

The Brexit Negotiations – A German Perspective

*Speech By Dr. Markus Krall at the House of Lords
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Honourable members of the House of Lords, Ladies and Gentlemen,

I Introduction and Summary

Before sharing my perspective on the negotiations of the terms of separation of Britain from the EU, or Brexit, allow me to express my gratitude for the invitation and the opportunity to speak to you at the House of Lords. I feel honoured and privileged to have been invited by Lord Fairfax.

This parliament stands as a beacon of liberty and free speech going back to times when the continent was still subject to the power of absolutist, non-constitutional monarchs.

This long standing tradition of liberty lies in my humble opinion at the heart of the decision that the majority of the British people has made with regards to its future role in Europe and the world.

I would like to put my deliberations into perspective: “A” German perspective I will deliver to you today, is not one shared by the German government, or mainstream media. It is rather my personal one which is based on a number of discussions with political staff in Berlin, including government officials, members of parliament, and lobby groups.

Based on this I will try to provide you with a brief picture of the German and the Brussels mindset and their interaction regarding Brexit before spending a few remarks on the misguided game theory approach resulting from the underlying ideological edifice. This will lead us directly to what I think to be the German government’s, specifically Mrs. Merkel’s, approach and how the gaps in its consistency can provide opportunities for the UK negotiation strategy. Finally I will take the liberty for a very short statement why I am taking an EU-critical position in a debate that is well known to my valued audience.

II The German State of Mind

Now, allow me to start with some observations about what I would like to call “the German state of mind”.

I once stumbled upon a little article in the Economist recounting an anecdote from 19th century France: Emanuel Litre, the leading French linguist of his time once fell prey to an error of judgment and as a consequence was caught by his wife with their housemaid in the conjugal bedroom *in flagranti*. As his wife entered the room she exclaimed “Dear, I am *surprised!*” And what did the erring Frenchman reply? “No dear, you are *astonished*, it’s us who are *surprised.*”

The term “astonished” very neatly describes the state of mind regarding Brexit in Germany, especially among its economic and political leadership. Germany is probably the one country in Europe that was emotionally and intellectually least prepared for the news that a majority in the United Kingdom had decided to call it quits with the European Bureaucratic Union. That has several reasons.

One is, that we Germans – regrettably – have a tradition of belief in the infallibility of government. While the liberal school of Anglo-Saxon origin views the state and its bureaucracy with a healthy dose of scepticism this is not so to the same degree between the rivers Rhine and Oder. This is also true for the media, which are toeing the “official line” because 80% of journalists identify themselves as left of centre. There is a resulting lack of democratic control and public debate.

Secondly, very much in line with the undemocratic decision-making the EU has adopted, we have seen a systematic erosion of the rule of law in Germany regarding European matters. This included the illegal bail out of broke Eurozone-members, Greece among others, the thinly veiled practice of government funding by the ECB through various programs in contradiction of the treaties and the opening of the borders in clear defiance of the Schengen treaty.

It is, by the way, a most deplorable observation that you can cajole my fellow countrymen – or at least a sizeable minority of them – into going along with the erosion of the rule of law if it’s for a presumed greater moral good. The end justifies the means.

The EU is a clear beneficiary of this attitude as Government and Brussels have become interchangeable terms for good reason. So for a majority of Germans as well as of officials in Berlin it was simply an unthinkable heresy when British voters said “we leave”. As it actually happened, they were completely *astonished*, and intellectually unprepared.

Thirdly, in the past, Germany and Britain have often been aligned in efforts to tame the Brussels bureaucracy, and push the EU towards free trade and open borders. The common market in its original free trade design was largely the result of Margaret Thatcher’s pressure. The Germans, who didn’t have the same political weight as a result of well-known historical developments gratefully took this for granted. The presence of Britain in the EU was in the German view a necessary counterweight to the school of *étatisme*, the primacy of the state bureaucracy coming from Paris. Now this balance of power in the EU is damaged.

