BANQUE
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IN RESPONSE TO ADVOCATES OF BREXIT AND OPPONENTS OF EUROPE

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Bruno Desgardins ***2 September 2016***

Right up to the very evening of the election Brexit was not expected to win, and yet 52% of British people, 36% of electors, voted "Leave", reminding us of the prescient words of **Raymond Aron: "Those who think that peoples will obey their interests rather than their passions have understood nothing about the twentieth century".** The irrational prevailed over the rational. The oldest parliamentary democracy in the world yielded, in its worst interests, to the sirens of a referendum. Society is split into two camps, political parties are imploding, and territorial unity is threatened. Young people in the 18-24 age group, which voted by a 75% majority to remain, were sadly over-optimistic, and only one-third of them voted, whereas 80% of the over-65 age group voted by a 61% majority to leave. The high priests of Brexit, Nigel Farage and Boris Johnson, were seized with panic at the result. Too late, but lucidly, they realized the damaging effects on ill-informed populations of their demagogic statements and preferred to give up the game and resign. But the damage has been done.

Some Britons (to reassure themselves?) continue to believe in the benefits of this decision and, curiously, some people in Switzerland apparently find this vote a good thing. But the two economies are very different. Whereas Switzerland is very competitive, even with a strong currency, as attested by its very large trade surplus, the United Kingdom is not competitive, even with a weak currency, as attested by one of the largest trade deficits of the OECD and a current-account deficit amounting to 5% of GDP. While Switzerland has a public debt that is shrinking, at 40% of GDP, and posts budget surpluses year after year, the United Kingdom's public debt, close to 90% of GDP, is worsening and every year it accumulates the worst budget deficit after Greece, with 4.9% in 2015. Switzerland remains an industrial power, with more than 20% of its GDP in this sector, while the United Kingdom is substantially deindustrialized, with just 11% of GDP coming from manufacturing industry. And we could keep on adding points of comparison which would be so many points of divergence. Switzerland grows rich by itself, but the United Kingdom will be impoverished, if only as a consequence of the depreciation of its currency.

The aim of this note is to go back over the assertions or allegations of an advocate of the Brexit cause, point by point, to foster debate and clarify judgment. No controversy, just precise facts and reminders that are essential to establish the truth. In line with our June note, "Europe, the day after", we by no means intend to deny the problems faced by Europe, but simply to highlight the loss that an exit from the European Union represents for the United Kingdom, possibly for England alone tomorrow, and the gain that an enhancement of certain policies, often rejected by the United Kingdom, such as security on the borders of the Union, a European defence policy, infrastructure and energy, could represent for Europe.

1. The future of the United Kingdom

1.1 “*If we had stayed in the EU, we would have been asked to help bail out the foundering PIGS”:*

No, this is confusing the Eurozone with the European Union! That aside, Ireland and Portugal did not default, Italy did not borrow, and Greece negotiated a debt rescheduling.

The British contribution has always been small, the smallest of the large countries, at 0.5% of GDP. On a per capita basis, Norway and Switzerland pay 90% and 50% respectively of the UK contribution. A Eurosceptic body, Open Europe, has calculated that 93% of European regulations would continue to apply to England in the event of membership in the European Economic Area. Not taking part in the European Economic Area, i.e. choosing a bilateral agreement in line with that negotiated by Canada, would cause it to lose the benefit of the European passport for banks, and would therefore be worse. The £18 billion balance of financial services with the remainder of the EU, useful to offset the balance-of-trade deficit, would be drastically reduced in the case of a Brexit.

1.2 "*We are the best performing economy of the EU*":

- ***How can one possibly say that the United Kingdom is the best performing economy***?

After World War II, one pound sterling was worth US$4, and at present $1.3, and yet the US dollar has itself been weak against the Swiss franc and other currencies.

- ***The poor structural statistics of the United Kingdom***:

After Greece, the United Kingdom has the largest budget deficit in Europe, at 4.9% of GDP in 2015, the biggest trade deficit, the largest current-account deficit at 5% of GDP, and a household debt ratio at more than 150% of gross disposable income, higher than that of the main countries on the continent and, unlike in the United States, it has not declined since 2008. The country has also long posted one of the highest inflation rates and, not surprisingly, until Brexit a 10-year bond yield far higher than that of France, which shows market perception of the risk.

- ***Dependence on foreign capital***:

The United Kingdom has amply benefited from foreign direct investment (FDI), accounting for 4.5% of GDP, which brought a large quantity of very necessary capital into the country.

