A FUTURUS Briefing on the EU referendum

UK MEMBERSHIP OF THE EU. The Threat to the UK Balance Sheet

Greece has not become insolvent because of its EU trading arrangements or because it did not receive enough EU regional aid or other EU money

Countries do not become insolvent because of trading arrangements, tariffs, non tariff barriers or quotas, although these are not unimportant.

This conclusion is based on simple accounting. The critical numbers in any financial entity, such as a State, are its balance sheet assets and liabilities, not its annual income or expenditure. Destabilisation in the balance sheet assets and liabilities is the usual cause of insolvency throughout history. It also usually leads to disorder and revolution.

Yet millions of words have been written about the benefits or disbenefits of the UK's current trading relations with the EU, future trading arrangements either through membership of the European Economic Area [EEA] or through World Trade Organisation rules or other proposals.

Very little attention has been paid to the UK's involvement in taking responsibility for the debts of EU countries and entities or how the UK's own enormous debt pile is considerably related to its contributions to the EU budget.

PART ONE

BRITAIN PAID HUGE EU BUDGET CONTRIBUTIONS INSTEAD OF SETTING UP A SOVEREIGN WEALTH FUND

Countries go insolvent because they carelessly throw away money over a long time, such as the UK's budget contributions to the EU, or they take on liabilities over which they have no control. Historically, war has been the greatest cause of state insolvency in both overspending or in incurring liabilities. The effect of EU membership on the UK finances both in investment foregone and in accumulation of liabilities is similar to that of a medium-sized war; it is simply spread over a longer period. Two minor wars, in Afghanistan and Iraq, are said by the Royal United Services Institute, to have cost the taxpayer £29 billion – about 7% of what has been given by the UK to the EU budget between 1973 and 2010.

Contrary to what is often asserted, the EFTA countries, such as Norway, Iceland and Switzerland, do not make contributions to the general EU budget, nor do they take any responsibility for the debts of the EU or its entities.

They do, of course, have programmes of assistance to the Eastern European countries and they participate, voluntarily, in some EU programmes, all of which are time limited, but there is no legal requirement for them to make any contribution to the EU general budget.

Supporters of the EU are often dismissive of the impact on the UK taxpayer of the UK's contributions to the EU budget and say that they are small in relation to the UK's GDP.

This in itself is an odd comparison. UK contributions to the EU budget are not to be compared with UK GDP; they are rather a dip into the meagre **net** savings available to finance net new UK investment, including providing for the capital assets required by migrants. This meagre saving is around 3% of UK GDP, for example, here are the relevant figures for 2011 and 2012:

	2011 (£)	2012 (£)
UK GDP (2011 values)	1,617,677	1,655,384
UK Gross Capital Formation	265,106	273,430
Capital Consumption	212,991	218,749
Net New Capital Formation	52,115	54,681

A legal obligation for the UK is to produce £17 billion pounds (in euros) or more for the EU budget every year in **perpetuity**, less £3.5 billion paid back as the Thatcher rebates. Any other money spent in the UK is a matter of EU policy, not legal obligation.

Therefore, adding the EU budget contributions to the Net New Capital Formation gives the total UK savings amount available in the British UK economy in 2011 and 2012.

	2011 (£)	2012 (£)
Net New Capital Formation	52,115	54,681
EU Budget Contributions, less rebates	13,500	13,500
TOTAL NET SAVINGS	65,615	68,181

One can see that about 20% of UK savings per annum were just given away to the EU under a perpetual legal obligation. Of course, some of these savings were recycled back to the UK economy as a result of EU policy, in spending by the EU in the UK on agriculture, rural support, infrastructure support, Jean Monnet professors, etc. However, this process in the main involved converting a chunk of UK savings into extra current expenditure or government capital spending, thereby reducing net new UK capital investment in the productive sector.

If 20% of the UK's savings are given away every year over 40 years, it is not surprising that this impacts on the UK's total debts. In March 2011, total UK government debt was £903 billion. Yet the total of the UK's contribution to the EU budget, after rebates, for the years 1973-2010, calculated at 2010 values, amounted to £379 billion. In other words, 41% of the then total British national debt was accounted for by payments to the EU budget. Used differently, they would have enabled the UK to build up the largest sovereign wealth fund in the world. Since 2011, UK government debt has risen faster than EU budget contributions, although these are still a significant contribution to the UK's debt escalation.