To put it bluntly: You guys are leaving us alone with a bunch of socialist Latin-European nut-heads. We are not delighted.

III The Brussels Attitude

The EU bureaucracy immediately adopted a hostile attitude towards your country’s democratic decision. It was viewed as a dangerous precedent, especially in the light of the frictions caused by the Euro and the widening cultural divide between what Donald Rumsfeld once called the old Europe versus the new Europe.

In the bureaucrats' view nobody should be incentivised to leave the club or even to think about it. He must not go unpunished. This attitude makes it impossible, by definition, to tolerate an economically successful United Kingdom outside the Brussels sphere of hegemony. Because if Brexit is a success, economically, politically and socially there is proof to the pudding that prosperity is possible without them. The plethora of Europe's presidents from Schulz (now ex-President) and Juncker to Draghi and Tusk would be walking naked. The emperors without clothes.

The resulting reaction has several elements: (1) Accusations of the vote being undemocratic because the British voters are not adults, and therefore presumably followed liars, (2) meting out punishment in the form of an extortionate "Brexit Bill", and (3) propagating fictional beliefs as facts which don't stand the test of reality.

The result is what I call a Brexit trap consisting of a prisoner's dilemma to be solved in a timeframe that is insufficient if one follows the Brussels script.

From all this brouhaha guiding negotiation principles were derived with the aim to let those little warm-beer-drinking and on the wrong side of street of history (let alone real roads) driving inhabitants on a chilly European archipelago understand their political heresy: "Turn back and repent, you English fools!" The indulgence selling priest Johan Tetzl would have loved the drama.

Let us take a closer look at the parts:

(1) Liars Poker: The accusation that the voters fell into a trap of lies originated, of all places, in the EU Commission whose bibulous president Juncker once coined the telling bon mot "if things get serious you have to lie!" Well, let me cautiously put it that way: This is difficult to beat in terms of irony, hypocrisy and unintended satirical quality.

(2) The 100 BN Euro bill: The final sip that the subsidy-hungry Brussels bureaucracy and its sycophants would like to take out of the net-contributor bottle that generously used to be provided by the United Kingdom. This is the indulgence receipt for those little black souls on the banks of the River Thames. Just to imagine Britain could ever be willing to continue the huge transfers which were one of the main reasons to leave the club is totally bizarre. However, bizarre and Brussels are compatible. The British tolerate this kind of thing by calling it "eccentric" which means several standard deviations away from the norm of mental sanity.

(3) What are those fictions being mixed with facts?

Fiction No 1: "We must not allow cherry picking"

This statement insinuates it is an altruistic act towards others to open your own borders for free trade. The EU which, if the new US-President offers himself as a convenient target, presents itself as a champion of free trade and permanently talks of win-win through open borders, yet has no problem whatsoever to ask non-members for entry payments for common

market access. That is a kind of protection money in return for not obstructing the free flow of goods and services with tariffs. That doesn't mean though they will not obstruct it with non-tariff hurdles. They are just giving it a different name. They call it "regulation", "norms" and "ban" and it's almost a no-brainer that all the small countries in the Brussels periphery have to swallow these toads and translate everything into their national legislation. *Bruxella locuta, causa finita*. Trade imperialism at its best.

Fiction No 2: "The four freedoms of the common market are indivisible"

This fiction is supposed to give strength to the demand of unlimited immigration and to make it impossible for EU member countries and Great Britain to deflect the storm of badly trained and even worse educated immigrants into their social systems. The claim of indivisibility is pure nonsense of course. No free trade agreement the EU has negotiated with third countries under the flag of TTIP, CETA or any other acronym makes this assumption. The reason is quite simple: Other large countries would tell the EU in unflattering words what they think of this if the demand would ever be brought up.

