

SUMMARY

Populism has spread across Europe and North America in recent years, culminating in the UK's vote to leave to the European Union and the US' election of Donald Trump as President. This year's EEAG Report addresses the causes and consequences of populism as it affects Europe in three closely related chapters. The first of these explores the nature of populism; the second focuses on Brexit; and the third examines migration into Europe. These three chapters follow the report's customary opening, with Chapter 1 devoted to a review of global macroeconomic conditions and outlook. The theme of populism, Brexit, and Donald Trump permeates this chapter, as well as increasing uncertainty and slowing global growth.

Chapter 1

Macroeconomic Conditions and Outlook

The world economy remained in recovery mode last year, despite a slight global slowdown. As in 2015, world trade declined during the first half of 2016, but subsequently picked up again. The initial decline was mainly caused by disappointing growth in advanced economies during the winter of 2015/2016. Advanced and emerging economies alike contributed almost equally to the revival in the global economy seen during the second half of 2016. In the major emerging economies of China, India and Indonesia, expansionary economic policies stimulated growth in the summer of 2016. Furthermore, recessionary trends in commodity-exporting emerging economies like Russia and Brazil weakened, especially thanks to a steady upward trend in the prices of many industrial and agricultural commodities and largely stable crude oil prices over the summer and autumn.

The pace of global economic expansion is expected to remain at around the same levels seen in previous years, but may dip slightly over the course of 2017. Political events with uncertain implications such as the Brexit decision, the election of Donald Trump as US president and the growing popularity of right- and left-nationalist parties in major European countries

have led to a surge in political uncertainty in many places and may have far-reaching consequences for the global economy in the years ahead. This higher uncertainty, together with the continuing slowdown in economic growth in China, is likely to prevent any stronger expansion in global production. Overall, growth rates for the world economy in 2017 are expected to be only about half as high as in the years prior to the global financial crisis.

The major economies will continue to develop heterogeneously, with the US economy growing more strongly than that of the euro area and Japan respectively. In the United States, the output gap has largely closed and real GDP will grow at trend levels, or slightly above them, in the quarters ahead. Although monetary policy is highly expansionary and fiscal policy will be supportive until at least the second half of 2017, Japan's economy is only expected to expand moderately. Stimuli from monetary and fiscal policy will be offset by the burden of structural factors like a shrinking labour force, a rising old-age dependency ratio and tight immigration controls. The pace of expansion in emerging markets will gradually slow down over the forecast period. In view of higher oil prices and the slight recovery in other raw material prices, Brazil and Russia will probably pull out of recession in the course of this year. India is also likely to expand rapidly. However, these positive impulses will be offset by the decline in economic growth in China and rising interest rates in the United States, which are likely to negatively impact financing conditions in emerging economies.

The euro area economy remains characterised by the massive structural weaknesses of some member countries, as indicated, for example, by the large volume of non-performing loans on bank balance sheets in Greece, Italy and Portugal; and the lack of competitiveness of the French and Italian economies. Accordingly, recovery is expected to continue at a moderate pace with developments in private consumption remaining the key driver. The improving income situation of households and rising employment are contributing to this phenomenon. Consumption growth rates this year will nevertheless be somewhat

lower than last year, because the gains in purchasing power attributed to lower energy prices will disappear.

With oil prices having risen last year instead of falling as in 2015, consumer prices are expected to increase, particularly during the first months of 2017. In line with the ongoing recovery, which will further close the output gap over the course of the year, core inflation is also expected to pick up. The inflation rate should therefore gradually approach the ECB's inflation target, which will allow the ECB to gradually tighten its ultra-loose monetary policy.

Chapter 2 Economic Policy and the Rise of Populism – It's Not So Simple

This chapter discusses definitions of populism, describes experiences with populist economic policies, and looks at how populist movements tend to view economic developments. We conclude by presenting a set of responses that may potentially limit the harmful effects of populist ideas and policies.

