

# UK ECONOMICS UPDATE

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## How will “splendid isolation” affect the UK?

- **David Cameron’s decision to pull away from Europe has called into question the UK’s entire future in the European Union. But when it comes to the UK’s near-term growth prospects, the debate over whether or not the Prime Minister was right to exercise his veto last Friday distracts from the bigger point that last week’s summit made little progress towards solving the euro-zone debt crisis.**
- Given just how much has been written in the press in the last few days about last week’s European Union (EU) council meeting (not all of it correct), it might be useful to distil in a few lines exactly what happened from an economic point of view.
- In exchange for allowing the EU Lisbon Treaty to be changed in order to enforce fiscal discipline in the euro-zone, the Prime Minister wanted to introduce safeguards to ensure that, as the euro-zone integrated further, crucial decisions on issues like financial regulation were not taken without full UK consent.
- **Contrary to many reports, this was *not* primarily about the proposed “Tobin tax” - a tax on financial transactions designed to curb speculative behaviour.** While it is true that this would hit the UK hardest if introduced (of the €57bn projected annual tax-take, €40bn is expected to come from the UK), the tax can only be introduced by a unanimous vote and so the UK already had a power of veto to stop it.
- Rather, it was about ensuring that the UK has a power of veto over any further changes to European financial regulations. One of the Prime Minister’s particular concerns was to prevent the ECB from stipulating that all trading denominated in euros should be cleared in the euro-zone and not in British banks.
- **Some have questioned whether Cameron should have gone to such great lengths to protect a fairly small part of the economy.** Although overall financial services account for about 10% of GDP, we have estimated in the past that wholesale financial services – i.e. the City – account for just 2% to 3%. **But Mr Cameron’s demands were not just about protecting bankers.** He also wanted to make sure that the UK has the power to introduce higher capital rules than in the rest of Europe – something which clearly has crucial implications for the wider financial and economic stability of the UK.
- But the Prime Minister came away empty-handed. Clearly this means that the financial sector has ended up no better protected. **But with the UK therefore refusing to ratify the treaty changes, the bigger question is what the implications are of the UK’s new “splendid isolation”.**
- **It is worth bearing in mind that this splendid isolation could be short-lived if the Europeans just back down on the issue.** After all, it was pretty clear that this was a game of bluff that back-fired and that no-one actually wanted the outcome that has emerged. So if Angela Merkel and Nicolas Sarkozy are keen to avoid more bust-ups with the UK, which could further hinder their attempts to solve the euro-zone crisis, the UK might yet end up getting its way.
- **Even if the euro-zone leaders stick to their guns, the UK could yet retain its influence if the euro-zone goes down the tubes within the next few months.** Of course, this would still be devastating for the UK’s economy. Nonetheless, as attention shifted to the catastrophic failure of the Franco-German effort, the UK’s recent actions would pale into insignificance. **Indeed, the UK could suddenly find itself with a lot of friends in Europe again.**
- But what if euro-zone does find a solution – or, at the very least, enough sticking plasters to keep the euro-zone project together for the next couple of years? **In that case, the situation could become rather nastier for Britain as international opinion turned against her.** In a worst case scenario, concerns about the UK cutting its connections with the rest of Europe could prompt a drop in inward investment to the UK and even a run on the pound. **(Continued overleaf.)**

- Admittedly, this seems unlikely when the far bigger question for international investors is what is happening in Europe – and when the situation there looks as dire as ever. **And remember that from an economic point of view, the most important thing is that the UK is very much still part of the single market and free trade area.**
- **At the very least, though, the UK could find its influence at the EU negotiating table severely diminished.** There was already concern that, by not taking part in the new monthly “eurozone plus” meetings, the UK might face decisions being made “behind her back.” Now that seems more likely.
- In theory, the EU could press ahead with all manner of rules and regulations – including on the financial sector – which the UK would have to comply with. Remember that most EU decisions are made by qualified majority voting, meaning that the UK would have no veto over the outcomes.
- **In that case, pressure for the UK to leave the EU altogether would surely grow.** Remember that in a House of Commons vote in October, some 81 Conservative MPs supported a referendum on Britain’s membership of the EU.
- **Indeed, in such a scenario, the break-up of the coalition and the calling of a general election could be quite possible.** Clear cracks in the coalition have unsurprisingly emerged over the weekend between the traditionally anti-Europe Conservatives and pro-Europe Liberal Democrats. With the Conservatives ahead in the polls and press coverage generally very supportive of David Cameron’s actions last week, it is easy to see why he might be tempted to call an election – and easy to see why he would probably win decisively.
- **Even if the coalition stuck together, the UK could still withdraw from the EU if it became obvious that it was not in the UK’s economic interest to stay in.** Either way, the implications for the course of UK economic policy and financial markets would be huge. **We are not saying that these are the most likely scenarios, but now that the Prime Minister has taken what is seen as a landmark step in terms of the UK’s relations with Europe, it is worth thinking about what the endpoint might be.**
- For now, though, where does all this leave the euro-zone crisis? **Although David Cameron has been accused of holding up efforts to sort out the euro-zone crisis, the other countries can still go ahead with their new “fiscal compact” outside of the Lisbon Treaty.** Admittedly, the process might be slightly harder now that they may not be able to use EU institutions to do so. The original idea was that the new fiscal disciplines would be backed by the threat of sanctions by the European Court of Justice and European Commission, but as these institutions are EU-wide, the UK could oppose their use in this way.
- **However, the big picture is that this fiscal compact is unlikely to do much to resolve the current situation anyway.** Indeed, the summit unambiguously failed to produce the action which many see as the main way out – namely, much bigger bond purchases by the ECB. (See *European Economics Weekly*, “ECB’s silver bullet turns out to be a blank,” 12<sup>th</sup> December.)
- **Accordingly, far more important for the UK’s near-term growth prospects than Cameron’s actions is the fact that euro-zone leaders have still not come up with a decisive solution to this crisis.** How this crisis develops will prove far more important for the UK’s near-term economic prospects than whether or not the UK has lost some negotiating power at the EU table.

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