However, note that half of this comes from the European Union, and it may be imagined that many investors, e.g. car manufacturers, will now prefer Spain or other destinations within the EU to open up the European market. Most of the FDI was motivated by access to the European market. When Nissan produced 475,000 vehicles in England in 2015, it sold half of them in the European Union, and for Toyota it was even 75% of production that was intended for export to the EU. What about tomorrow? What is the attraction of a small country of 65 million inhabitants compared with a large market of 500 million? Let us immediately dismiss the idea that a devaluation of sterling will restore the competitiveness of this industry, because too many components are imported.

- ***British industry is small and not very competitive***:

Small because it accounts for only 10% to 11% of GDP. Not very competitive because even the depreciation of the pound sterling in 2008 did not produce export growth. China is a large market, but the United Kingdom exports less to China than to Ireland, although it is only a small market of less than 5 million inhabitants! France is not a model of competitiveness, and yet the French-British trade balance is positive by €12 billion in favour of France! A look back over the last twenty years shows that the emergence of China on the international stage has cost the United Kingdom 30% of its export market share versus only 20% for the major economies on average. An exit from the EU will mean the United Kingdom will lose European markets which absorbed 45% of its exports. Undeniably, the country will take time to find outlets elsewhere in the world to offset this loss.

- ***Depreciation of the pound sterling***:

In a country like the United Kingdom, so dependent on imports, accounting for 30% of GDP, this means a loss of purchasing power for the British, an impoverishment of the consumer. There is no possible comparison with Switzerland which, thanks to its economic strength, regularly enjoys an appreciation of its purchasing power on the international stage.

- ***Anxiety of the markets and the Bank of England***:

If it were true that the United Kingdom is the best performing economy in Europe, the most robust, how can you explain the fact that in July the composite PMI fell into recession territory at 47.7? How can you explain the anxiety of the markets, reflected by the depreciation of the pound from 1.50 against the US dollar on the eve of the referendum to 1.30 at present? How can one explain the anxiety of the Bank of England, which has so drastically revised from 2.3% to 0.8% its growth forecasts for 2017? What accounts for an interest rate cut to 0.25%, the lowest level in the last three hundred years? And what accounts for the enlargement of the asset purchase programme, increased from £375 billion to $435 billion and extended to corporate bonds worth £10 billion?

The Financial Times has estimated the risk of job losses due to Brexit at 3 million. Following the recent decisions, there is no longer anything to be expected from a possible further interest-rate cut, at the very most a reduction in interest charges for borrowers in the housing market.

1.3 "*No one can match us (the UK) in the service sector*":

According to Deloitte, 40% of the European headquarters of the top 250 firms in the world are set up in the United Kingdom. Finance and related services account for 2.1 million jobs, the equivalent of 7.2% of the labour force, and £66 billion in tax revenues, i.e. 11% of total revenues according to the City of London.

What will become of some of these jobs and revenues tomorrow, when the City loses its European passport, when a large number of financial services will have to migrate to continental Europe, and when Frankfurt, Amsterdam, Paris and Dublin will strive to attract those services?

In any case, it is not manufacturing industry, which accounts for only 10% of GDP, that could offset these losses, because one can hardly expect multinational firms to invest in a British territory reduced to its own boundaries.

1.4 *"The CANs have been among the best-performing developed countries in the world. Australia has gone for 25 years without a recession"*: the idea that the United Kingdom would be more successful outside the EU.

- ***A reminder***:

The Financial Times has demonstrated clearly how much the UK has benefited from European Union membership. Between 1958 and 1973, per capita GDP in France, Germany and Italy increased by 95%, and in the UK by only 50%. In 1973, the UK was "the sick man of Europe", and EU membership obliged it to be more competitive.

- ***Differences***:

These economies are not comparable. Canada and Australia are two commodity-producing countries. The economy of the latter is very closely tied to Chinese demand.

- ***The British economy is far more dependent on Europe than the two economies mentioned above***:

13% of the UK's GDP and 50% of exports are destined for Europe, 9 million jobs are linked to those exports, and 46% of foreign direct investment (FDI) flows come from Europe. The Commonwealth could not be a fallback solution because it absorbs only 10% of British exports.

1.5 "*The US, China, India…do not have free access yet they export huge amounts to the EU and pay mainly a 4% tariff*":

The comparison is meaningless, because the first two countries mentioned are between five and eight times larger in terms of GDP, and all three are important and indispensable markets. The United Kingdom accounts for just 3% of global GDP, and England, without Scotland and Ireland, far less.

1.6 *"We are now six years into negotiating a deal between EU and Canada":*

That says it all, and that is what awaits England, which will have to renegotiate about fifty trade agreements with third-party countries.

