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MACROCOSM

## UK: In or Out?

Thursday, January 17, 2013

Lorcan Roche Kelly

**It's the ideal moment to join the euro, but Cameron will choose isolation over integration.**

United Kingdom Prime Minister David Cameron [will deliver a speech](#) tomorrow on the future of the European Union, and the UK's relationship with it. There has been [much media speculation](#) that he may announce an in-or-out referendum on the UK's EU membership, or that he will try to further reduce Brussels' influence over domestic UK affairs. We think he will reaffirm the UK's position as an EU member, but will seek to renegotiate the terms of that relationship -- a change in terms that may eventually lead to treaty changes.

It is no secret that the UK has been resisting the increased pace of EU integration during the debt crisis of the last three years, and has been willing to use its veto to maintain distance from Brussels (see "[E Pluribus 26](#)" December 12, 2011). It's ironic -- by the numbers, the UK and the euro area have never been closer.

In 1997 -- when the question was whether to get closer, not more distant -- Chancellor of the Exchequer Gordon Brown developed five tests to see if the UK was ready to join the euro -- or EMU, as it was known then.

1. *Convergence*: if business cycles and economic structures meant that the UK could live comfortably within the constraints of the euro
2. *Flexibility*: if business and labor markets have the ability to adjust to the changed environment within the euro
3. *Investment*: if joining the euro would lead to better conditions for firms making long-term decisions to invest in the UK
4. *Financial services*: measure the impact of euro membership on financial services within the UK
5. *Employment and growth*: if joining the euro would promote higher growth, stability and employment

The UK ran these tests in 1997 and [again in 2003](#). The 2003 results found that convergence had improved since 1997, and that euro membership would benefit the UK financial services industry, but that significant structural differences remained. In light of these differences -- and some political expediency, as they had promised a referendum before joining the euro -- the 2003 Labour government decided not to try to seek membership in the euro.

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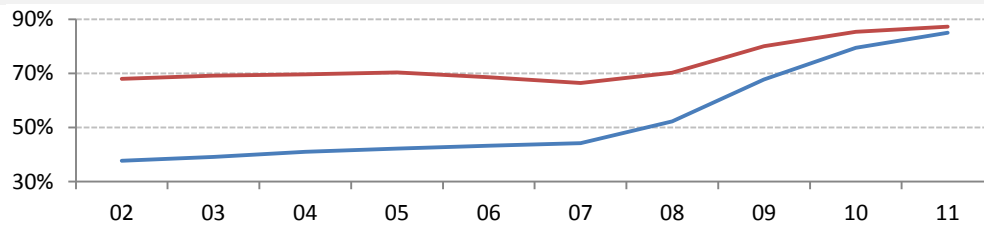
### Update to strategic view

**UK MACRO, EUROPE MACRO, FX:** The UK economy has converged with the euro area economy, but domestic UK politics intervene to put the UK on a path towards increasing global irrelevance. If Cameron seeks to redefine the UK's relationship with the EU in his speech tomorrow in such a way that leaves the UK more isolated from the European project -- and does so via a divisive treaty change and referendum -- then it is likely that the UK will lose much of the global influence it still retains. For the UK economy, it will risk the dominant position of the City of London in global finance, and prolonged uncertainty will negatively influence domestic investment decisions.

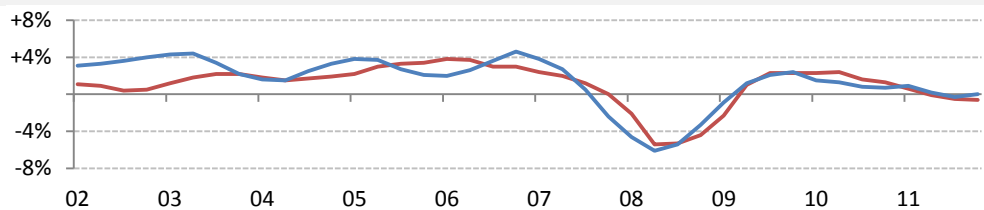
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Even with the benefit of a decade of hindsight, the case for a UK membership bid in 2003 is still unproven. But objectively, in 2003 the convergence test -- the first of the five, and a critical touchstone -- could not be passed. But an interesting trend has emerged since the global financial crisis began in 2007: UK and euro zone macro indicators have started to converge, and some are moving in lockstep (please see the charts below). Brown's convergence test is being passed brilliantly.