A key feature of populism is to pit a virtuous people against a ruling elite, often portrayed as agents of dangerous external forces that is robbing "the people" of their rights, values, prosperity, identity and voice. Populist parties on both the left and the right, often have a strong, charismatic leader, set themselves up as anti-establishment, and promote nationalism and traditional values. At the other end of the scale, elitism, pluralism, and cosmopolitan liberalism promote pluralistic democracy, tolerance, multiculturalism, multilateralism, and progressive values.

Populist economic policies claim to advance the interests of people who fear they have lost out, and been abandoned by the political establishment. But their agenda is short-sighted. It denies the consequences of public spending now for taxation either now or later; and fails to evaluate alternative options. Populists often focus on single issues like international trade or migration, and overemphasise their negative aspects. They also frequently blame economic problems on foreigners. As a result, populist macroeconomic policies are often expansionary, offering short-term benefits whose long-term costs are discounted.

Immigration is the major driver of populism. It is argued that immigrants compete with native workers,

take away jobs, depress wages, and are a burden on the welfare state. Populist parties respond with measures to limit immigration. The claimed effects of immigration are not, however, supported by the evidence, which actually shows a varied picture across countries, a wider range of outcomes, and a finer balance between overall costs and benefits.

Globalisation and international trade are secondary targets of populist criticism, as they are blamed for creating uncertainty and destroying jobs. Foreign countries stand accused of dumping goods in domestic markets and engaging in unfair trade practices. Trade, the populists argue, promoted by the analyses of biased experts, benefits the elites while impoverishing the people. Again, the populist critique makes valid points, but gives a distorted perspective. Protectionism is a superficially attractive solution, but it tends either not to work at all, or only at great cost.

Populists generally dislike European integration for its creation of supra-national institutions, the internal market, and the euro.

Populist parties have emerged in response to the demands of voters. Who supports these parties and why? While economic factors have contributed to their growing following, social factors and attitudes have also played a substantial role. Actual vulnerability, due to employment insecurity, stationary or falling real wages, and lack of social services may have been overshadowed by perceived vulnerability, relative deprivation, and a perceived lack of political effectiveness.

Parties who wish to reduce support for populism will need to counter the feeling that they are unresponsive to the needs of voters. Data on UK voting show that Brexit supporters were typically older, less well educated, and included many outside the workforce. The Brexit vote may thus have been a backlash from older, more conservative voters, against changes in attitudes to race, gender and social identity. Data nevertheless suggest that while less immigration would not have swung the result against Brexit, smaller public spending cuts in certain regions might have done.

Mainstream political parties are searching for responses to the populist challenge. Adapting policies, or incorporating populist elements to draw off populist support, has enjoyed little success in the past: "UKIP-lite" does not seem to satisfy anyone. In some countries, populist parties may be invited to join coalitions.

tion governments. An alternative policy may be to isolate or demonise them. Again, this is not a very promising response. Thinkers on the left like Jürgen Habermas argue that mainstream parties need to set out distinct political positions.

Mainstream parties need to recapture the narrative, address the substantive concerns of the voters and develop more convincing messages. They have to defend policies based on evidence and resist the slide into the “post-truth” world that is flourishing in social media. There may be a role for independent agencies to evaluate political platforms and provide straightforward information to the electorate. Such agencies, however, would have to work hard to establish their authority in the face of sceptical electorates.

Referenda have provided a vehicle for the populist advance. While they have a legitimate role to play in a democracy, they need to be used with caution in the future, as they may undermine the power and responsibilities of representative institutions.

Chapter 3

Britain and EUexit – The People Versus the EU

Brexit represents an extreme instance of a more general scepticism over European integration. Hence it provides an opportunity to reflect on how narrow and short-term political perspectives interact with the European Union’s cumbersome and incomplete economic policy framework. The British push for a divorce partly derives from a vision of the European Union that differs from that of other members. The United Kingdom has long interpreted its interests as diverging in fundamental ways from those of most continental European countries. Traditionally it is less regulated, hostile to the idea of Europe-wide fiscal centralisation, less concerned with the fortunes of the agricultural sector, and more dependent on financial services. The United Kingdom has been slightly more successful or dynamic in terms of GDP growth than most European economies on average over the last few decades; but since the 2008 financial crisis it has performed relatively poorly in terms of productivity and wage growth, a combination that is likely to continue to fan populist protest, even after ties with the European Union have been severed.