Fiction No 3: The United Kingdom needs the EU more so than vice versa

Yes, the market for goods and services is larger in continental Europe. So what? If you are running a trade surplus of 120 billion Euros annually, you don't want to put that at risk, do you? That though is the EU surplus with the UK. A continent that by design and ignorance, has neglected its infrastructure for security and defense over decades might have an incentive to be friends with a country which didn't commit that folly. Again Brussels has to look over the Channel. The party that has – with over 3 million - three times as many people working in Brexit country compared to just one million British working on the continent should be interested in not failing on a deal to protect all of them, does it? Who needs whom in this situation? Is that really so clear? I beg to differ.

Fiction No 4: 30,000 regulations need to be renegotiated

Smugly the members of the platitude party point out to us that 30,000 EU regulations and laws supposedly need to be renegotiated between Great Britain and the EU27 and that it would be impossible to technically achieve this. In this we can find a misunderstanding and an involuntary confession:

The misunderstanding is that Britain and the EU have to agree on all paragraphs of this deluge of laws. Is it not rather a sovereign decision of the United Kingdom to adopt these regulations partly, in full or not at all? If the EU views some of them as conditional for a free trade agreement they should draw up a list and use CETA and TTIP as benchmarks. Then one can discuss if the UK can accept that list or not.

Now to the involuntary confession: We are flooding the continent with so many regulations, laws, executive orders and decrees that it becomes impossible with normal human capacity to comply with the law. Winston Churchill had a comment on this: "If you have ten thousand

regulations you destroy all respect for the law". Exactly! Juncker's minions have over delivered on this by a factor of three.

IV The EU Chicken Game Theory Negotiation Guide

The political intention behind the use of these fog grenades is easy to discern and one could even have a certain tolerance for it, if it was just about the creation of a rational negotiation strategy. The problem is: Europe's politicians have told this to each other so often in their echo chamber that by now they really believe it! They have fallen prey to their own propaganda.

The result of this giant echo chamber of mutual self-assurance and stew of self-righteousness is the conviction that the Brexit negotiations are inherently a game of chicken. The one who first blinks will lose. The concept is completely insufficient to capture the inherent complications of the problem, but also pretty obviously overtaxing the intellectual capabilities of its proponents.

The enemies in this game of chicken are not just the insubordinate secessionist rebels in London, but all countries and political forces toying with the thought of following their example; or those just daring to remind the Bureaucratic Party of the principle of subsidiarity in an "ever closer union". They shall get a preemptive lesson that it will be painful to spurn the intrusive love of those who define their political *raison d'être* in attaching their tentacles to other people's fridges.

This game theoretical toxic waste is even articulated by some professors who belong to the close circle of advisors of the German government. It is though pretty obvious that the question as to what game we are playing is far from resolved. This game is not one of chicken. It is not an "I win you lose" game. That is only the case in the thin intellectual reasoning of people who would do well to learn about the assumptions and limitations of game theory before they employ it and turn it into a guide for their political war cry.

Looking at the economic and technological realities mentioned above makes it clear this game rather is a prisoner's dilemma. Incentives for cooperation will be switched off on both sides as a result of the erosion of trust. This is a sorry state of affairs that will produce losers only.

The ability for critical reflection has been degraded and degenerated by this exercise in such a way that old and proven principles of behavior and respect in the mutual dealing between sovereign nations have gone overboard. This is specifically true regarding the respect for the territorial integrity and sovereignty of the United Kingdom. Quotes bubble up from Europe's capitals about the desire for secession of Scotland, Northern Ireland and Wales, even of London! The NATO ally Spain is encouraged to abuse the opportunity for a Gibraltar debate by giving Madrid a veto over a matter they had not even asked for.

Instead of minding their own business they are minding the business of a sovereign nation in a completely outrageous way. Why? Because they do not view members of the EU as sovereign states with sovereignty embodied in the will of their people. This is the Juncker version of the Brezhnev-doctrine. EU member states are viewed as provinces which have to be administered

for the advantage of the administrators and whose population (note: not People!) is granted the privilege to occasionally applaud in an acclamatory fashion in order to demonstrate their gratefulness.

