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Economics of Populism

Macroeconomic Conditions and Outlook

Economic Policy and the Rise of Populism

Britain and EUexit

Immigration and the Refugee Crisis

EEAG European Economic Advisory Group @ CESifo

The EEAG Report

on the European Economy

2017

The European Economic Advisory Group (EEAG) analyses key economic policy issues of common European concern. It aims to offer the public and policymakers research-based insights. Taking into account the variety of perspectives within Europe, the group fosters bridge-building between research and policy as well as across European countries.

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Foreword

The European economy continued to recover in 2016, albeit at a slightly slower pace. Within the euro area in particular, the ultra-loose policy of the European Central Bank, with its negative interest rates and quantitative easing, led to a devaluation of the euro and boosted Eurozone exports. Structural weaknesses like poor competitiveness and large volumes of non-performing loans in the financial system, however, illustrate persisting disparities within the European Union. Combined with growing political instability – both within the European Union and around the world – they make Europe's future economic development look very uncertain.

While previous reports by the European Economic Advisory Group (EEAG) at CESifo have elaborated on financial and economic weaknesses as well as imbalances in Europe, this year's report, the sixteenth in the series, discusses the worrying rise of populism, which poses an equally serious threat to European cohesion. As indicated by the report's title – "Economics of Populism" – it focuses on the populist economic policy agenda, the factors generating support for populism and the implications of populist policies.

The introductory Chapter 2 defines populism, populist economic policies and the populist view on economic developments. It reveals how the populist agenda is short-sighted, provides overly simplistic answers to complex questions and adopts an overly narrow approach, neglecting the multi-dimensionality of most economic policy issues. The chapter also clarifies the importance of checks and balances and democratic compromise in effective economic policy. The abuse of referenda and veto powers, by contrast, hamper the implementation of beneficial policies and foster the rise of populism.

Brexit is the outcome of a referendum that was, at least partly, captured by a populist discourse. Chapter 3 looks at how general scepticism over European integration catalysed into Britain's decision to leave the European Union. Looking to the future, the chapter also takes a clear stand on the exit process: a bitter divorce for both Britain and the European Union must be avoided at all costs. To facilitate a harmonious break, both sides need to state their negotiating positions clearly, publicly and quickly. From an EU perspective, Brexit represents an opportunity to learn valuable lessons and sustainably remodel the Union.

The rise of populism in recent years is closely related to migration flows and the refugee crisis, which is the topic of Chapter 4. This chapter describes these flows and discusses the implications of migration for European economies and populations. The chapter also explains how populist parties stand to benefit from the integration challenge currently facing Europe. It makes policy recommendations for resolving the refugee crisis and undermining populist arguments.

As always, the first chapter of the report contains an in-depth analysis of the economic situation of the European Union and other countries around the world, together with a forecast for the year ahead.

The European Economic Advisory Group at CESifo, which is collectively responsible for all parts of the report, consists of seven economists from six countries. This year the Group is chaired by John Driffill (Yale-NUS College) and includes Torben M. Andersen (Aarhus University), Giuseppe Bertola (University of Turin), Harold James (Princeton University), Jan-Egbert Sturm (KOF Swiss Economic Institute, ETH Zurich), Branko Urošević (University of Belgrade) and myself (Ifo Institute and University of Munich). The members participate on a personal basis and do not represent the views of the organisations they are affiliated with.

I would like to express my gratitude for the valuable assistance provided by the scholars and staff at CES and Ifo who helped to prepare the report. This year's participants were Felix Hugger and Christopher Weber (assistants to the group), Stefan Lautenbacher, Nikolay Hristov and Andreas Steiner (economic forecast), Lisa Giani Contini (editing), Christiane Nowack and Christoph Zeiner (graphics), Katharina Pichler and Elisabeth Will (typesetting) and Ines Gross (cover). I also wish to extend my warmest thanks to Swiss Re for hosting our December meeting.

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Munich, 1 March 2017

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- Democratic political processes must leave room for fruitful disagreements and debates. While mechanisms for compromise are needed, too much consensus can backfire.
- Referenda should be used sparingly and their role needs to be clearly defined in the constitution.
- Economic policy almost always benefits some people and disadvantages others, but the disadvantaged should not be allowed to veto change. Welfare states need to protect those groups negatively affected by economic developments.
- Delegating clearly defined tasks to independent and supra-national institutions can play a valuable role in restraining populism.
- EU institutions should act strictly within their mandate and EU policies should adhere to the principle of subsidiarity. The EU Commission should focus on its role as a guardian of EU treaties.

Chapter 3 Britain and EUexit – The People Versus the EU

- The UK and the EU-27 should lay out the basis for negotiating Brexit with the utmost clarity. They must not lay themselves open to the charge of misleading the public and hence creating an informational deficit that enhances the perception of a democratic deficit.
- The terms of Brexit need to comply with a norm of constitutional adequacy, which would also reflect the extent to which it is acceptable to regional units, including Scotland and Northern Ireland.
- The terms of Brexit should be subject to economic scrutiny, and the various options need to be assessed in the light of different development scenarios on a European and international level.
- There is a danger that the Brexit negotiations will lead to a bitter divorce that harms both Britain and the EU-27. It is a key responsibility of policy makers to avoid such an outcome.
- Brexit – and other international developments – offers Europe the opportunity to sustainably remodel itself to more accurately reflect its citizens' aspirations. Such a remodelling is unlikely to occur via intergovernmental bargains, but they may nevertheless prove the only way to consider the trade-offs of costs and benefits in different policy areas.

Chapter 4 Immigration and the Refugee Crisis – Can Europe Rise to the Challenge?

- EU member states must avoid policies that may intensify crises in already destabilised countries, or create new hot spots.
- EU member states should act preventatively to help vulnerable countries develop their economies, thus reducing incentives for their inhabitants to emigrate.
- The European asylum system needs an overhaul. Current practises and regulations are designed for much smaller numbers of asylum seekers and are inadequate to handle present inflows.
- New policies are called for to manage the expectations of potential refugees and prick the refugee bubble while protecting both European borders and individuals in real humanitarian need.
- Cooperation among EU member states regarding immigration and asylum-seekers is essential. This should feature:
  - Common, transparent and comprehensive EU eligibility rules and regulations in the area of asylum and refugee protection, that leave little or no scope for different interpretations across member states.
  - A network of asylum application centres in safe areas outside of the EU borders and closer to the conflict zones.
  - Equitable and incentive-compatible sharing of the burden.
  - Significantly improved cooperation in protecting the outside borders of the European Union, including fighting organised crime and illegal immigration.
- The EU should forge closer partnerships with countries that may potentially be willing to host asylum application centres.
- Cooperation with the Western Balkans already exists and should be deepened.
- Cooperation with Turkey is essential, but visa-free travel into the European Union can only be granted following a marked improvement in human rights in the country.

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 coalition 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.

EEAG (2017), *The EEAG Report on the European Economy,* "Macroeconomic Conditions and Outlook," CESifo, Munich 2017, pp. 12–49.

