

COUNCIL *on*
FOREIGN
RELATIONS

Center for Geoeconomic Studies

Global Economics Monthly
December 2015

Addressing Economic Populism in Europe

Robert Kahn, Steven A. Tananbaum Senior Fellow for International Economics

OVERVIEW

Bottom Line: The European Union (EU) faces rising populist pressure, reflecting long-term challenges to economic policymaking that can only partly be addressed by a cyclical recovery and debt relief. By strengthening the credibility of economic policy and the region's resilience to shocks, better policy coordination and a faster path to economic union would go far toward securing a better economic future for Europe and addressing some underlying causes of populism.

Economic populism is rising in Europe across both creditor and debtor countries, with winds of change blowing from left and right on the economic policy spectrum. The new left-wing government in Portugal will likely unwind many of the EU-supported economic policies of the past several years, while Poland's new right-wing government is calling for diminished involvement in Europe's economic unification agenda.

Economic populism is rising in Europe across creditor and debtor countries and from the left and right.

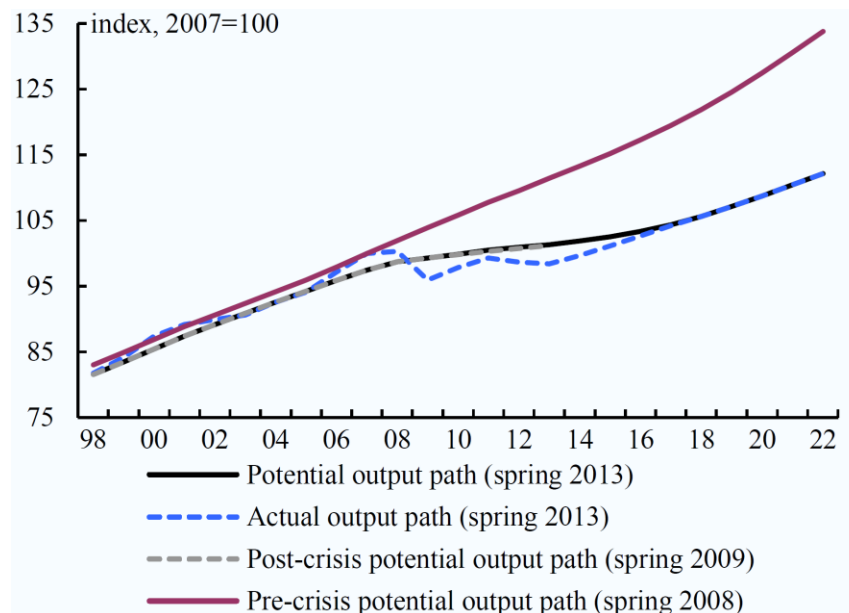
Elsewhere, both left-wing and right-wing populist parties, such as Syriza of Greece and the National Front of France, have won elections and political influence at national and European levels by running on a platform of reduced austerity and less European integration.

A portion of the surge in economic populism is cyclical, the result of a deep and protracted recession and debt crisis that has exposed the limits of policymakers' ability to produce durable growth. Economic activity

in Europe has fallen far below what had been expected just a few short years ago (see figure 1). Both the long-term loss of output and disappointment over expectations of recovery are common features of recessions. But there are more structural and long-lasting forces underlying the rise of populism, including a rapidly aging population coupled with a fragmented labor market that makes the absorption of immigrants challenging, pressures on wages from globalization, and structural unemployment as the result of domestic market distortions. All contribute to a loss of confidence in the process of European integration and its foundational economic assumptions (including free movement of labor and migration). Failure to reverse these trends adds to a more pessimistic view of the future in Europe that undermines the credibility of mainstream economic policies and the governments that implement them.

Governments are bending in the face of these winds, loosening budgets and talking more about debt relief. In 2016, fiscal policy in the monetary union looks set to be mildly stimulative, as countries put off commitments to meet EU deficit targets in the face of slow growth and new security demands. On the whole, these developments are healthy for growth, though not without a cost in terms of higher debt levels and a renewed concern about sovereign and corporate creditworthiness when not coupled with additional debt relief. But such changes are unlikely to restore broad public confidence in the European experiment. Recent polling highlights the continued low levels of confidence across the continent in European economic institutions and their leaders.

FIGURE 1. EUROZONE: VARIOUS POTENTIAL AND ACTUAL OUTPUT PATHS



Source: European Commission, Directorate-General for Economic and Financial Affairs.