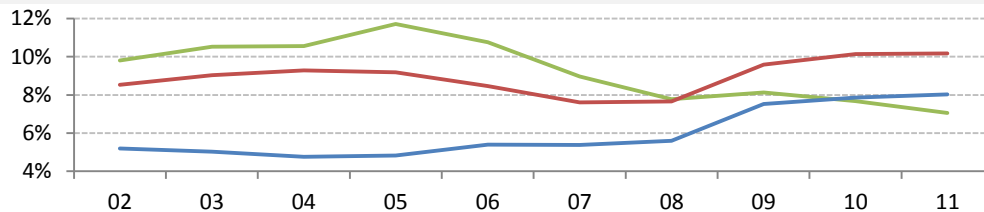
— UK and — euro area debt-to-GDP ratios have rapidly converged



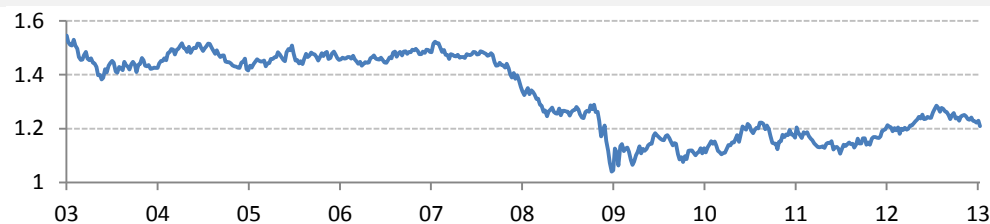
There is little difference between — UK and — euro area real growth rates



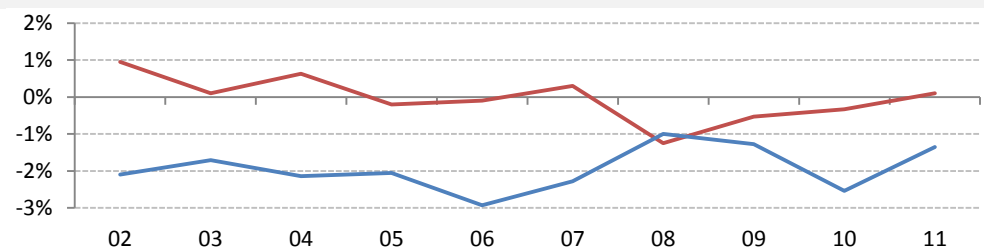
— UK and — euro area unemployment are moving in lockstep vs — Germany



— Sterling versus the euro has stabilized



The current account is an exception: — the UK is lagging — the euro area



Source: Various, TrendMacro calculations

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**Recommended  
Reading**

[How to Wage the Debt-Ceiling Fight](#)  
Keith Hennessy  
*Wall Street Journal*  
January 17, 2013

[\[Reading home\]](#)

Overall, the UK is more like the euro area today than it probably ever has been. And yet it is less likely to join the euro area now than it ever has been.

- As we always tell clients, the euro is a political project first, and an economic one second. Likewise, the decision to join the euro would be driven by political rather than economic forces.
- While Cameron's coalition Liberal party is in favor of ever closer union, his own Conservative -- or Tory -- party has a large euro-skeptic wing that would rather be out of the Union.
- Further, the strongly anti-EU UK Independence Party (UKIP) [recently passed](#) the Liberal party in polling, with Cameron's Conservatives risking [losing more support to UKIP](#) if he is not seen as taking a "hard line" on the EU.
- So, instead of seeking a closer union or even euro membership, the UK will continue to try achieve a relationship with the EU similar to its ["special relationship" with the US](#) -- a close but informal cooperation among two sovereign states.
- Unfortunately, the UK may end up getting with the EU exactly what the "special relationship" forged during World War II with the US has become -- a partnership where the UK is decidedly the junior partner, and one where it has little to no influence over the decisions of the other.
- The US, for its part, [warned](#) the UK last week that it wished for the UK to remain close to the heart of the EU. This view was [not greeted warmly](#) in the UK, but it does point to the real political landscape.

So it seems the UK is more willing than ever to go it alone, choosing to value the optionality of national sovereignty over further integration within the larger European Union. The UK, by backing away -- politically -- from the EU at the moment when it is most expedient -- economically -- for it to take a large step in the opposite direction, is risking becoming less internationally relevant -- politically *and* economically.

- The UK cannot forever remain the financial center for euro trading if it continues to distance itself from the currency. A loss of business from the City of London to Frankfurt and Paris -- the euro area financial hubs -- would damage the UK economy overall, as financial services currently [accounts for about 10%](#) of UK GDP.
- If Cameron decides the renegotiation of the UK's relationship with the European Union will require a new treaty -- and it is difficult to see how he can achieve much without one -- then there will be a period of uncertainty surrounding both the negotiation of and voting on any treaty. Remember, any treaty change would have to be voted on by all EU members, not just the UK.

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### Bottom line

The UK economy has converged with the euro area economy, but domestic UK politics intervene to put the UK on a path towards increasing

global irrelevance. If Cameron seeks to redefine the UK's relationship with the EU in his speech tomorrow in such a way that leaves the UK more isolated from the European project -- and does so via a divisive treaty change and referendum -- then it is likely that the UK will lose much of the global influence it still retains. For the UK economy, it will risk the dominant position of the City of London in global finance, and prolonged uncertainty will negatively influence domestic investment decisions. ▶