Macroeconomic Conditions and Outlook

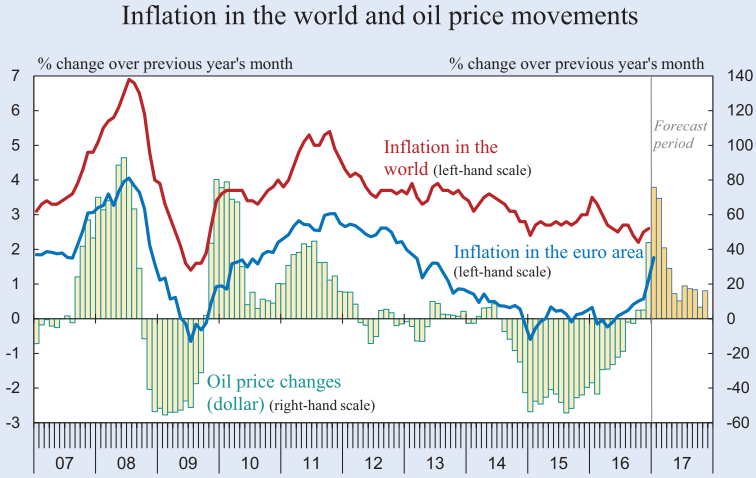
1.1 Introduction

The world economy remained in recovery mode last year, despite a slight global slowdown. The initial decline was mainly caused by disappointing growth in advanced economies during the winter of 2015/2016.[1] During the second half of 2016, an increase in exports accounted for a significant uptick in the pace of expansion in the United States. In Japan repeated postponement of fiscal consolidation and the implementation of a new stimulus package supported economic activity. Furthermore, the moderate recovery in the euro area has continued. In major emerging countries like China, India and Indonesia, expansionary economic policies stimulated growth in the summer of 2016. Finally, recessionary trends in commodity-exporting emerging economies like Russia and Brazil have weakened, especially since the prices of many industrial and agricultural commodities have been creeping upwards again for several months and the price of crude oil has been largely stable over the summer and autumn at around 45 US dollars per barrel, after reaching a trough of below 30 US dollars in January last year. These relatively stable oil prices were principally driven by two key effects: rising demand for oil from mainly China and India; and negotiations amongst OPEC members that led markets to expect a limitation of future oil production. In November 2016, and for the first time since 2001, a global supply agreement was reached that was also signed by Russia. Subsequently, the oil price rose to over 50 US dollars per barrel. Both the low oil price at the start of 2016 and its increase by the end of the year imply strong impulses for inflation rates around the world, especially during the first months of 2017 (see Figure 1.1).

[1] This development is illustrated in Figure 1.26, presented below.

The political changes that have occurred over the past eight months may have far-reaching consequences for the global economy in the years ahead and have certainly already increased uncertainty. In a referendum in June 2016, the United Kingdom decided to leave the European Union (see Chapter 3 of this report). Negotiations over the conditions of this so-called Brexit between the new British government and the European Union are due to start soon. In November 2016 Donald Trump won the presidential elections in the United States. Also Trump's victory came as a surprise to many and raises questions about the future orientation of economic policy in the United States, and particularly of fiscal and trade policies. On several occasions during his campaign the newly elected president argued in favour of more expansionary fiscal and protectionist trade policies, together with a significant reduction in his country's security commitments on the international stage. Finally, in December 2016 Italy held a referendum on constitutional changes that was clearly rejected at the polls. These constitutional changes would have made this economically-troubled country more capable of political and economic reform. Instead its Prime Minister Matteo Renzi stepped down and a caretaker government took over. The Italian president will most likely initiate new elections this year, ahead of the next regular elections scheduled for early 2018. The populist 5 Star Movement, which has been popular at the polls for over a year now, has

Figure 1.1



Source: IMF International Financial Statistics, last accessed on 31 January 2017. Forecast based on a constant oil price assumption from January 2017 onwards.

announced a referendum on Italy's exit from the euro area should it win. Depending on how the current caretaker government reforms election law, a relative majority of votes may suffice to win an absolute majority in parliament. Given Italy's economic weight and its high public debt levels, the announcement of a referendum, or even the increased awareness of such an outcome, is likely to cause major turbulence in financial markets.

Overall, none of these political developments have triggered the adverse cyclical effects expected. After a brief period of turbulence, financial markets have by and large staged speedy recoveries. Of the three events cited above, the Brexit referendum triggered the most visible market reactions. Nevertheless, in late summer most stock market indices were already above their positions of May 2016. Similarly, consumer and producer sentiment in the United Kingdom and the European Union only weakened temporarily during the summer, but have improved steadily since then. Finally, the British real economy proved to be robust and recorded a similarly high growth rate for the third quarter of 2016 as seen in the previous three quarters. The US presidential election did neither negatively affect the financial markets, nor consumer or producer confidence. Sentiment even improved after Trump's election probably thanks to expectations that the newly elected president will implement expansive fiscal policy measures.

Nevertheless, the election of Donald Trump as US president and the rejection of constitutional reform in Italy may have major negative consequences in the short term too. Indicators of political uncertainty in the United Kingdom, several other European countries and the United States increased sharply in June and have risen significantly again in November after a previous temporary decline. At the end of last year, uncertainty indicators were still at a significantly higher level than at the beginning of 2016. This may in itself reduce willingness to invest and acquire more durable consumer goods, and thereby affect the economic performance over the forecasting period.

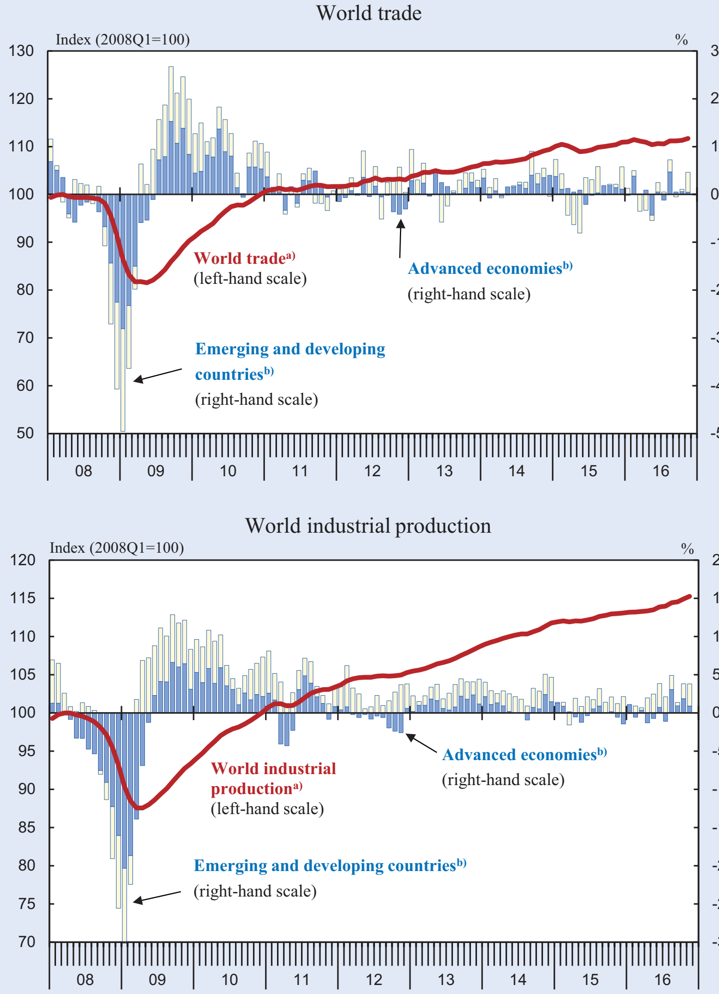
1.2 The current situation

1.2.1 The global economy

As in 2015, world trade declined during the first half of 2016 only to subsequently recover again (see Figure 1.2). Industrial production also picked up during the second half of 2016. However, whereas trade impulses were largely generated by advanced econo-

Figure 1.2

Regional contributions to world trade and industrial production



[a)] Three month moving average level. [b)] Contribution to annualised monthly growth rate thereof.