In clear denial of the facts it is being claimed that for Scotland there is indeed a new situation after Brexit justifying a new vote on independence. When Scotland voted, the Brexit vote had already been scheduled. Everybody knew it could go either way. So Scotland voted, in the full knowledge of the possibility of Brexit, for the continued Union with England. What then is the new fact on the ground? Would another outcome of the vote also have constituted a reason to vote again? Do we want to turn every democratic decision of political significance in the future into a reason to split up nations after centuries of common history due to regional differences in the voting result?

The whole debate is testament to the abysmal disdain of the Brussels bureaucrats and their satraps for the voter's will and the expressions of this will by the people.

Polls are accepted only if they fit their purpose. Especially with regards to European matters we have seen it more than once that people were called to the polls until the result was compliant. In this sense Ms. Sturgeon is a docile pawn to her Brussels masters: Repeat the vote until you get what you want and then lock that in. This lack of democratic credibility is a central *Leitmotiv* of the EU's governance, where the composition of every decision making body is the result of horse trading instead of universal suffrage.

There is a reason why the term "one man – one vote" originated in the English language. We even use the English term in Germany quite frequently. This reason is the historically developed democratic tradition on the island. And this is the very same reason, why the British have a deep rooted aversion against undemocratic bureaucratic elites. And it will be damned difficult to exorcise it out of them.

V The German Government's Situation and Position

Let me briefly talk about the German government's political motivations.

The first element driving the German government into the arms of Mr. Barnier's confrontational approach is the budgetary aspect. The UK is together with Germany the only other net contributor of significance to the EU-Budget. The expectation that the sycophants in the Berlaymont will not reduce their subsidisation and redistribution schemes because of Britain's departure can be taken for granted. Getting a budget under control, let alone reducing one is totally anathema for this "*class distributif*".

Germany alone has not nearly enough votes in the EU-Commission, the council, or any other common institution to organise cuts in line with the smaller size of the budget available. In every European council exercising power, from the commission to the ECB, the rule of one country – one vote leads to the absurd result that the weight of a voter is inversely proportional to the size of his country's population. In the doubtlessly most influential body on the

continent, the ECB-council, a Maltese voter has the weight of 204 German voters. That probably reflects the fact that a Maltese understands monetary theory and policy 204 times as well as a German citizen. I dare to call this sorry state of affairs a special form of apartheid. It contradicts democratic principles and traditions and an institution with the ambition to replace democratic nation states cannot claim any legitimacy on such a basis.

And even though Germany does have some leverage, albeit not de jure but de facto, Merkel does not want to use it as a matter of principle – unless forced by circumstances. If the outcome of the recent elections can contribute to this remains to be seen. I would so far say it didn't.

So, not willing to pick a fight over budget reductions and savings in the corridors of the Berlaymont chancellor Merkel has decided that the Brexit bill is of utmost importance to limit the additional demands directed at Germany. To blow it up to 100BN Euros would imply that Britain's net contributor position is preserved for a decade or so at current levels. Needless to say the coalition formed by these interests will not want to give anything back in return to the UK taxpayer.

Deflecting these demands from Britain can only be managed by disputing the components of the bill line by line, demanding value added in return, a quid pro quo, because that was also part of the deal in the past. And free trade is certainly not a quid pro quo in this sense, because both sides profit from it from the start, the EU even more so than the UK.

There is a second element which I believe has a large influence on a number of key decision makers in Berlin, especially on our very powerful finance minister Wolfgang Schäuble. He is part of a generation of politicians with a genuine "faith" in the EU as the central "project of peace" on the continent. This group does not believe that they can succeed in building a new version of the *Europe des Patries* that the founding fathers dreamed of if the existing institutions are demolished and hence support the misguided idea of an "ever closer union". For that reason they don't see the original vision as an option any more.