1.7 *"Yes, our universities and our farmers and other grantees get money from the EU… think of these grants as UK money going to Brussels and round tripping. There is no reason why the UK government shouldn't continue the funding":*

Yes, you can hear complaints from the beneficiaries, such as farmers, researchers and many others, and no, Europe cannot be reduced to compensatory cheques and payments. Yes, the European Investment Bank paid £8 billion in 2015.

The British government will have to substitute for Brussels in managing these aids.

1.8 "We should adopt a foreign policy like Germany or the Scandinavians":

That would be better than intervention in Iraq, but this isolationism is clearly not in the British tradition.

The Brexit camp is very heterogeneous, sharply divided between ultra-liberals, nationalists and those disillusioned with globalization. It is impossible to overlook the 48% of voters, young educated Londoners, open to Europe and frustrated by the result.

2. The debate about Europe: strengths, weaknesses and future.

2.1 "The EU is as arrogant as the Titanic":

There are two ideas in this assertion, which are put into perspective by the seven arguments below.

- ***Europe remains the leading commercial power***:

Of all the regions, it is Europe that is the most integrated, because 70% of trade takes place inside the region, compared with 50% on the American continent for NAFTA members and 50% for Asian countries. The European Union produces one-third of the world's scientific publications, the United States one-quarter, and China 20%. Even if does not want to, the European Union can get by without the United Kingdom. The EU's exports to the United Kingdom do not exceed 2.5% of its GDP.

- ***Potential growth has declined***:

Domestic demand is subdued, like everywhere in the developed world, and possibly more than elsewhere because the population is ageing faster than in the United States, but the unemployment rate is falling, to 10.1% in August, and the growth rate expected by the ECB is 1.4%. Even if the inflation rate, at 0.2% in August, has sometimes been negative, deflation has been avoided. At the end of July, the Eurozone posted growth in credit volumes of 1.9% year-on-year.

- ***Europe knows that it must choose***:

It can stay confined to a free-trade area, as the British wish, or initiate new joint policies. Although one could rightfully criticize the Commission for its punitive attitude or regret its bureaucratic nature, there is no doubt that the bogging down of Europe in recent years is largely due to the British refusal to increase the European budget, and allow new policies, e.g. in energy and defence, to move forward. Pragmatically, Europe will have a successful future if jobs are created and if citizens' purchasing power improves, so there is a need to encourage training and research and to accelerate the Juncker Plan, the much talked-of €315 billion in infrastructure investment.

- ***United we stand, divided we fall: divisions and barriers are sources of weakness***:

Recently, it is because the European Union is the leading economic power in the world that it was capable of sending the Chinese a firm message regarding flat steel and, to combat dumping, apply retroactive customs duties of between 18% and 35%. Likewise, a united Europe can have a standoff with the US Treasury

Department over the taxation of big US corporations in Europe. The United Kingdom alone will not be able to do so.

- ***The European Union organizes solidarity between its Member States***:

It is hard to imagine the Eastern European countries, which are sometimes critical, depriving themselves of a generous bonanza which has allowed rapid growth in per capita GDP since their EU accession: for example, each year Poland receives net aid of €13.7 billion, Hungary €5.7 billion, and Romania €4.5 billion.

- ***The European Union already offers a certain flexibility***:

While some call for a Europe with several speeds, generally two-speed, they seem to forget that the Eurozone has a certain perimeter and Schengen has another, and that in the future a tax on financial transactions could bring together about ten countries. In fact the Treaty of Lisbon opens up the possibility of cooperation if nine countries support a given project.

- ***Many European Union Member States have managed to conduct ambitious reforms***:

These reforms will pave the way for convergence. Examples are the job market reforms in Germany under Schroeder, more recently in Spain, and very recently in Italy.

2.2 "wonderful for Germany":

There are two ideas here: Germany is favoured by a weak euro but exports deflation.

- ***Europe does not benefit Germany alone!***

If there is one country that has benefited from special treatment, it is the United Kingdom: each year, Germany makes a contribution of €25.8 billion, France €19.6 billion, Italy €14.4 billion, and the United Kingdom €11.3 billion, an amount that is scarcely more than for Spain, which pays €10 billion and whose GDP is almost twice as small as that of the UK.

- ***The currency is not the only factor of competitiveness:***

Admittedly, German exports were worth €1200 billion in 2015, posting 6.4% growth despite the sluggishness of global trade, admittedly the German trade surplus is €248 billion, i.e. 8% of GDP, and admittedly Germany benefits from an undervalued euro, but the pound sterling has been constantly weak and each year the United Kingdom posts a very large trade deficit. Germany's fiscal discipline, giving a budget surplus of 1.2% of GDP in the first half of 2016, and British fiscal indiscipline, have nothing to do with Europe.

