their firepower in recent years and their direct exposure to euro-zone banks was "manageable".

4.3 'The great unknown'

According to Phillip (2012) Funding costs for UK banks have soared as international investors worry about the possible collapse of the single currency, said monetary policy committee member Ben Broadbent. UK banks which are considered to be vulnerable to the potential domino effect of euro-zone countries running out of funds, have passed on the costs to British businesses as the panic has spread. Efforts by the Bank of England to flood financial markets with cheap money and bring interest rates to a historic low have had little effect in recent times, he said, and are likely to carry on being blunted by the ongoing crisis.

According to Jill (2012) the UK's banks will not escape unscathed, although they are better insulated than those in the euro-zone. In the event that the peripheral countries leave the euro-zone, Barclays faces losses of €37bn and bailed out Royal Bank of Scotland some €26bn.

According to Adrian (2012) the current UK banking scandals hitting the headlines serve only as a smoke screen to the European debt crisis which is continuing to unravel and impact the global economy. As the politicians unpick the mess and countries stave off their over dependence on debt there are a wide range of potential outcomes. While PwC are not in a position to know what will happen from here, businesses should monitor developments carefully. Ensuring contingency plans are in place is a prudent course of action.

In recent weeks the Bank of England has committed to inject a further £50bn into the UK economy taking the total size of quantitative easing to £375bn. Southern European states continue to raise money in the financial markets but are being forced to pay higher interest rates, with Spain’s borrowing costs hitting new record highs. The Greeks have gone back to the polls and have managed to cobble together a grand coalition intent on pushing through austerity measures insisted upon by the EU and IMF.

The global economy is still in a precarious situation with Sovereign debt historically high in US, Japan and across much of Europe. It is unclear what impact record low interest rates, quantitative easing and ECB bank recapitalization will have on global inflation and the global economic outlook. How global deleveraging affects economic growth and inflation will depend on fiscal, regulatory and monetary policy responses.

Following are four broad scenarios which may play out but there are many others.

Under any of these scenarios there are key issues for business to consider and review. If scenarios 2, 3 or 4 were to unravel, there are potentially greater consequences and disruption to operations within the financial service community.

With the increased risk of any default, management should assess their ability to monitor the quality of their counterparties and as necessary develop new frameworks that provide a fresh and continuous look at health and fitness of these counterparties.

The evolution of the euro crisis is likely to have further significant impacts on both the volatility and price levels in currency and commodity markets, with implications for hedging strategies. Management should consider how portfolios and assets are stress tested under such volatile conditions and consider if these risk exposure benchmarks are still fit for purpose.

If some countries drop the Euro and revert to legacy currencies while others remain, systems will need to be able manage new currencies and have the capabilities to report and record split/dual currency settlement.

There could be further impacts on bank lending and liquidity, particularly in any country which decides to leave the euro. Cash and other financial and physical assets may become trapped, exposures to banks which may be in difficulty need to be monitored and managed. Custodians need to be prepared to quickly segregate, isolate, agents, counterparties, holdings and transactions.

5. Conclusion

In order to conclude our discussion on the issue, we can say that, despite the fact that the European crises have a negative impact on the UK's economy the EU membership also has certain benefits for UK. To conclude whether the losses faced in the economy due to crisis overcome the gains from the benefits of EU membership, below is an overview of the losses and gains.

50 % of overall trade of UK is with EU and if crisis hit Europe, it will ultimately have an impact on the economic activities within UK. Inflation rate has raised, exports have dropped and the global competiveness of the exporters has negatively impacted due to these crises. Euro zone crises are creating huge uncertainty which has reduce the public spending in euro-zone resulting in dropping the sales in UK. Furthermore the knockout effect will affect not only the companies with direct exposure in European market but also the SMEs and other larger businesses with no direct exposure to the Euro-zone.

The three scenarios mentioned by Investment Insight (2012) summarizes the impacts of euro-zone crises on UK which are

1. Politicians muddle through which ultimately leads to fiscal union
2. Orderly Greek default and coherent flight plan to fiscal union
3. A disorderly Greek default and leads to euro break-up

Under these scenarios UK may face problems like dependence of investment decision on risk assets and the resulting oscillation of market between the two extremes, persistence of low growth environment, contagion within the global banking sector and the special impacts on the weaker banks who has weak balance sheet and are unable to cope with the economic crisis they are facing, drop in sterling, debt problems and the need to reduce this problem through deleveraging process, sidelining of the UK from participation in major European decision making related to the future of the euro economic zone and UK may also be dragged under low growth and a potentially deflationary environment for a number of year etc.

With European crises Europe will face crises in two broad areas which are the banking crises and the government debt crises. Both of these crises could probably spill over into the UK if the financial crisis of euro-zone last further long putting the UK's banks under huge risk. The recovery of UK from recession depends on the crises of debt in Europe. The European debt crises have caused massive layoffs UK financial institutions. British think tank even believe that once the euro-zone crash, 2012 UK gross domestic product decreased by 2.3%, the proportion of the budget deficit to gross domestic product will return to a high of about 10%.

Another loss described by Damien Gayle (2012) is that Britain is once again suffering a recession and this year unemployment risk is three million, (forecaster reports). Europe's debt crisis has paralyzed the UK's economic recovery, the GDP growth forecast is from 1.5 per cent to 0.2 per cent (Ernst & Young Item club).The nine European countries - including France – had downgraded credit ratings have plunged world stock markets into turmoil. Accumulating of equity stakes of UK banks in 100s of ailing companies to whom UK banks have lent money can cause disastrous consequences for these businesses. As the economic conditions get worse in Europe, banks are lowering the extent of their support to the struggling companies. Consequently these struggling companies are put in more risky conditions related to administration and this is not only limited to suffer the struggling companies only but the leaving lenders too are facing hefty losses on loans that they have lend to these struggling companies. King said, the level of UK inflation in the next one may remain to more than 2 percent, while economic growth will likely slow down due to the European debt crisis to contain. European debt crisis is one of the biggest obstacles in UK's recovery from economic crisis.

While on other hand European Union's membership have large number of benefit for UK in trade, jobs, travel and work, lower prices and greater choice for consumers.UK is able to cope with global challenges and other important issues like climate change, energy, cross-border crime, counter terrorism and the fight against world poverty. The EU is the world's largest multilateral trading bloc, with a single market of over 490 million people. Membership of this market brings significant opportunities to UK business and consumers. The UK has seen substantial growth in both inward and outward FDI since accession to the EU. EU cooperation is also vital in the field of Justice and Home Affairs: working with EU partners on issues such as terrorism, illegal migration and organized crime provides a real opportunity to improve the security of UK citizens.UK has global interests and a significant role on the world stage, with a permanent seat on the UN Security Council and membership of the G8. It can and often does act alone. But on many foreign policy issues it can best achieve its foreign policy objectives by working with and through the EU. In many situations, 27 voices are louder than one, and when they speak in concert with their EU partners, their demands have a greater chance of being heard. Membership of the EU also brings benefits for the UK when negotiating external trade agreements.

From above discussion we can conclude that although European Union membership has large number of benefits for UK but it also faces large number of obstacles in its economic recovery due to this membership. On one hand it can increase its trade with the help of this membership while on other hand it has to face problems like high inflation rate, high unemployment, reduced GDP growth etc. in order to cope with this situation, UK need to scrutinize each and every policy and regulation or any act promulgated by the EU to ensure that it in best interest of UK's economic recovery and economic growth.

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