PART TWO

The previous part considered the mismanagement of the UK's assets whereby 20% of its net savings were simply handed over to the EU.

This second part considers the mismanagement of UK liabilities and contingent liabilities in relation to the EU and proposes the UK should move to the position of the EEA states such as Iceland and Norway **urgently**.

If the UK leaves the political, judicial and monetary structure of the EU, but remains in the Single Market via EFTA/EEA [European Economic Area] membership, what would this mean for the UK's financial risk exposure? The UK, under this plan, would be in a future position roughly similar to Norway.

What is Norway's current risk exposure to the EU and its entities?

NIL

What is the UK's current risk exposure to the EU and its entities?

The UK, as a member state, has a 'joint and several' liability for all EU debts. That means that if any EU state cannot pay its share of EU debts, such debts are added to the still solvent countries' liabilities. Strictly enforced 'joint and several liability' is a most onerous obligation and is rarely entered into in modern commerce. Effectively it adds the risks of all the participants to the contingent liability of the strongest participants. It resembles the liability of shareholders before limited liability became law in the nineteenth century.

Additionally, there is specific risk exposure to the European Central Bank (ECB) where the UK is a shareholder, the European Investment Bank (EIB), various EU financial support operations such as the Balance of Payments programme and the EFSM (European Financial Stabilisation Mechanism). Also, UK exposure to the IMF and the IMF's risk in bailing out EU states could also be seen as an EU related risk, albeit at a secondary level.

What is the advantage for the UK to have risk exposure to EU liabilities?

Norway is not exposed to EU liabilities.

It should be noted that the UK has extra one-sided exposure. It is exposed to the liabilities of the EU and its entities, including the ECB, but there is no corresponding EU states' exposure to UK liabilities such as the Bank of England, except for the exposure of the other EU states to 'joint and several' liability for the UK's share of EU debts.

There is, therefore, no advantage for the UK in the current one-sided risk exposure. Exit from the EU as soon as possible would remove an overhanging risk which could crystallise at any moment.

The attitude of HM Treasury, the City and big business

Despite the one-sided risk exposure for the UK because of its participation in the EU and its offshoots, there is great complacency expressed by UK financial and business regarding the overhanging EU liabilities.

Risk is a matter of the quantum of liabilities and the spirit of contagion. While the liabilities can be estimated the outbreak of contagion and panic is almost impossible to forecast.

The nature of panic is that risk does not matter until it suddenly does matter.

Prudent finance should always be aware of balance sheet risk and counter-party risk and contingent risk.

Therefore, withdrawing from the EU and adopting the position of an EFTA/EEA state would be prudent finance.

The peculiarities of EU accounting

The financial activities of the EU, the ECB and its entities all suffer from certain financially unattractive characteristics which would heavily downgrade them if they were not perceived by financial markets as unconditionally backed by the strongest EU states.

a) There is financial opaqueness, poor accounting not up to IFRS [International Financial Reporting Standards] and unwillingness to recognise losses. As in other areas, EU behaviour does not conform to standards it prescribes for others.

b) Most EU institutions, such as the ECB and the EIB, operate on a very slim capital base. It is the assumed joint and several liabilities of the EU states, especially Germany, which gives confidence to those transacting with or lending to these institutions.

   One should note that this point has meant that Germany has, perhaps reluctantly, become the arbiter of the EU.

c) There is a pattern of non-adherence to the EU treaties and compacts such as the Stability and Growth Pact.

d) The Constitution of the ECB, which purports to control the reserves of all the national central banks, but has only a very small capital base, is an accident waiting to happen.

e) The trillion euro bond buying programme, started by the ECB is actually breaking up the EMU as the bond buying is done by national central banks in national bond markets. The ECB is morphing into a collection of currency boards in a new-style ERM according to Willem Buiter, the well-known economist at CityGroup. The weaker EU countries which can no longer print their own currency are at risk of collapse.

What are the EU liabilities which could impact on the UK?

Additional to its obligations under 'the joint and several liability' of all EU member states for all EU debt, there are specific UK exposures.

