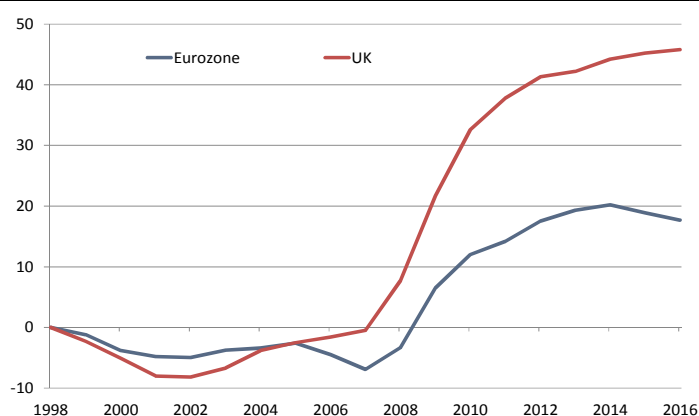


6 May 2016

## UK and Eurozone: mind the gap

### Increase in public debt since the start of the euro



Change in the ratio of public debt to GDP since 1998, in percentage points of GDP. End-2015 debt ratios: 90.7% for the Eurozone after 71.8% in Q4 1998; 89.2% for the UK (up from 44.0%). Source: Eurostat; Berenberg projection for 2016.

- Better off alone?** Advocates of Brexit often claim that the UK would be better off if it detached itself more from an allegedly dysfunctional Eurozone and linked itself closer to faster-growing regions of the world instead. Strictly speaking, the assertion does not make sense. Being a member of the European Union does not prevent the UK from trading more with other regions. Germany serves as a good example for this, **exporting three times more to China than the UK**. Like Germany, the UK could improve its global competitive position by getting its domestic policies right. There is no need to eject itself from what is still the UK's largest market, the EU.
- Advantage UK:** There is a kernel of truth in the underlying assertion. The Eurozone has serious problems. Small Greece probably needs external support almost as much as Northern Ireland. Also, it took the European Central Bank a painfully long time to realise it ought to act as a lender of last resort in emergencies, just like the Bank of England did immediately after the start of the post-Lehman crisis. Since the introduction of the euro, UK real GDP per capita has risen by a cumulative 25%, outpacing the 16% gain in the Eurozone by a significant margin.
- Advantage built on debt:** The clear UK lead in terms of growth has come at a cost, though. Since the Eurozone switched from national currencies to the euro at the end of 1998, the UK's ratio of public debt has increased by 45 percentage points of GDP versus an increase of just 19 points in the Eurozone (see chart). The gap looks set to widen further in 2016. The UK has paid for its economic advantage by building up much more public debt. If the UK were to impose sufficient austerity onto itself to bring the rise in the debt ratio in line with that of the Eurozone, the UK's economic advantage over the Eurozone would partly vanish in the process.
- Shifting burdens onto the future:** Whether the UK strategy of running huge deficits or the Eurozone strategy of painful prudence makes more sense is a question with no easy answer. Both have shifted burdens onto the future. In the UK, the extra debt mountain needs to be serviced or corrected through painful austerity. In the Eurozone, austerity has added to the problems of national labour markets that are often not flexible enough. Whereas the UK unemployment rate for workers under 25 years of 13.4% in Q1 2016 matched the 13.3% of late 1998, the rate has risen from 19.8% to 21.5% in the Eurozone. In the Eurozone, more young people are denied the chance to hone their skills in a job. Arguably, a UK-style increase in public debt may have prevented that.
- What the UK and Europe need:** The UK needs consistent fiscal repair and some domestic reforms to ease supply bottlenecks such as the housing shortage. It can do so in the EU. The damage of a Brexit, notably the partial loss of access to the EU market for services, would hurt UK growth and add to its debt mountain. To raise its trend growth, the Eurozone needs France to follow the labour market reforms of Germany (2004) and Italy (2015). Unlike Brexit, such reforms would make sense for both sides of the English Channel.

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