What they see being endangered is no less than their lifetime achievement. This is no weak force for inhibiting sound judgment.

The problem they face is the timely coincidence of Brexit with the Euro-crisis. They know that it is impossible to push the southern European countries towards the market reforms necessary to enable their economic survival inside the Eurozone. They have tried and failed repeatedly. However the Euro is of such centrality in the ideological edifice they have erected that it is being defended come hell and high water even in the face of complete absurdity, unsustainable cost and life threatening risks. The Euro however is the time bomb that will likely blow up the European institutions in a single cataclysmic event. I am convinced it will do so during the next German government's term in office.

The reason is simple. The Euro has created huge trade imbalances inside the Eurozone. Goods and capital have been flowing from a super competitive Germany (for which the Euro is

undervalued) to a decrepit “Club Med” (for which the Euro is overvalued). As a consequence, unsustainable levels of debt held by Germany through a variety of vehicles have been accumulated. At risk are bonds bought by German institutional investors (Euro 1.8 TRN), the ESM commitments as part of the “Euro-rescue” efforts (200 BN), and the Target-2 exposure. Target-2 is an overdraft loan the Bundesbank has handed out at zero interest, unlimited, unsecured, for indefinite time and without any control or discretion to the other central banks of the Euro system. As of September 2017 it added up to 850 BN Euro. I call this combined approximately 2.8 TRN Euro exposure my country is running “the biggest hedge fund on the planet with one single bet, namely that the Euro will be saved”.

The problem with this sort of policy is that it creates imbalances in the real economy which cannot be kept under the rug forever. Specifically the flat yield curve at zero level erodes the earnings power of commercial banks. Our calculations show that most German and indeed EU commercial banks will start suffering substantial operational losses from 2019/20 onward. This translates into shrinking risk taking capacity of the banks which in turn leads to shrinking credit volumes, shrinking bank money creation and deflationary pressure. Paradoxically the desperate push for more inflation thus will create deflation.

Furthermore, the zero interest rate environment has kept hundreds of thousands of companies in business that would have gone bust under normal cost of capital conditions since 2007. Thus, it created what I call an army of corporate zombies which infect the banks credit books with junk quality loan exposures. These companies will fail in the event of rising interest rates or a downturn in the business cycle. Their breaking wave of defaults will likely lead to losses north of 1,500 BN Euro for the Euro-zone banking system taking down more banks than the US-mortgage crisis did.

While refusing to acknowledge this publicly, the German government has been made acutely aware of these imbalances as OECD, IMF, BIZ and a number of private institutions have all confirmed the estimate that so called zombie firms are by now making up 9-10% of Europe’s total number of firms.

It reinforces the stance of Juncker, Barnier, Merkel and Schäuble that they must avoid cracks appearing on the facade of the remaining EU-27. Politically they cannot afford to lose a single additional country. Not from the EU, and not from the Eurozone, as leaving it automatically involves a trigger to leave the EU.

VI The Leverage the UK can apply

Now, how does this play into the Brexit negotiations?

Paradoxically, this situation could be leveraged by the UK to the advantage of a constructive negotiation strategy. It might be a winning strategy to put some focus on Berlin in the coming months. This has several reasons:

