It's All about the Money… – Brexit, Trump and the Euro

Charles Dumas
Chief Economist
Lombard Street Research

The worldwide liberal establishment watched with horror as their views were being trashed by angry working-class majorities in Britain and the US. Clearly there were specific national and historical factors at work causing majorities for Brexit and Mr. Trump. But especially in the British case, though also globally, a measure of blame for the rejection of liberal (or ordo-liberal) values lies with the euro.

The euro area and the easy money

The euro area's gross imbalances are beyond remedy without a complete revolution in governance. So, the only way the slowest major member of the convoy (Italy) can get any growth at all is when the EA countries adopt excessively easy money. Competitive devaluation has ensured a current account surplus in north-central Europe (including Sweden, Switzerland and Denmark) of half a trillion dollars, over $300 billion in Germany alone. Even before the beggar-my-neighbor devaluation induced by Mr. Draghi in late 2014, the surplus was huge. This was a major economy, already in massive surplus, devaluing to create export-led growth! This is globally anti-social: The workers of Anglo-Saxon deficit countries have responded.

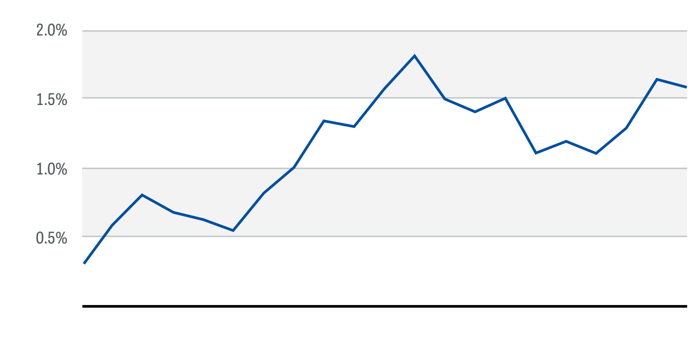


Figure 1: Current account of Germany, China, Japan, 4 Europeans & 4 Tigers, percent world GDP

Excessive saving made in China

The EA is not alone. While Germany is the number one savings glutton, number two is China, though with greater need for export-led growth than Germany. Japan, too, deserves a dishonorable mention. China, however, is the prime mover in both receiving relocated jobs from advanced countries and excessive saving. China's national savings rate has been an exorbitant half of GDP every year since 2007, initially offset by somewhat excessive capital spending and large trade surpluses, more recently tilting even more towards wasteful capex. Some effects:

- Massive domestic 'metal bashing' and property waste, with excess capacity seriously undermining industrial competitors elsewhere in the world and threatening instability in China itself through a run-up of domestic debt
- Export surpluses either requiring mounting debts elsewhere or acceptance of Chinese government-directed capital gaining control of key industries
- Long-term global downtrends in the return on assets and interest rates
- Poor returns to Chinese savers inducing them to save even more

Other countries have to bear the burden of the deficits corresponding to these surpluses; the resulting excessive debts accounted for the financial crisis and the euro crisis, as forecast and analyzed, respectively, in my books *The Bill from the China Shop* (2006) and *Globalisation Fractures* (2010). The mix of austerity and income losses caused by this was additive to the malign effects on workers in deficit countries caused by globalization in relocating advanced-country jobs to emerging markets. Since 2014, a fresh round of competitive devaluation in Japan and the euro area has reflected the savings gluttons' apparently never-ending inability to generate adequate domestic demand.

In other words, it is not globalization alone that has undermined workers' incomes in the US and Britain, but the incontinent savings excesses of much too large a section of the world economy, with consistently undervalued currencies. Germany and Japan are the most culpable countries that should get on with enjoying themselves by spending their incomes and ceasing to expect the rest of the world to run up debts to provide them with assets – which is what has to happen every time a German or Japanese saver puts money in the bank.

What about the man in the street?

It is widely supposed that Germany has been the gainer from the euro structure, under which it has achieved ever lower relative costs through the euro's exchange rate being held down to reflect the less competitive Mediterranean economies. But the figure below shows the real growth per head of GDP and personal disposable income between 1998, the last pre-euro year, and 2015, both years being mid-cycle and therefore comparable. German GDP growth is roughly similar to the US and UK. But ordinary Germans have not benefited: Their real disposable income has lagged 10 percent behind. Even France has done better on this measure.

But the broad conclusion from the figure must be that not only has the euro structure been a substantial factor in the 2016 US and UK votes, but also it has been a disaster for its actual members. Italians have actually seen a fall in per-capita real GDP and a large, 7 percent fall in their standard of living. Greece is obviously far worse. But no country emerges with credit.

It is time for this gross folly to be ended. The EA establishment refuses to face up to the euro's failure and engage in deep reform, including a fiscal union without which the euro cannot survive in the long term. The centrist, solid citizens in power have become the fanatics – the only solution is 'more Europe.' The left and right extremists have become the sensible pragmatists. They say 'It has not worked – can we stop now, please?' This role reversal has not escaped voter attention.