Source: CPB Netherlands Bureau for Economic Policy Analysis, World Trade Monitor: November 2016.

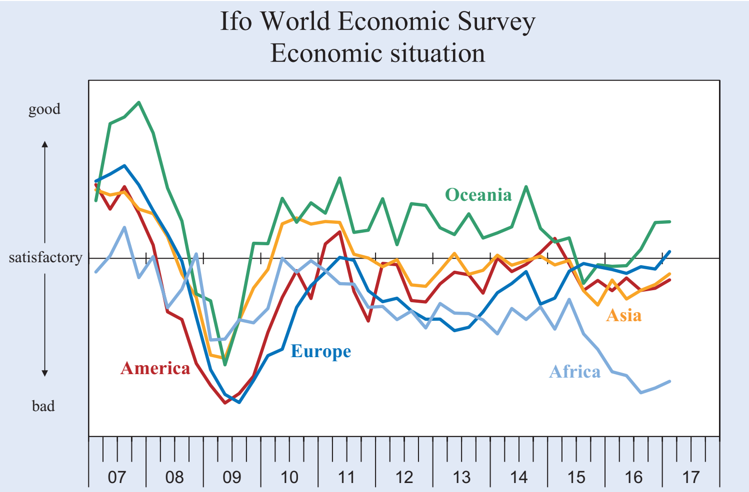
mies, industrial production growth in the emerging and developing countries outweighed that of their advanced counterparts. From an overall perspective, after a subdued first half of the year, the global economy subsequently regained momentum. Advanced and emerging economies alike have contributed almost equally to revive the global economy.

By and large economic sentiment in most parts of the world remained stable. In Asia, America and Europe sentiment remained at historically low levels, while in Oceania the situation took a turn for the better at the end of last year. Africa, on the other hand, was on a downward path throughout last year (see Figure 1.3). World trade and world GDP are expected to have increased by 0.8 and 2.4 percent respectively last year (see Table 1.A.1).

Nevertheless, the global economy is still growing less than it did in the years preceding the financial crisis. World trade in particular seems to have moved down into a different gear since 2011. Whether this is a structural or a more temporary phenomenon is heavily debated and will depend on which of the various theories turns out to bear more weight. We broadly distinguish between three lines of thought.

Firstly, growth in global investment has been rather subdued since the financial crisis. Since investment is the most trade-intensive component of GDP, this development has depressed growth in cross-border trade in goods. It remains unclear, however, to what extent the weakness in investment growth is a temporary phenomenon that may perhaps be related to higher levels of uncertainty, or is of a more structural nature.

Figure 1.3



Source: Ifo World Economic Survey I/2017.

What speaks for the structural story is the gradual rebalancing of the Chinese economy towards greater consumption and the re-evaluation of the assets and structural changes undertaken in several advanced economies towards less capital intensive sectors. These might have translated into slower, but more sustainable investment growth.

Secondly, growth in global value chains might have matured. This is supported by empirical studies showing that this effect is especially strong in China and is also present to a smaller extent in the United States. As China moves up in the global value chain, in particular, the foreign content of its exports diminishes.

Finally, the slowdown in trade liberalisation, or even the adoption of protectionist measures in the aftermath of the financial crisis, may also have depressed trade growth. It is difficult to predict whether the change in political attitudes is temporary or of a more lasting nature.

1.2.2 United States

Momentum in the US economy was weak during the first half of 2016 and remained below the potential 1.5 percent as estimated by the Congressional Budget Office. During the second half of the year, however, growth picked up, with real GDP increasing by 1.6 percent in 2016.

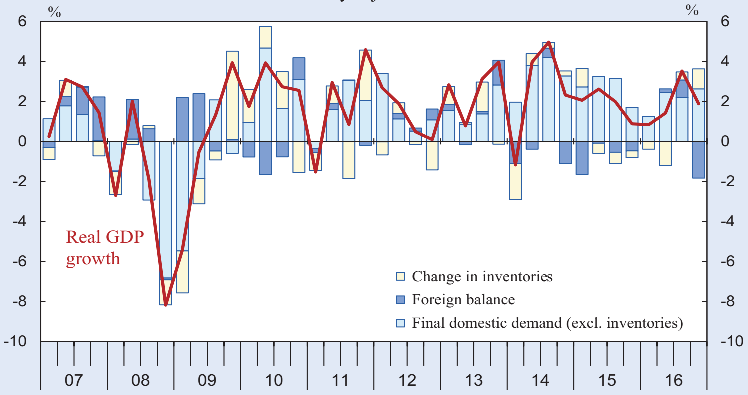
Although consumer spending provided far less of a boost to the US economy in 2016 than in the preceding two years, spending on healthcare and leisure goods, motor vehicles and housing continued to generate high growth contributions (see Figure 1.4). The overall slight increase in government spending was driven by expenditure at the state and local level, while the federal government has hardly provided any economic impulses largely due to lower expenditure on public defence.

Gross capital investments contributed negatively to overall growth. While commercial con-

Figure 1.4

Contributions to GDP growth[a)] in the United States

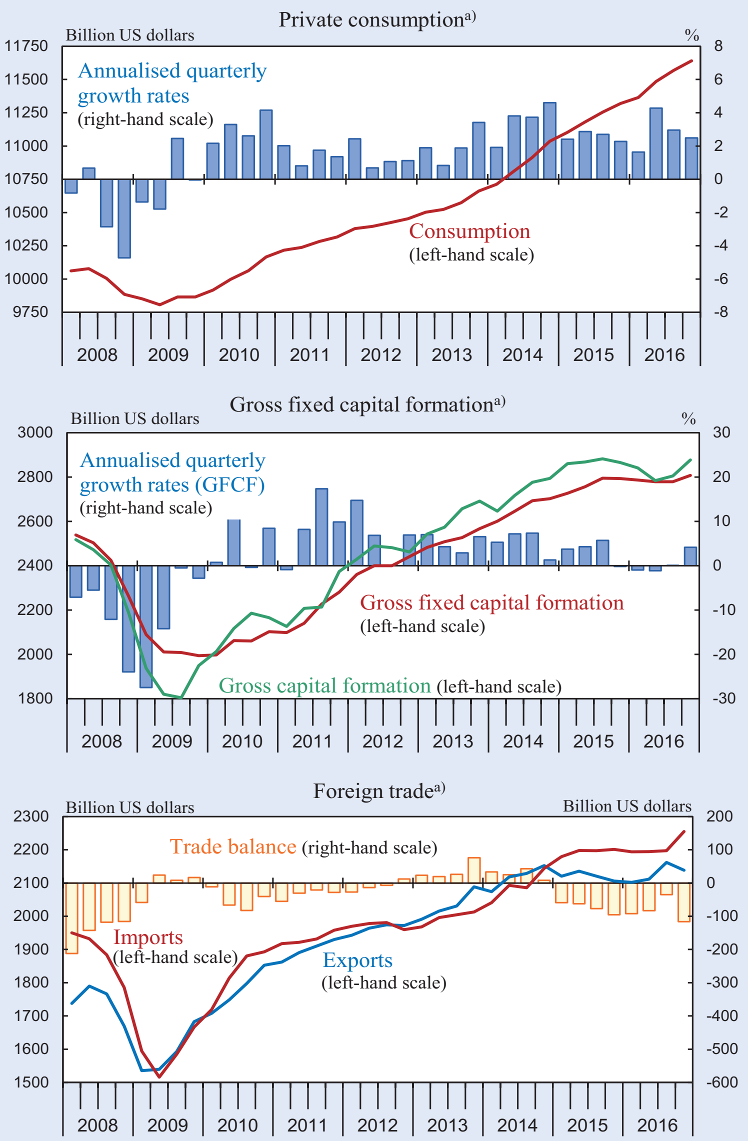
Seasonally adjusted data



[a)] Annualised quarterly growth.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2017; EEAG calculations.

