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The Economic Consequences of Populism

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Populists weaponize economic hardships and identity conflicts for political gain. Their strategy has propelled many of them to the political mainstream across Europe, the Americas, and elsewhere. But what do they do with their newly acquired powers? Do their post-election policies mimic those of the traditional elites they replace, or they depart from the mainstream and bridge their divisive pre-election rhetoric to a dismal post-election reality? To oversimplify: Are populists bad governors?

POPULISTS: BAD GOVERNORS?

The answer, as usual, is more nuanced than the question. More than 30 years ago, when Sachs (1989) and Dornbusch and Edwards (1990) started the economic theory of populism and witnessed it grow into a populist paradigm, the answer was clear: A populist governance is bad news for the economy as it normally ignores hard budget constraints and market incentives. A brief lift-off of the economy driven by a saviour government and a charismatic leader at its helm is sufficient to temporarily lift voter spirit and welfare. However, the same populist government makes the same voters permanently worse-off in the long run. It does so by spending way more than it can afford to, subjugating the central bank, inflating prices, sparking exchange rate and fiscal crises, and blaming everyone else for it.

For decades, case studies have broadly confirmed the above populist paradigm for Latin America. As a result, it was still credible well after the Global Financial Crisis (Dalio, 2017; Edwards, 2019). However, in the wake of the Crisis populists swamped ballot boxes well beyond Latin America. Today, voters in most consolidated democracies accept that populists will enter parliament. In some cases, they would go on to form part of the ruling coalition or even nominate prime ministers and presidents. The promotion of the populist rule from a

Latin American idiosyncrasy to a global phenomenon has profoundly diversified the types of populist governors we observe. It is this variety that has reignited the debate on the economic effects of populist rule. So, again: Are populists bad governors?

The answer depends on the executive constraints populists face after the elections, and the types of economic and political effects we are after. In the spirit of Taggart and Rovira Kaltwasser (2016), we examine two types of constrained populists: (i) junior coalition partners and (ii) populists with a ruling majority. There is a third type as well: one where executive constraints are non-binding, such as the authoritarian and totalitarian regimes created by the ultra-nationalist populists like Mussolini, Hitler, Stalin and Putin. The ruin they bring to the rest of the world without any regard for the self-harm to their societies makes everyone worse-off and is a separate talking point. However, the constrained populists are a more domesticated bunch. The alleged harm they bring is also primarily domestic. Where do we see it?

Like any other government, a populist one affects two broad elements of domestic life: the state of democracy and the state of the economy. To measure the effects, widely accepted dynamic measures of democracy such as the ones produced by Freedom House (2018) and Marshall et al. (2019) can be linked to data on electoral outcomes. By combining those data sets, empirical political economists can distil the political effects of populist rule. This combination of data sets, however, can do much more than that.

The data on electoral outcomes produced by Döring and Manow (2019) can pinpoint the time populists migrate from the political fringe to the mainstream (and back) in 33 developed parliamentary democracies. Most of them are current or past members of either the European Union or the OECD. Studies covering both Europe and Latin America exist (Rode and Revuelta, 2015; Stankov, 2018), but Döring and Manow (2019) deliver a preferable time coverage enabling us to track the electoral evolution of populist parties over much longer periods of time. Profound transformations of the local political landscapes can then be linked to the subsequent changes in the lives and livelihoods of millions. This is what makes these political transformations interesting to economists.

A recent study (Stankov, 2020) links populist governance episodes to an array of fiscal, monetary, and real macroeconomic indicators. The indicators have been published by Jordà et al. (2017) and represent the longest publicly available series of macro-financial data for most of the developed economies. Mapping this data to the political landscape enables Stankov (2020) to check if the populist paradigm bites beyond Latin America. Chapter 4 of the freely available open-access book offers an answer: To a large extent, economic populism does not extend well beyond Latin America.

POPULISTS CONSTRAINED BY CHECKS AND BALANCES

It does not extend well, because most populists beyond Latin America have, at least for now, settled for a somewhat irrelevant role of junior coalition partners. As such, they can only have a marginal say in the design and roll-out of core macroeconomic policies. This is valid for both far-left and far-right populists in their junior coalition roles, and for virtually all real indicators that Stankov (2020) looks at: GDP per capita, consumption, investment, and trade.