Due to the opaqueness of EU accounting, all comment on these liabilities should be treated as indicative rather than matters of exact calculation.

i) The losses of the European Investment Bank: 16.2% of these would be attributed to the UK as its 'capital key'. The potential contribution on the uncalled capital alone for the UK is £35.7 billion. Should losses exceed called and uncalled capital, there could be further calls for shareholders, the EU states (including the UK), to put in more capital.

ii) Juncker's Commission centrepiece policy is a euro 315 billion lending package worked through the EIB but without any extra capital funding from the EU states. This programme will greatly increase the size and likelihood of losses at the EIB, it is piling 'pork on pig'.

iii) The losses of the European Central Bank: The UK's share is 14.517%. Initially, these losses are the responsibility of the eurozone countries. On paper, the UK's maximum liability is call up of uncalled capital, about euro 1.5 billion. Once the ECB has exhausted its called and uncalled capital, the question of recapitalising the ECB is unclear. There is, however, the ability of the ECB to call on EU states' currency reserves under a Council Regulation of 8th May 2000. The shocking fact is that the UK taxpayer is likely to be involved as a shareholder and face the choice of outright refusal to commit funds or participate in the cost of bailing out the ECB. The potential losses of the ECB are enormous:

- Losses on worthless bonds and loans, especially Greece;
- Target 2 Liabilities (these may be refused by the ECB and returned to the EU states at risk);
- Emergency Liquidity Assistance: euro 85 billion was given to Greece under this programme at the time of writing;
- Balance of payments' facilities.

iv) Losses under the EFSM (the European Financial Stabilisation Mechanism). These are the loans to Ireland and Portugal originally for three years, now extended to 2042. These are part of the 'joint and several' liabilities of the EU states. Some of this organisation's funds were not drawn in 2010 and the EU now proposes to allocate these funds to Greece as a 'bridging loan' pending the new third bail-out of Greece. This bail-out is now unlikely because of IMF opposition but the 'bridging funds' will certainly be drawn and part allocated to the UK's total liabilities.

v) Losses under the EU's Balance of Payments Assistance Programme (not to be confused with the ECB's balance of payments facilities). These are under 'joint and several' liabilities again.

vi) Exposure to any IMF losses regarding its activities in the eurozone, specifically in Greece. At present, this is a secondary matter because there is no direct IMF/EU states linkage.

vii) A specific UK loan to Ireland of £3 billion now extended to 2042.

Quantifying the Liabilities

It is in the nature of contingent liabilities that the actual change into undoubted liabilities is an unclear process and the timing is uncertain.

Some risks will never arise, others will disappear because of unexpected events.

In many cases, the EU institutions will ‘extend and pretend’, that is to say, carry assets on their balance sheets which are known to be seriously impaired but have not been formally written down, and this could go on for years.

Bail-Ins

While the UK taxpayer remains exposed to losses in ill-financed and ill-run EU entities, the recent policy moves initiated by the Financial Stability Board, a G7 entity founded in 1999 and now part of the G20, is to reconstruct failing banks by ‘haircuts’ for bondholders and confiscation of bank deposits, known as bail-ins. The EU’s Resolution and Recovery directive is based on this.

Bail-ins occurred in Cyprus in 2013 and another version occurred in Greece, where cash deposits of local government and state entities were swept into the Bank of Greece.

The use of bail-ins is a recognition that government and EU funding of deficits and losses is reaching its limit for the stronger countries such as Germany.

Conclusion

While non-EU EEA states have no risk exposure to EU liabilities, the UK has enormous exposure. Moreover, it is, in part, one-sided with no corresponding EU risk exposure to the Bank of England.

It is likely that further collapse in the finances of eurozone governments and banks will not attract open-ended EU entity support as in the period 2009-13 and resort will be made to bail-ins and haircuts on bondholders. However, prudent finance would be for the UK to leave the political and monetary structure of the EU and move to EEA status urgently.

At present, there is complacency in the City and big business about UK risk exposure. Further likely financial problems in the eurozone could turn this complacency swiftly into panic.

Non-EU EEA states do not contribute to the EU general budget. These states do not have liability or contingent liability for the debts of the EU member states or EU entities.

This is a position the UK should take up as a matter of urgency.

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