Figure 1.5

Business cycle developments in the United States



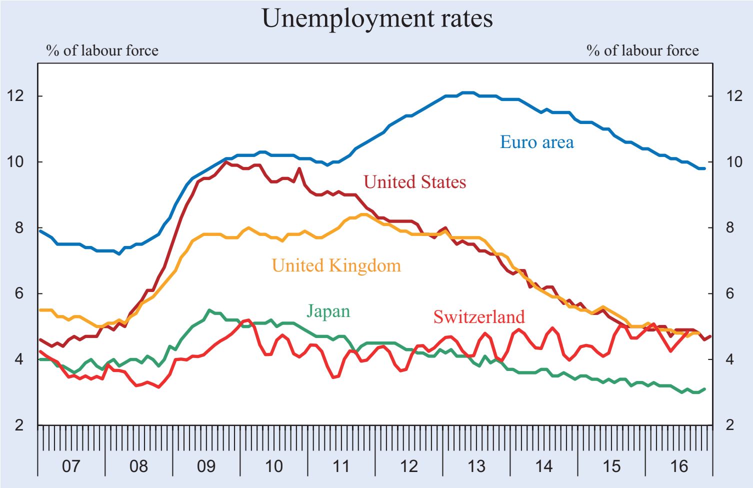
[a)] In constant prices, seasonally adjusted and work-day adjusted.
Source: US Bureau of Economic Analysis, last accessed on 31 January 2017.

struction remained weak, residential construction activity fell. After strong growth in the number of building permits in 2015, the rate has now stabilised at half of its 2007 level. Lower investment by manufacturers and the public sector has negatively impacted non-residential construction. The latter is characterised by lower spending on infrastructure projects like water and energy supplies. Low capacity utilisation rates in manufacturing, mainly due to subdued developments in raw material extraction caused by low oil prices, had a dampening effect on equipment investment.

For the first time in two years, foreign trade contributed positively to GDP growth last summer and autumn. Exports expanded sharply in autumn (see Figure 1.5). This was, however, mainly a result of increased demand for US soybeans caused by poor harvests in Brazil and Argentina. After a long flat phase, imports increased.

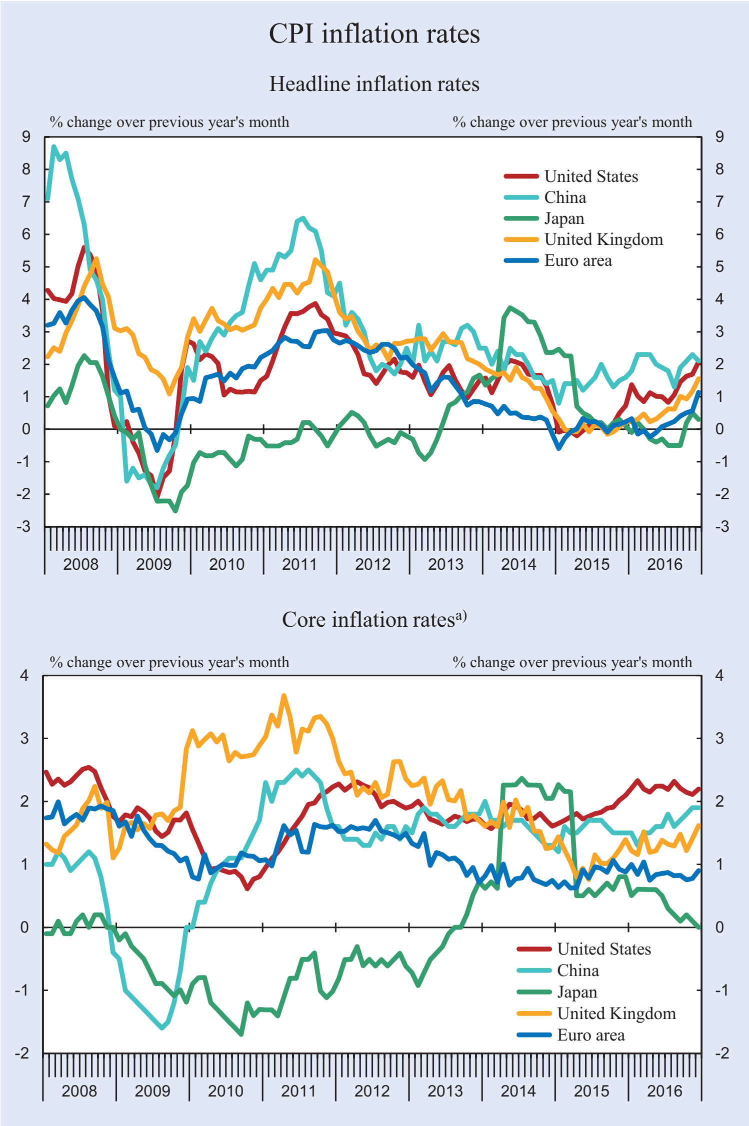
The labour market continued to develop positively in 2016, although to a lesser degree than in previous years. An average of 180,000 new jobs were created per month, with recruitment proving particularly strong in the healthcare and education sectors, as well as in the business-related services. The unemployment rate has thereby settled down to levels in line with full employment, resulting in an average unemployment rate of 4.9 percent for 2016 (see Figure 1.6). Also, broader key measures, which include e.g. the number of discouraged workers and the share of full-time workers, have recovered accordingly. The number of vacancies is well above the pre-crisis level, and many voluntary resignations indi-

Figure 1.6



Source: OECD, Main Economic Indicators, SFSO, last accessed on 31 January 2017.

Figure 1.7



a) Consumer Price Index (CPI) excluding food- and energy-related items.
Source: US Bureau of Labor Statistics, Statistics Bureau of Japan, National Bureau of Statistics of China, Eurostat; last accessed on 31 January 2017.

cate good employment prospects. The labour force participation rate also stabilised at slightly below 63 percent, which – despite being substantially lower than before the start of the financial crisis – is seen as a positive sign by the US Federal Reserve when taking into account demographic developments.

The low level of unemployment is gradually driving up nominal wage growth, which is likely to increase price pressure. The personal consumption expenditure (PCE) deflator excluding energy and food, a preferred inflation measure of the Federal Reserve, has tended sideways since the beginning of 2016 and stood at 1.5 percent at the end of last year. The change in the consumer price index excluding energy and food was consistently above 2 percent throughout 2016. However, taking food- and energy-related items into the basket paints a different picture: the annual change in the index of consumer prices averaged only 1.2 percent in 2015 (see Figure 1.7). As the underlying base effects of previous decreases in raw material prices have started to disappear, headline inflation is ensured to recover this winter.

1.2.3 Asia

Growth in *China's* economy remained at a historically low, but steady pace throughout 2016: real GDP expanded by 6.7 percent. Monetary and fiscal impulses mainly compensated for the structural downward trend in the manufacturing sector and have stimulated the construction sector and real estate services since the beginning of last year.

The state-orchestrated stimuli for industries with high overcapacity have stopped the fall in producer prices in the manufacturing sector, which had manifested itself since 2012. Core inflation has also risen slightly since the beginning of 2016. After largely stagnating since 2014, house price developments have followed an upward trend since the beginning of last year. As a result, in addition to monetary authorities, many local governments reactivated macro-prudential measures during the second half of 2016. These measures included tighter regulations on private individuals owning several houses or apartments.