The longer uncertainty prevails over the United Kingdom’s access to markets and the nature of future

migration policy (including the position of current EU nationals working in the United Kingdom), the higher the costs of Brexit will be. There is a powerful bargaining logic that points in the direction of a bitter and damaging divorce, which may end up leaving both sides worse off. That would be catastrophic. Should integration fail to yield positive results in the remaining EU-27, ordinary Europeans will start to question Europe’s *raison d’être* and their own identity. The populist political equilibria that result from “all is lost anyway” sentiment can be pre-empted if the European Union monitors its policies and credibly promises that they can deliver a brighter future, well worth some short-term sacrifices. When discussing the terms and conditions of Brexit, both sides need to set out the basis for negotiations with the utmost clarity, so that they do not lay themselves open to charges of misleading the public and hence creating an informational deficit that reinforces perceptions of a democratic deficit.

Chapter 4

Immigration and the Refugee Crisis – Can Europe Rise to the Challenge?

Unrest in the Middle East and North Africa, and the Sahel region, has triggered the massive displacement of people locally, to neighbouring countries, and has caused an unprecedented exodus of refugees to Europe. The number of refugee arrivals peaked in 2015 with 1.3 million asylum applications submitted to EU countries. Most applicants came from Syria, Afghanistan and Iraq. Although various measures have slightly reduced refugee flows into the European Union in 2016, the underlying problems remain and pressure of humanitarian-driven migration on Europe persists.

The number of displaced people is staggering and points to severe human suffering. Unfortunately, large displacements of people due to wars and natural catastrophes are regularly seen in various parts of the world. In a European context, the conflict in Bosnia in the 1990s also produced large displacements of people and waves of refugees. Recent migration flows, however, are of a somewhat different nature. The Bosnian conflict followed the fall of the Iron Curtain and was generally considered a European problem. The current conflicts are taking place outside of Europe in culturally more distant societies, making it hard to argue that they should be primarily considered as a

European problem too. In addition, the current flow of refugees, while comparable with that observed in the 1990s at the peak of the Balkan conflict, also involves much broader and more populated areas of the world, thus raising the issue of absorption-capacity.

Across Europe, and not merely on the far-right of the spectrum of political discourse, the massive immigration of culturally (and, often, visually) very different people fuels fears primarily related to the preservation of European national identities and ways of life. Importantly, the current refugee crisis comes on top of the problems created by the financial crisis from which many European countries have not fully recovered and which have challenged social cohesion. There is widespread criticism not only of immigration by refugees, but also of worker migration and globalisation in general. Many traditional European political parties reacted slowly and, in the eyes of many, inadequately at the onset of the refugee crisis. This provided a major opportunity for populists to start shaping the debate. Perhaps more than any other single issue, opposition to immigration has become the battle cry of European populists.

The refugee wave is a humanitarian challenge calling for cooperative solutions across countries, and definitely among EU-countries. Developments to date, however, seem to be going in the opposite direction. A number of member states have taken their own non-cooperative routes. Attempts to allocate refugees across member countries have failed, and the Schengen arrangement is threatened. These events have exposed severe structural problems within the European Union and exacerbated the EU crisis.

This chapter begins by looking at the big picture in terms of migration issues before moving on to specific issues related to the current crisis. We present a few facts on migration flows globally and in Europe, followed by longer term population and migration forecasts, and move on to discuss the factors influencing migration flows. Next, we comment on some key aspects of humanitarian migration policies, particularly as they apply to Europe; and discuss the potential economic impact of the current refugee wave, with a special focus on its labour market effects and implications for public finances. Finally, we analyse important challenges and risks related to the current crisis and formulate a set of policy recommendations.