However, when a consolidated democracy elects a far-left or far-right prime minister, the game changes. Because prime ministers are agenda-setters, their impact on policies is potentially far-reaching. By extension, their policies carry more potent economic ammunition. Here is when it becomes interesting, as some nuances come to light about how far-left and far-right populists govern. Far-left and far-right prime ministers differ in their short-run impact on the real macro economy. Specifically, while far-left prime ministers in the developed countries coincide with recessions, far-right prime ministers do not. In the long-run, however, and similar to Latin America, any governance by extreme politicians worsens the real economy.

In a sharp contrast to the Latin American experience, populist governance across the developed countries does not have a pro-inflationary effect. We can see that for most of the studied monetary indicators: Narrow money, broad money, short-term interest rates, as well as long-term interest rates. As before, there appears to be a distinction between cabinets formed with the help of populist parties and cabinets governed by a populist party representative. Most fringe populists seem unable to leverage their political clout for a monetary expansion, even though they have become part of the ruling coalition. However, in a somewhat puzzling contrast to Latin America, governments across the developed world with either far-left or far-right prime ministers are associated with monetary *contractions*, which defies the notion that those populists walk the talk of economic populism.

Therefore, when it comes to monetary policy, populists in the developed world are much closer to the political mainstream than those in Latin America. This is partly because of fortunate timing: While Latin American populists have had the chance to change the rules governing central banks to soften fiscal constraints, ruling populists in Europe have largely inherited those rules in an environment of strong checks and balances and even stronger inflation memory. This heritage suppresses political agendas to undermine central bank independence in Europe, unlike the potent interference we have traditionally seen in Latin America.

Stankov (2020) offers similar conclusions on fiscal policies by linking the Jordà et al. (2017) macro-financial and Döring and Manow (2019) electoral outcomes data sets. The fiscal component of the macro-financial data tracks public debt to GDP, government revenues and expenditures, local currency exchange rate with the USD and indicates if the country has experienced a systemic financial crisis. There is weak evidence that cabinets formed with far-left parties are more prone to fiscal expansion, while cabinets formed with far-right parties limit government deficits. Some evidence emerges about the fiscal impact of far-left prime ministers. The evidence, however, is still inconclusive: The estimates alternate signs over time, suggesting a possible misspecification of the underlying econometric model.

Using instrumental variables, the evidence on the fiscal impact of far-left populists was recently extended, but it still found no conclusive evidence of fiscal expansions initiated by far-left prime ministers in the developed world. Similarly, once in power, far-right prime ministers in those countries are largely ignoring economic populism. Meanwhile, recent evidence has repeated the same old strong messages on Latin American populism: Once in power, Latin American populists knock off living standards and growth (Absher et al., 2020; Ball et al., 2019; Cachanosky & Padilla, 2020). Still, not all populists are equally perilous as their governance is nuanced, even within Latin America itself (Campos & Casas, 2021).

NOT ALL POPULISTS ARE EQUALLY PERILOUS

Financial markets seem to know that. Fresh evidence from financial market performance under populist rule points to significant differences in how markets react when a populist wins an election (Hartwell, 2022). While markets in Latin America shiver and are volatile for days, those in Europe and the USA barely budge on the news that their governments will be run by populists. This, perhaps, is a good lesson from the variety of populist governance episodes across Europe and Latin America: If you want to know if a country will end up with a bad populist, watch the local financial market performance around its elections.

POPULISM VS THE NEW MAINSTREAM

Populists openly dislike the rules of the game and try to undermine them. However, when it comes to walking the talk, reality matches their toxic rhetoric primarily in Latin America. Yes, Trump has engaged in a trade war with China, biased the US Supreme Court and took some shine off the City on the Hill; Farage has finally compelled the UK out of the EU; Le Pen may still wake up as a French president; and Orban-et-al's illiberal democracies will keep muddying the waters of European politics for some time to come. All this has surely been and certainly will be very entertaining to their comrades in the Kremlin.

However, Europe is slipping through the Kremlin's oily fingers. When it finally does, the path to restoring political stability and mainstream policies in Europe will be open. As this cannot be such a distant moment, the time is now to define *new mainstream* policies. A new social consensus fitting the realities of the 21st century needs to be at the heart of this new definition, so that our divided world makes its distant ends meet somewhere in the middle. The last time this was done in Western Europe was in the wake of WWII and it led to more than half a century of peace and prosperity for the people, by the people. Perhaps this time around, mainstream policies have a chance to evolve into something a bit more benignly populist. You may call it democracy's survival instinct or its embedded self-correction mechanism. Either way, it may well be our once-in-a-century chance to reject the old mainstream and save ourselves from the perils of the previous century's populism.

Dr. Petar Stankov is the author of *The Political Economy of Populism: An Introduction,* (London: Routledge, 2020).

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