The *Japanese* economy started off with a high pace of growth slowing to more or less the potential rate at the end of 2016. Due to a low base year effect stemming from 2015, the annual growth rate only turned out to be 1.0 percent last year. The key drivers of growth were public investment and private construction investment. Exports suffered from the strong appreciation of the yen during the first half of 2016. The revaluation was due to financial markets downwardly adjusting their expectations about the future extent of monetary policy divergence between Japan and the United States combined with higher risk aversion due to an uncertain global outlook. As a result of the strengthening of the yen, consumer price inflation slid back into negative territory. Energy price developments made this a temporary phenomenon: in October inflation turned positive again. The yen's appreciation was largely reversed during November and December 2016, which should support inflation in the near term.

The growth rate of *India's* economy was above average last year. Whereas investment and exports were weak, positive impulses to consumption, coming from a near normal monsoon and an increase in public wages, drove the pick-up in GDP growth. In addition, government spending on subsidies and infrastructure surged. The trade deficit has declined markedly since 2014. However, this development is no longer due to very dynamic exports, but rather to far weaker imports. Inflation rose to around 6 percent during the first half of 2016 only to fall back to 3.6 percent in November last year. The year 2016 has probably seen a 7.4 percent increase in GDP for India.

After a weak winter half in 2015/2016, the Asian Tiger countries (*South Korea, Taiwan* and *Hong Kong* and *Singapore*) regained momentum. Both private consumption and investment were able to recover from their temporary weakness. Foreign trade also picked up. With the structural weakening seen in the Chinese economy since 2012, however, massive export growth has become a thing of the past. As a reaction to unfavourable economic conditions and weak price pressure, the central bank of South Korea reduced its base rate to a historical low of 1.25 percent in June last year.

The emerging Asian economies (*Indonesia, Thailand, Malaysia* and the *Philippines*) also picked up again after having a rather cautious start to the year 2016. Public consumption delivered an above-average contribution to growth, while foreign trade was weak. In addition, the central bank of Indonesia cut its base rate by a total of 100 basis points in January, February, March and June.

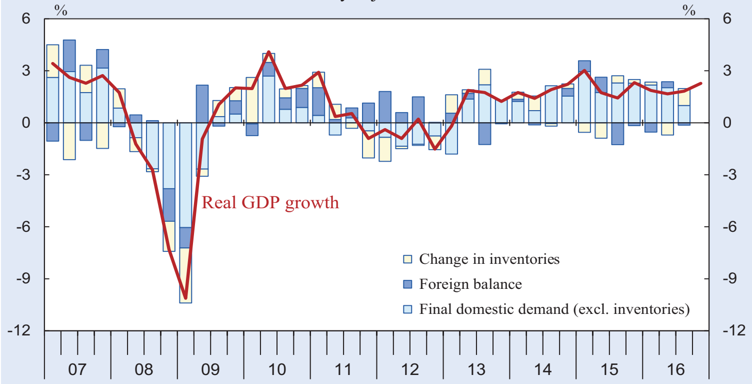
1.2.4 Latin America and Russia

Not least because of political uncertainties, the economic momentum in Latin America (Brazil, Mexico, Argentina, Venezuela, Columbia and Chile) remained weak last year. In the economic heavyweight Brazil, overall output continued to shrink. Financial investors looking for returns and confronted with delayed monetary policy tightening in the United States nevertheless started to bet on a political and economic stabilisation in Brazil. This led to a strong real appreciation of the Brazilian real against the currencies of its most important trading partners, and thereby actually dampened the strong momentum in foreign trade. Negative growth contributions also came from private consumption, while for the first time in three years there was an increase in gross fixed capital formation. Albeit slowly falling and despite the decline in import prices, inflation is still well above the 4.5 percent inflation target. The central bank of Brazil nevertheless cut interest rates twice in October and November last year.

Apart from a temporary decline in growth in the second quarter of last year, the *Mexican* economy has remained on an otherwise stable expansion path for the last three years. While domestic demand continued to develop strongly, foreign trade has not to date benefitted from the sharp depreciation of the Mexican peso that began in early 2015. This did, however, push up inflation, forcing the Mexican central bank to increase its base rate five times last year.

In *Argentina*, extensive reforms implemented by the liberal government have not yet produced the desired results. In the hope of attracting more foreign direct investment, the government has lowered trade barriers and government subsidies, but this has so far failed to pull the country out of the recession that it entered at the end of 2015. The reforms did, on the other hand, lead to a strong depreciation of the Argentine peso, which in turn boosted inflation. The rate of change in overall output in the Latin-American region is expected to have been –1.6 percent last year.

Figure 1.8



[a)] Annualised quarterly growth.
Source: Eurostat, last accessed on 31 January 2017; EEAG calculations.

Although the rate of decline started to abate during 2016, the *Russian* economy remained in the recession that started mid-2014 and was caused by a plunge in oil prices, as well as international sanctions following the annexation of Crimea and the outbreak of war in Ukraine. Inflation has been falling rapidly since August 2015, when it peaked at around 16 percent. At the end of last year it stood at 5.4 percent. Fluctuations in the Russian ruble are largely driven by the prices of oil and natural gas, which are Russia's main commodity exports. The currency took a dramatic fall to a historical low in January 2016, as oil prices reached their lowest levels in over a decade. As oil prices subsequently started to recover, the ruble also gradually stabilised. The decline in inflation and the stabilisation of the ruble allowed the central bank to further reduce its base rate by a total of 100 basis points in June and September last year. Overall GDP probably declined by 0.5 percent last year.

1.2.5 The European economy

The cyclical situation

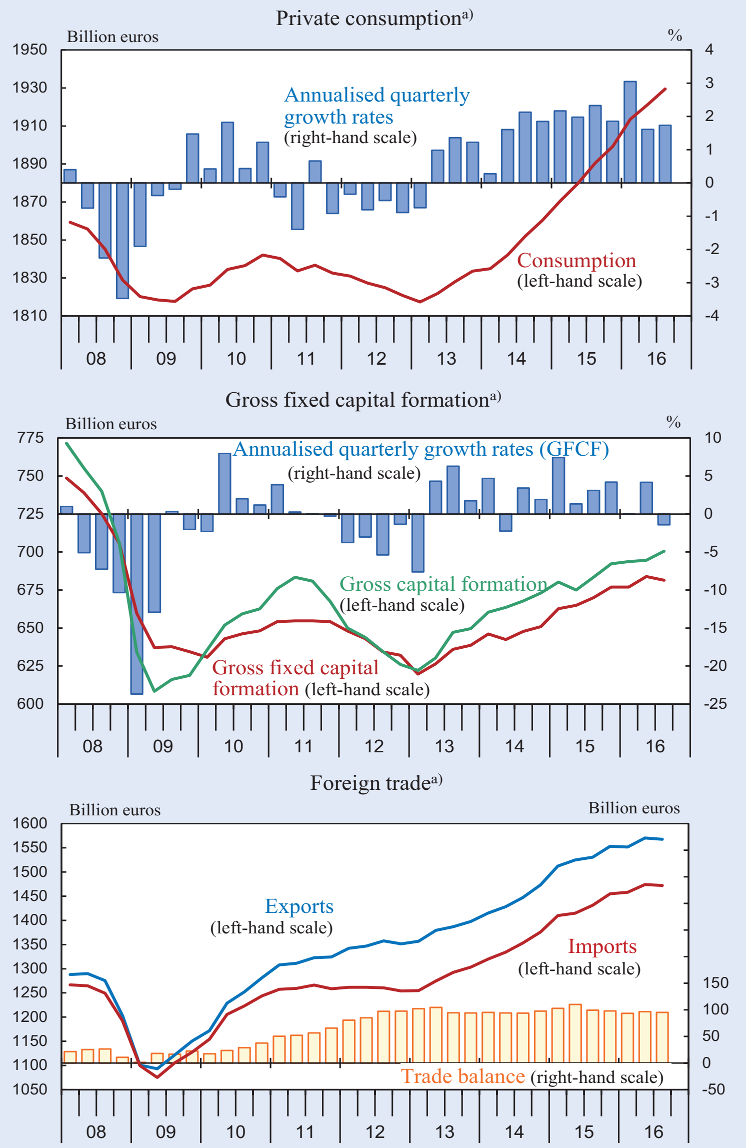
Although a moderate slowdown in growth was observed, the overall economic recovery continued throughout 2016 (see Figure 1.8). Since the end of the recession in the second quarter of 2013, the average annualised GDP growth rate in the European Union has amounted to 1.9 percent. The recovery was fuelled by private and public consumption. Private consumption reached its highest quarterly growth level since 2007 to date in the first quarter of 2016 (see Figure 1.9). The small, and partly even negative inflation rates, which were at least partially caused by the substantial reduction in energy prices, did relieve household budgets and gave an unexpected boost to growth in private consumption. Investment was more volatile throughout last year, but also contributed positively overall. Despite the low real value of both the euro and the British pound, foreign trade only provided small impulses.