- It is of utmost interest for Germany to avoid being pushed into an even higher net contribution after Brexit. This can either be achieved by an outrageous Brexit bill for the UK or by savings in Brussels. The UK needs a clear communication strategy to the German public and political decision makers that spending in Brussels necessitates big cuts. A targeted PR strategy focusing on Germany might be worthwhile to be considered.
- The EU-27 have a 120 BN Euro trade surplus with Great Britain, much of it coming from the bilateral trade between Germany and the UK, much of it easily substituted from other sources. When I attended a presentation of a Ministry of Finance official to the commission of the Economic council for the Financial Industry a few months ago this matter was brought up in the subsequent discussion. It very quickly resonated with the representatives of companies and banks that were present. However, before the number was thrown into the debate, 95% of the participants were unaware of it. The resulting question for the UK negotiators is: How can public awareness be built with the effect to create political awareness?
- The security debate in Germany is heating up. The influx of 1.5M refugees from Syria and North Africa, 85% of them young men, into Germany has created a severe public security problem. Germany has dropped to rank 51 in the global travel security index and now trails behind Rwanda, Morocco, Korea, Albania, Azerbaijan and Tajikistan. Cooperation with the one country in Europe that is leading in electronic intelligence is therefore imperative for our security. That fact alone creates a certain level of leverage through mutual interest and it would not hurt reminding Berlin of this.
- We are also witnessing an increasing tendency for the Russian bear to flex his muscles. At the same time our American friends are dealing with an internal constitutional crisis. It is clearly of the utmost importance for the European members of NATO to step up their own defense spending and reinforce their mutual defense commitments. Here, realistically there are three, possibly four relevant countries: UK, France, Germany and Poland. The survival of the EU is conditional on the continued willingness of the militarily significant European members of NATO to work together for mutual defense. The critical decisions will be taken in Berlin, Paris, London and Warsaw not Brussels. Again, it is clear that the UK would not use this as a point of leverage, but Berlin can be obtuse when it comes to issues of defense and it would not hurt to remind the Chancellor of these matters.

Why do I believe this collection of German interests is relevant for the UK? Because while we have seen above what the current drivers of the Merkel administrations behavior are, it is also clear that she does have a huge leverage over the other key players, namely Macron, Juncker, Barnier and the governments of the southern periphery which she is reluctant to use:

- The monetary policy of the ECB which currently accommodates the unwillingness to reform Italy, Greece, Portugal and others could not be conducted without Merkel's tacit approval. Draghi wants to continue this as long as he presides over the ECB-council in 2019.

- France's president Macron has aimed for a mix of timid reforms and more intra-European redistribution. Transfers and socialisation of risks through schemes like Eurobonds, etc. are his goals. There will be some sort of deal of money for reforms and although I don't think it will work, he is looking to Berlin for help. President Macron's biggest worry currently is that the liberal FDP opposed to this gains too much strength in a future German government.
- Italy needs, apart from the continuation of the ultra-loose monetary policy Berlin's tacit approval to rescue more of its banks with tax payers' money in violation of the new treaty regulating failed banks resolution, a move that will create more debt and more target-2 transfers from the Bundesbank to the Banca d'Italia.

To summarise it: Germany is the one country in Europe that can least afford to let the Brexit negotiations fail. And it is the one country with the largest leverage over the negotiations while at the same time refusing to use it. This may have some implications for the UK's negotiation strategy. I also think any discussions need to take place at the very highest level, power is concentrated in my country and it would take a rare courageous minister to buck the line coming from the Kanzleramt. However: Make no mistake with regards to chancellor Merkel's attitudes. She will not be helpful to the UK without the application of what I would call "constructive pressure" changing her European equations in favor of a balanced result of the negotiations!

VII Concluding Remarks

Honorable members of the House of Lords, Ladies and Gentlemen,

The Prime Minister of the United Kingdom during its finest hour, Sir Winston Churchill, whom I regard as the greatest statesman of the 20th century, and whom I hold in the highest esteem for liberating Europe and my home country, once coined the immortal phrase

"The truth is incontrovertible. Malice may attack it, ignorance may deride it, but in the end, there it is."

For me in this matter there is one simple truth: The British people have made a democratic decision in line with your best traditions, values and a vision of Britain that recaptures and preserves its state of liberty, freedom and democratic patriotism, a role model for a free and prosperous Europe. They have done this because they observed that those values collide with the direction the EU has taken.

This decision is to be respected and this is a truth that is currently attacked by malice, derided by ignorance, but in the end, there it is.

I thank you very much for your kind and patient attention!