- ***Germany is not as strong as people think***:

Although Germany now produces 20% of the EU's GDP while France and the United Kingdom produce only 14% each, Italy 12%, Spain 8% and Poland 5%, it also has some weaknesses. It saves too much, it invests insufficiently in education and infrastructure and it has an ageing population, so that on the 2050 horizon France will probably have a larger population.

2.3 "crucified southern Europe":

- ***Southern Europe benefited from the euro***:

Thanks to the creation of the euro, the market's perception of the risk represented by Southern European countries permitted a fantastic easing of interest rates, thus lightening the debt burden. At the origin of the euro, Italian 10-year rates were 5.21%, while they are now 1.12%, Spanish rates have decreased from 3.88% to 0.93%, Portuguese rates from 4.22% to 2.97%, and Irish rates from 5.53% to 0.39%. The only exception is Greece, but the scale of the recent crisis explains this, and the country's fiddling with its figures at the time of entering the euro provides another explanation. To be more accurate in our analysis and eliminate the effect of market expectations, we adopt the 10-year interest rate of these countries a few months earlier, in July 1998: Spain's interest rate was 4.99%. So the positive impact of the euro is even more striking.

- ***The southern European countries were not crucified; simply, they themselves hampered their own competitiveness***:

Between 2000 and 2008, hourly labour costs in the manufacturing sector increased by around 50% in Greece, 42% in Portugal, 38% in France, 34% in Spain and 31% in Italy, when they increased by only 11% in Germany (source: ECB). Between 1999 and 2009, the pay of Greek civil servants increased by 120%.

- ***Greece is an interesting example***:

It is easy for the Greeks to blame the Community institutions, but the primary cause of their difficulties is the lack of competitiveness of the economy, insufficient specialization in growth sectors, the shortcomings of the education system, and the small number of workers, 4 million, compared with the number of pensioners, 2.5 million, not to mention 1.5 million unemployed.

- ***The Brussels authorities are showing understanding faced with the difficulties of the southern European countries***:

For example, no penalty for an excessive budget deficit has been levied on Spain or Portugal. The ceiling was 3%, and the Spanish deficit was 5.2% in 2015, and the Portuguese deficit 4.4%.

2.4 "Italian banks are bust without government help but the EU rules forbid it":

- ***The undercapitalization of Italian banks is one of Europe's problems***:

Outstanding non-performing loans have been multiplied by four since 2008, reaching €360 billion, equivalent to 20% of Italy's GDP, whereas this percentage did not exceed 5% for US banks in 2007. Bank branches are clearly overstaffed.

- ***The issue has not been finalized***:

Italian taxpayers will almost certainly not have to pay for a bailout, even though the European banking law of December 2014 provides for this. The Italian government will almost certainly be authorized by Brussels to bail out its banks or relieve them of part of their non-performing loans or place part of them in a bad bank.

- ***Spain benefited from this treatment***:

This was two or three years ago and Ireland had previously obtained European aid worth more than €70 billion without any offsetting conditions (as a reminder, Germany and France initially wanted to make the grant of this plan conditional on a hike in the Irish tax rate on corporations).

2.5 “*Greece is literally beyond help*”:

Greece has not been abandoned, but has benefited from numerous bailout plans, the third of which, granted just before the summer, amounts to €86 billion. In exchange for these aid measures, Greece is implementing reforms: the retirement age will be raised from 65 to 67, pensions will be decreased slightly, and the VAT rate has been increased from 21% to 23%.

The economic situation is improving.

2.6 “*The PIIGS show few signs of recovery*”:

This is completely false. The trade balances of Spain and Portugal, negative to the tune of 10% of GDP in 2007, are now at equilibrium again.

Production costs have been reduced, competitiveness is recovering, and foreign investment in these countries is increasing (e.g. Renault in Spain).

Spain is expected to post 3% GDP growth this year. The country reorganized its banking sector in the wake of the real estate crisis and for some months now it has seen a strong pickup in loan volumes and attractive floating rates. The country had to use only €40bn of the €100 billion offered by the European Union. The ratio of bank branches per inhabitant, one of the highest in the world, has been reduced by slashing the number of branches from 46,000 to 30,000. Tourism, accounting for 14% of GDP, is boosted by an influx of foreign tourists.