The pace of recovery still remains well below those of previous post-crisis upturns. According to estimates by the IMF, the European Commission and the OECD, Europe still has a significant output gap, although this is closing slowly, partly because of lower potential growth. Possible reasons are a lack of willingness to carry out necessary labour and product market reforms, as well as initiating a credible consolidation of fiscal budgets in crisis-afflicted countries. Other constraints include the outcome of the Brexit referendum (see Chapter 3), a continuation of the migrant crisis (see Chapter 4) and the strengthening of populist movements (see Chapter 2). Each of these factors have a negative impact on business confidence in Europe and thereby prevent investment from taking off.

The recovery in Europe has helped to reduce the EU unemployment rate, which fell from its peak of 11 percent in April 2013 to 8.3 percent in October 2016. In the euro area, it fell below the 10 percent mark for more than a month for the first time since 2009. In the European Union, employment levels thereby surpassed pre-crisis levels for the first time. When focusing on the euro area, these figures point in the same direction, albeit in a still somewhat less pronounced manner. Employment remains below the levels seen before the wake of the financial crisis.

Figure 1.9

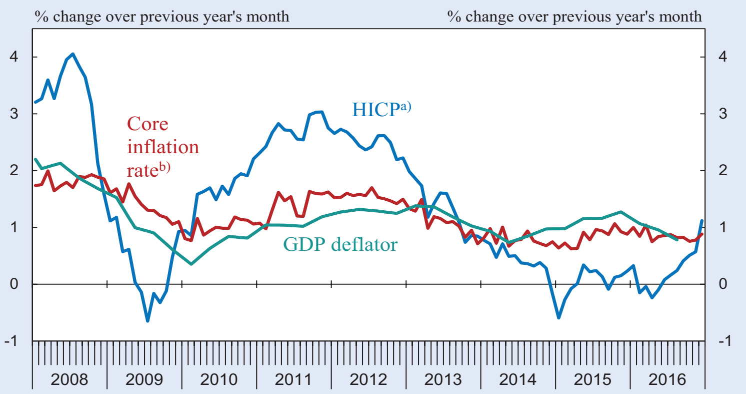
Business cycle developments in the European Union



a) In constant prices, chain-linked volumes, reference year 2010, seasonally adjusted and work-day adjusted.
Source: Eurostat, last accessed on 31 January 2017.

Figure 1.10

Price developments in the euro area



a) Harmonised Index of Consumer Prices. b) HICP excluding energy, food, alcohol and tobacco.
Source: Eurostat, last accessed on 12 January 2017.

In the wake of the still significant output gap, core inflation remained broadly unchanged during last year. Although headline inflation rose to 1.2 percent in December after declining to a low of –0.2 percent in April, this increase was entirely due to the fading effect of past decreases and a more recent acceleration of energy prices. When looking at core inflation, i.e. excluding food and energy prices, the inflation rate remained at 0.8–0.9 percent throughout the same period. It thereby stayed well below the medium-term target of the European Central Bank (ECB) to keep overall inflation below or close to 2 percent. Since the financial crisis, core inflation has consistently remained below target (see Figure 1.10). The fall in core inflation, as also shown by reduced increases in the GDP deflator, mainly reflects the continued under-utilisation of production capacities and the still limited scope for firms to increase prices as a result. Furthermore, the efforts required in crisis countries to improve competitiveness through wage and price reductions keep exerting deflationary pressures on the euro area as a whole. Finally, the price effects of past tax increases (e.g. increases in value added tax rates) as part of austerity packages have now faded.

Differences across Europe

In the individual countries of the European Union, the economic recovery looks quite diverse. Among the larger economies, growth rates in France and Italy were once again below average. The (former) crisis countries Greece and Portugal also still have not caught up to the rest of

Europe. Cyprus, Spain and Ireland, on the other hand, posted above-average growth rates last year.

Despite a weak performance during the second half of last year, largely driven by disappointing contributions from external trade, the *German* economy continued its upswing that began in 2013. As GDP has, on average, been expanding at rates higher than potential output, the output gap that materialised during the euro crisis has now more than closed. The upswing has nevertheless been modest compared to previous ones. It not only differs from past recoveries in that way, the underlying forces for Germany are also unusual. Such previous phases were often driven by a substantial increase in exports that then transferred to the domestic economy through an expansion in machinery and equipment investment and income growth. This time is different. In none of the previous booms since the 1970s was such a small increase in exports recorded as during the last couple of years. Weak demand from its European trading partners and the significant slowdown of the Chinese economy and other emerging countries were probably key factors in this development and are likely to be the main reasons why the current upswing in Germany can only be described as moderate. The dynamics of machinery and equipment investment have also been rather weak historically. In light of the exceptionally low lending rates, this may seem surprising at first, but can be explained by the slowly developing sales prospects in many foreign markets and the unusually high level of uncertainty over the future course of economic policy in many important partner countries.

Key pillars of the current recovery have been private and public consumption together with construction investment. As far as private consumption is concerned, however, it should be noted that Germany has witnessed a substantial increase in population. Strong immigration, largely triggered by external developments, has offset the demographically-induced decline in Germany's domestic population. More heads mean higher consumption of goods and services. Such exogenous population growth stimulates the economy per se. In per capita terms, consumer spending developed similarly as in any other past boom. However, refugee consumption levels tend to be well below the German average. In that sense, refugee migration alone depressed average per capita private consumption in Germany. Hence, the increase in population through a strong inflow of refugees cannot fully explain historically strong private consumption growth.

The fact that the refugees primarily received social benefits in kind during the asylum procedure meant that their arrival did trigger public consumption. Compared to previous upswings, the government sector did contribute significantly to overall economic expansion in Germany. Fuelled by loose financial conditions, the increase in construction investment is also above average. Overall, economic growth reached 1.8 percent in Germany last year.