Figure 2: Real per-head growth of GDP and personal disposable income, in percent 2015/1998.

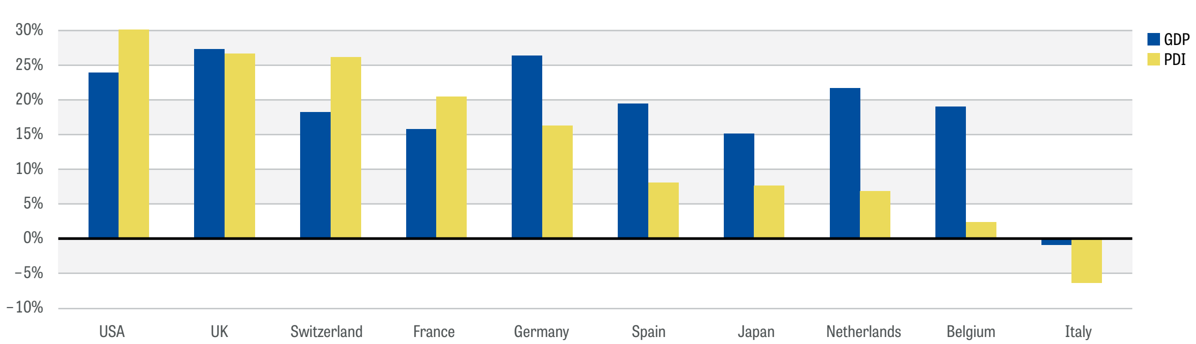
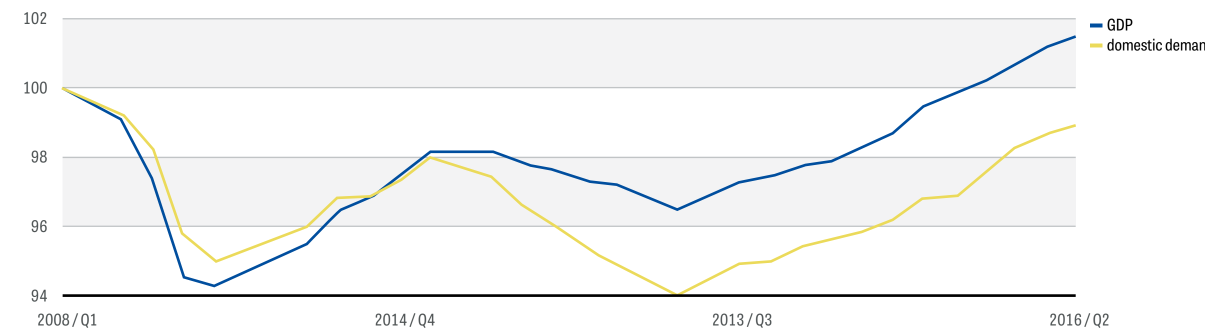


Figure 3: EA real GDP & domestic demand, pre-crisis peak = 100
Source: Datastream, TS Lombard



Brexit partly caused by the euro

The British have always (and rightly) pointed to the sub-optimal and wasteful CAP as evidence that the EU does not work. Aside from the euro experience reinforcing this belief, the euro has had three consequences that directly encouraged Brexit voters. Without these three effects, the vote might well have gone the other way:

1. EA GDP, and especially domestic demand, was extremely weak, with a double-dip recession. In 2007, half of British exports were to the EA, so about 15 percent of UK GDP was blighted for eight years.
2. On top of major capital inflows to Britain from the former Soviet Union, China and OPEC, the euro-crisis provoked substantial extra flows, so the pound's post-crisis devaluation was too shallow. This weakened British output in a demand-deficient world in much of 2009 – 2015.
3. Large numbers of laid-off EA workers and unemployed youth surged into Britain in search of work, adding to already strong immigration and to downward pressure on low-income British workers.

Over the past 20 years, China's explosion onto world markets has led most advanced countries to lose export market share – on average nearly 20 percent. But Britain's real exchange rate – using relative labor cost comparisons – was 14 percent higher in 1996 – 2016 (pre-Brexit) than in 1975 – 1995. Not surprisingly, the British loss of market share in the past 20 years has been 30 percent, higher than typical for high-income countries though less than in Italy and Japan (both down more than 40 percent).

Since Brexit, the pound's real exchange rate has fallen 15 percent or so, and is now below the 1975 – 1995 average mentioned above. This should help rebalance the economy away from bloated London, towards the industrial Midlands and North. Given Britain's current full employment, the next major policy move may need to be tightening, not the loosening foreseen by many commentators and officials.

Low-income immigration since 2000 has raised the labor force growth rate by 0.5 percent a year (from 0.3 percent to 0.8 percent) restraining wages to the benefit of profits – and thus shareholders. This has increased demand for living space, benefiting landowners. A reduction in the rate of immigration should lead to a reduction of inequality, which has risen in the 35 years since China, followed by the Soviet Bloc and India, entered the world economy properly.

Britain's vote for Brexit was emotionally distressing, at least for this author, but it looks intellectually justified.