Ireland posted 7.5% growth in 2015 and has regained an unemployment rate of 8.4%, similar to the percentage noted before the crisis. Household debt represented 2.1x households' gross disposable income in 2009, and is 1.7x at present.

In ***Italy***, the results are more modest, but the labour market reform in 2015 allowed 0.3 million jobs to be created.

In ***Portugal***, the budget deficit was reduced from 8.9% in 2014 to 3.6% in 2015, but in particular structural reforms were implemented: the retirement age was increased to 66, the number of civil servants was reduced by 70,000, welfare benefits were reduced, and the minimum wage was frozen at €500. And the country is regaining competitiveness.

2.7 *"PIIGS bring extremist parties to power*":

Where are the greatest threats? Austria, Finland, Denmark, three countries less hurt by the crisis than the PIIGS. What is the weight of far-right parties in Portugal, Spain and Ireland? Insignificant. In Greece, the Golden Dawn movement is strong but far behind Syriza. The Five Star movement, Podemos and Syriza are not extremist but alternative parties. None of them seeks to leave Europe and, faced with the realities of power, Syriza soon gave in.

CONCLUSION regarding Europe and the United Kingdom:

- Regarding Europe, let us repeat the words of the greatest of Englishmen, ***Winston Churchill***, who in his speech in Zurich in 1946 shed light on the future: ***"If Europe were once united in the sharing of its common inheritance, there would be no limit to the happiness, to the prosperity and glory which its three or four hundred million people would enjoy".***

There is still some way to go:

- o Economically, either a two-speed Europe must be imagined, or/and the ambition must be to reduce income inequalities between the poor, Bulgaria, and the rich, Austria, which are 1 to 3.7x, closer to the gap between the United States and Mexico (1 to 3x) than that between rich Delaware and poor Mississippi (1 to 2). It is true that Bulgaria joined the EU recently and that the catch-up achieved in eastern Europe is huge, but it is necessary to stimulate Community investment in infrastructure, research and education.

  The Community budget of €155 billion, of which €62 billion for agriculture and €41 billion for territorial cohesion, cannot remain at less than 1% of GDP when the US federal budget represents around 18% of GDP. Possibly a Eurozone budget should be created, and a finance minister for the Eurozone, and one could even consider a single representation in the major international bodies. Tensions are building up between northern and southern Europe. ***Pascal Bruckner*** stimulates thought by noting two attitudes to debt in Europe, one in the North based on a serious and economical attitude tolerating no excessive deficit, and the other in the Catholic South, which is very tolerant of human fallibility and shows inexhaustible indulgence toward our shortcomings.
- o Politically, it is surprising to see that, since 1979, the turnout rate in European elections has halved while the powers of the EU Parliament have increased. It is therefore essential to continue to bring Europe closer to its citizens, to avert the risk of decline, and to accelerate integration on policies that are emblematic for the citizens, such as border security, defence and energy.
- o Diplomatically, Europe's inability to be united in coping with the Balkans crisis in the 1990s has left traces. Europe must be strong because, as ***Michel Foucher*** reminds us, ***"83% of the 75 most serious international hot spots are less than six hours from Brussels".***

- Regarding the United Kingdom, it is fashionable to discredit the experts, but is it not surprising that all the international authorities, from S&P to the IMF, and including the Bank of England, arrive at the same conclusion, namely a loss of growth potential for the United Kingdom.

- So far Brexit has had few consequences for the currency and the economic situation, but this is because the exit process is likely to be long, and even (this is our impression) will never be finalized. Since the vote, we note the resilience of consumption and exports, but this is the consequence of the fall in sterling, 2.5% wage growth, an influx of tourists and favourable weather conditions. Caution is still needed, because the savings ratio, at 3.8%, is already low and inflation will rise following the fall in sterling. The rise in the stock market is due to the impact of the depreciation of sterling on the earnings of big UK companies and is not a reflection of confidence in the country's economic prospects.
- In contrast, the figures for investment and the PMI sentiment indicators reflect at best a legitimate wait-and-see attitude, and more likely some anxiety. Similarly, several large real estate funds (M&G, Aviva, Standard Life) have frozen £15 billion in assets, i.e. blocked redemptions, and S&P's decision to downgrade the country's rating by two notches, to AA, is justified, as is the downward revision of the growth outlook by the IMF.
- While Brexit was largely due to the perception of a problem related to migrants, it ought to have been separated from Europe because, in the past twenty years, two-thirds of migrants have come from non-EU countries. If there is one point on which the Europeans will not give way in their negotiations with the United Kingdom, it is a separation between the free movement of labour and access to the single market.

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