During 2016, growth in *France* moved like a rollercoaster. Whereas it started off the year on a high note and then turned negative, growth recovered subsequently. For the year as a whole, a modest growth rate of 1.1 percent resulted, which was not sufficient to turn around labour market conditions for the better and allow for a significant decline in unemployment figures. Unemployment still stood at 9.5 percent in November last year. Last summer a labour market reform was adopted in which firm-specific working condition agreements are to take precedence over industry-wide arrangements. Over time, this reform might lend some moderate support to employment development. However, in the short run, it triggered strikes and protests that led to production disruptions and thereby contributed to the stagnation in investment spending, which had expanded substantially in the three preceding quarters. Exports have so far neither benefited from Europe's slow recovery, nor the weaker euro.

After a good first quarter supported by the weather and ticket sales for the European Football Championship, private consumption subsequently stagnated. Only public consumption thereby turned out to be a robust spending pillar in France. The recovery of the oil price ended the short phase of negative inflation rates at the beginning of the year. Inflation continued to rise to 0.8 percent in December. However, high unemployment and the still clearly negative output gap are dampening underlying price pressure. Core inflation has stayed below the euro area average and hovered around 0.6 percent for most of the year.

Even before the Brexit referendum on 23 June last year, the first rifts were seen in the stable upswing experienced by the United Kingdom in recent years. Although the UK economy expanded significantly during the first half of the year due to robust private consumption and a surge in construction activity, the subliminal effects of uncertainty about the outcome of the referendum were already visible. Machinery and equipment investment already grew more slowly than previously, and the expansion in construction investment was exclusively attributable to public construction activity. During the second half of last year, i.e. after the Brexit vote, public and private consumption also remained the main stabilisers of the economy; and investment activity was mainly driven by public construction. Investments in equipment and machinery, on the other hand, were very weak and confirmed the assessment that companies have already begun to restrain their investments due to uncertainty over the future relationship with the European Union. The uncertainty is also reflected in the exchange rate: since the referendum in June, the British pound has depreciated by 10 percent against the euro with consequences for foreign trade. Imports declined during the second half of the year, while exports increased somewhat. Real GDP grew by 2.1 percent in 2016.

Italy has not been able to participate in the European recovery that started in 2013 to date. Real GDP has only increased by a mere 2 percent and is still nearly 8 percent below pre-financial crisis levels. Accordingly, the unemployment rate in Italy remained broadly unchanged and averaged 11.6 percent in 2016. In contrast to the year before, private consumption barely contributed to overall growth. This was particularly due to depressed consumer sentiment created by uncertainty surrounding the referendum on constitutional reform in November and the stability of Italian financial institutions. Besides these uncertainties, the investment climate remained poor also because of Italy's rigid labour laws, high labour costs, inefficient public services and its judicial system (see Table 1.1). Consolidation efforts by the public sector also led to small growth contributions from public spending.

Table 1.1

Labour costs[a)]

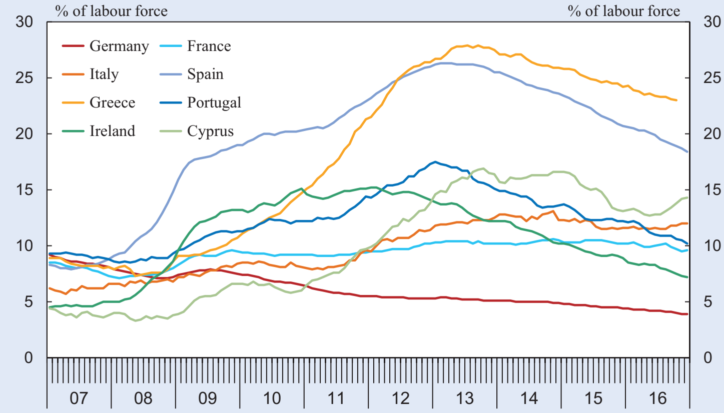
	Compensation per employee[b)]		Real compensation costs[c)]		Labour productivity		Unit labour costs		Relative unit labour costs[d)]		Export performance[e)]		
	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	1999–2013	2014–2016	2016
Germany	1.4	2.5	0.4	0.7	0.6	0.5	0.8	2.0	– 1.3	0.8	0.6	0.6	0.0
France	2.6	1.1	1.1	0.4	0.7	0.5	1.8	0.4	0.0	– 1.0	– 1.6	0.4	– 1.2
Italy	2.0	0.3	– 0.1	– 0.6	– 0.3	– 0.1	2.5	0.7	0.5	– 0.4	– 3.0	0.1	– 0.5
Spain	2.6	0.6	0.2	0.4	0.6	0.5	2.3	0.3	0.5	– 0.8	– 0.7	1.6	3.5
Netherlands	2.7	1.2	0.8	0.9	0.8	1.2	2.0	0.0	0.1	– 1.1	– 0.2	0.6	0.7
Belgium	2.7	0.4	0.9	– 0.6	0.8	0.6	2.0	– 0.4	0.3	– 1.7	– 0.9	0.7	1.6
Austria	2.2	1.6	0.5	– 0.1	0.8	0.1	1.5	1.8	– 0.3	0.4	– 0.5	– 0.7	– 1.0
Finland	3.0	1.2	1.3	– 0.3	0.9	0.3	2.1	0.8	– 0.3	0.8	– 1.4	– 1.9	– 0.4
Greece	2.8	– 1.3	0.6	– 0.4	0.8	– 1.2	2.8	0.3	0.6	– 0.1	– 1.0	– 3.9	– 9.5
Ireland	3.6	2.4	1.5	1.2	1.8	10.1	2.0	– 6.8	0.6	– 8.8	2.1	12.7	0.5
Portugal	2.7	– 0.2	0.4	– 1.7	1.1	– 0.2	1.9	0.7	0.0	– 0.4	– 0.2	0.8	0.4
Slovakia	6.5	2.4	3.3	2.7	3.5	1.5	2.4	1.6	2.0	0.7	4.6	1.0	1.4
Slovenia	5.7	1.3	2.1	0.4	1.9	1.4	3.6	0.0	– 0.1	– 1.0	1.0	2.7	3.4
Estonia					3.8	0.1	4.9	4.7	2.2	5.2	1.2	0.9	1.6
United Kingdom	3.6	1.2	1.6	0.1	1.1	0.6	2.4	0.4	– 1.1	0.2	– 1.6	– 1.5	0.3
Sweden	3.6	2.6	2.0	0.9	1.4	1.8	2.3	1.2	0.4	– 2.8	– 0.8	1.8	0.7
Denmark	3.1	2.0	1.0	1.4	1.0	0.1	2.2	1.9	0.2	1.0	– 0.5	– 1.3	– 1.6
Poland	5.2	2.3	2.0	1.8	3.4	1.8	2.2	0.9	– 0.5	– 0.9	2.4	4.4	6.2
Czech Republic	4.8	2.9	3.0	1.4	2.4	2.0	2.1	1.3	2.5	– 1.0	3.6	3.5	2.1
Hungary	6.6	2.5	1.4	0.7	2.0	– 0.4	5.1	3.0	1.7	0.3	3.8	5.2	5.2
Switzerland	1.5	– 0.7	0.8	0.0	0.7	– 0.2	1.0	0.1	1.1	2.6	– 0.1	– 3.1	1.7
Norway	4.8	2.8	– 0.1	4.0	0.5	0.9	4.4	1.8	3.1	– 5.1	– 3.6	– 1.9	– 4.2
Iceland	6.5	6.7	1.5	2.2	1.6	0.5	5.3	6.1	– 1.5	12.2	0.7	2.9	3.6
United States	3.3	2.4	1.2	1.0	1.6	0.3	1.7	2.2	– 1.6	7.2	– 1.6	– 0.4	– 0.3
China									4.1	3.8	10.1	0.1	0.2
Japan	– 0.9	0.7	0.3	– 0.6	1.0	– 0.2	– 1.5	1.3	– 2.9	0.9	– 3.0	0.6	– 2.5

[a)] Growth rates for the total economy. – [b)] Compensation per employee in the private sector. – [c)] Compensation per employee in the private sector deflated by the GDP deflator. – [d)] Competitiveness: weighted relative unit labour costs. – [e)] Ratio between export volumes and export markets for total goods and services. A positive number indicates gains in market shares and a negative number indicates a loss in market shares. – [f)] Covers the period 2010–2013.