THE THREAT TO EUROPEAN INTEGRATION

In Europe, as elsewhere, economic populism goes beyond a debate over expansionary policies to encompass political ideology and rhetoric that divides society between “the people” and “the elite,” and argues that politics should serve the former. Across Europe, distrust of mainstream institutions, policies, and policymakers is rising, often fueled by pessimism about the future. More specifically, European populism integrates elements of nationalism and euroscepticism to caution that further EU integration, propelled by national and foreign elites, threatens national sovereignty and ultimately people’s well-being.

Populism in Europe is becoming persistent, reflecting the depth of Europe’s economic crisis and the manner in which the early years of the euro created unrealistic expectations for the future, particularly in the periphery. The Syriza party and its often antagonistic relationship with Greece’s creditors destabilized the bailout talk this past summer, and Greece’s exit from the eurozone (“Grexit”) remains a high probability. But populism is on the rise in creditor as well as debtor countries, including in economies growing relatively quickly (e.g., Germany and the United Kingdom) as well as those suffering protracted contractions (e.g., Greece, Finland, and Spain). The majority of these populist parties, both left and right, oppose European monetary union and further integration. Some do support free trade, but many oppose the Transatlantic Trade and Investment Partnership (TTIP), as the negotiation is conducted by the European Union rather than national governments. Moreover, most of these parties argue strongly for tighter immigration restrictions on non-EU countries. Although these parties’ differences make cooperation at a pan-European level difficult, it creates a hostile environment to further liberalization and market-oriented reform.

European populism integrates elements of nationalism and euroscepticism.

ECONOMIC POPULISM AND CRISIS PREPAREDNESS

Economists have long recognized the existence of populist economic policy cycles, drawing on the experience of emerging markets. One popular formulation refers to “an approach to economics that emphasizes growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints, and the reaction of economic agents to aggressive non-market policies.” This literature, often anchored on the experience of Latin America, argues that macroeconomic populism results in overly expansionary policies. In many economic models, economic populism is reflected in a policy cycle of excessive credit creation, overvalued exchange rates, and external deficits, followed by crises.

In lieu of slow growth and bailout fatigue in the region, many populist economic policies converge in the skepticism over, and even rejection of, austerity and neoliberal economic reforms. These are the very policies, such as labor market deregulation and privatization, that are often prescribed to European debtor countries by the International Monetary Fund (IMF) and EU. Populism appeals because it promises simple solutions to complex problems. For European voters in debtor countries like Greece and Portugal, who have suffered from falling living standards with no end in sight, the resounding rejection of austerity seems the simplest, yet most viable, option. However, economic populism is not limited to an anti-austerity stance. Since his election as prime minister of Hungary in 2010, Viktor Orban has pursued financial nationalism, which asserts monetary sovereignty, undermines central bank independence, favors national financial institutions, and rejects international official creditors like the IMF. Economic populism may result in unsound policy choices by oversimplifying economic realities and isolating such countries from the global economy.

WHAT'S NEXT

Populism is on the rise and has proven resilient to the modest economic recovery now underway in Europe. In some respects, these pressures have resulted in a modest easing of economic policies to support growth. But that near-term perspective downplays the longer-term risks that result from weakened governments and their more limited ability to respond to future economic shocks. The tragic Paris attack last month is a watershed event for European policymakers, which will place additional demands on them to coordinate responses to shared challenges including non-EU immigration, which many populist parties oppose. Following the incident, Prime Minister Orban stated that the current refugee settlement system will spread terrorism, and later argued that the EU should overhaul its founding treaties.

Europe needs

more demand and more austerity.

From this perspective, the current debate over whether Europe needs more demand (as many periphery country policymakers would argue) or more austerity (a common view in creditor countries) misses the point. Europe needs more of both. If European governments want to move forward with the integration project, they need to keep populism at bay through cyclical measures including debt relief, moderate austerity and more public investment, and growth promotion. They also need to promote a more complete banking and fiscal union in order to bolster confidence in the longer-term sustainability of the euro project. Still, such measures are necessary but not sufficient. Macroeconomic policies cannot be the entire solution. A comprehensive approach to addressing the substantial political, social, and economic challenges facing Europe is needed to fully address the underlying causes of today's populism.

Looking Ahead: Kahn's take on the news on the horizon

Greece receives bailout loan

Greece received the next tranche (two billion euros) of its EU loan package, but saw its parliamentary majority slip ahead of tough negotiations on pension reform, debt relief, and a new IMF program, which are likely to be delayed well into 2016.

Argentina elects Mauricio Macri

Argentina's new center-right president is likely to roll back the populist policies of his predecessors and implement more market-friendly measures to help Argentina attract foreign investment and return to international capital market.

Federal Reserve may raise interest rates

The minutes from the Federal Open Market Committee's October meeting suggest an interest-rate increase is possible in December. Even so, if inflation remains low and below the Fed's target, the pace of rate increase will be gradual.