Source: OECD Economic Outlook No. 100, November 2016.

Figure 1.11

Unemployment rates in selected euro area countries



Source: Eurostat, last accessed on 31 January 2017.

Doubts about the stability of Italian credit institutions cooled down the business climate last year. Although these banks generally weathered the global financial crisis fairly well, as they did not invest excessively in speculative investments abroad and were not – through too little diversification in their lending portfolios – exposed to negative developments in the real estate sector. However, the weak economic development in the aftermath of the financial crisis and the postponing of structural reforms led to an accumulation of bad loans: around 18 percent of the loans granted in Italy have now been classified as "non-performing loans". A recapitalisation of the distressed financial institutions by the government is not in line with the new EU directives, which prescribe that the shareholders and creditors of subordinated bonds first need to be taken on board. The securitisation of distressed loans, as initiated by the Italian government, and the increase in the capital of private banks by private funds has defused the situation for the time being.

Despite political uncertainty created by not being able to set up a government for ten months until October last year, the *Spanish* economy managed to stay on its high growth trajectory that started in 2014. With a rate of 3.3 percent in 2016, it achieved the by far highest GDP growth rate amongst the larger EU countries. With the exception of public consumption, all spending components significantly contributed to this upswing. Indeed, GDP almost returned to its pre-crisis level of early 2008. Although the unemployment rate is still high, this development led to a drop from 20.5 percent at the start of 2016 to 19.3 percent in November.

Of the smaller (former) crisis-afflicted economies, *Cyprus* and *Ireland* fared well. Cyprus has been back on a steady growth path since early 2015, with average annualised growth rates of almost 3 percent. Ireland is even surpassing this performance with an average annualised growth rate of over 5.5 percent. Last year these two economies grew by 2.9 and 4.3 percent respectively. In *Portugal* real GDP has also been on an upward trend since spring 2013, albeit at a rate (1.3 percent) that is not comparable to that of Cyprus or Ireland. Although Greece has technically moved out of recession with a growth rate of 0.3 percent for 2016, its economy has basically been stagnant since 2013. Despite these low growth rates, these two countries have also seen a noticeable turnaround in their labour markets. Unemployment has been steadily falling in all four economies since at least 2015 (see Figure 1.11).

Albeit going strong, the recovery in the *Central and Eastern European* member states of the European Union lost some of its momentum during last year. This was mainly due to weaker demand from the euro area. Domestic demand was robust almost everywhere. Cheap oil and low commodity prices continued to act as an economic stimulus. In addition, real household income increased, not least because the price level rose only slightly and even declined in some places. Equipment investment also made an overall positive contribution to the increase in GDP in the region. Its expansion was facilitated by interest rates, which remained low throughout the year. All of this led to a further noticeable improvement in the labour market situation everywhere, which was accompanied by a significant drop in unemployment rates in all countries.

Nevertheless, differences between these Central and Eastern European countries continued to prevail. Whereas Romania, Slovakia and Bulgaria each reported growth rates of well above 3 percent, Latvia, Estonia and Hungary were the laggards of the region last year, with expansion rates of below or equal to 1.5 percent. As a result, the central bank of Hungary lowered its key policy rate in three equal steps by a total of 45 basis points to 0.9 percent. The Baltic states still suffered from the recession in Russia.

1.3 Fiscal and monetary policy

1.3.1 Fiscal policy

Fiscal policy is unlikely to continue the consolidation course of recent years seen in most large advanced economies in 2017 (see Figure 1.12). In the United States, the further increase in the structural fiscal deficit generated significant impulses for economic activity last year. As no concrete fiscal plans for the new US government are available yet, the present forecast assumes that fiscal orientation will remain roughly neutral this year, in the sense that the structural deficit will hardly change. However, it is possible that a further increase in the fiscal deficit of the United States will emerge.

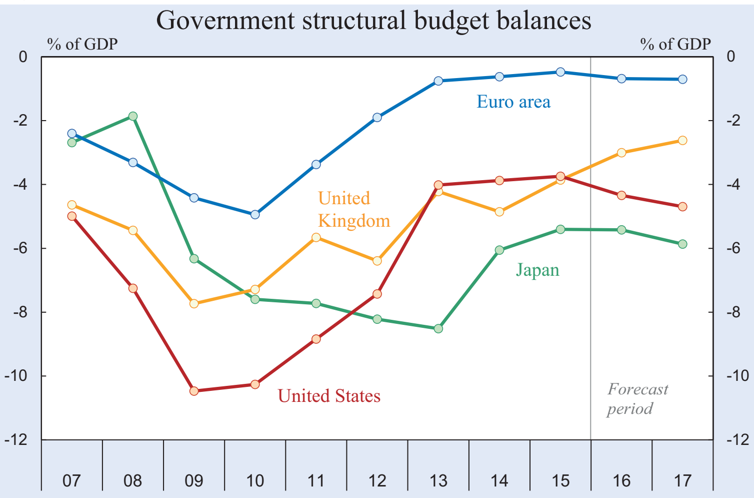
In Japan, in view of the low rate of expansion, a new economic stimulus plan was launched at the beginning of last year. Furthermore, the planned value added tax increase for April 2017 was postponed to 2019. Other originally foreseen fiscal consolidation measures were further shifted out into the future. As a result, the intensity of fiscal consolidation has decreased noticeably for 2017.

In the major emerging economies, the expansionary orientation of fiscal policy seen last year is expected to continue. In China, for example, large-scale public investment programmes were announced in early 2016, and lending by state banks markedly expanded in the summer of 2016. Further support measures are foreseen for this year. In India, wages in the public sector have recently been massively increased and indirect tax reforms have been implemented. The governments of Indonesia and Russia are also planning to expand their investment and consumption spending. Albeit to a lesser degree than in the recent past, fiscal policy in Brazil is likely to be contractionary.

The fiscal consolidation course of the years 2011 to 2013 has since been relaxed in Europe. The fiscal deficit of the euro area and the European Union has nevertheless continuously improved since 2010 and reached approximately –1.9 and –2.0 percent last year (see Table 1.2). However, during the last few years the improvements have only been achieved due to increased revenues and lower spending that are related to the economic recovery on the one hand, and the ECB's expansionary monetary policy on the other hand. The latter resulted in a reduction of governments' interest payments. Correcting for these effects, and hence looking at the so-called structural primary balance, actually shows a slight worsening of the fiscal balance in the euro area in recent years. According to the most recent estimates by the European Commission, the thus measured discretionary fiscal impulse was – like the previous year –0.2 percentage points in relation to potential GDP last year. The greatest impulses were observed in Spain (1.1 percentage points), Austria (0.8 percentage points) and Italy (0.4 percentage points). In Germany, the structural primary surplus decreased by 0.4 percentage points, while fiscal policies in Greece, Ireland, the Netherlands and Portugal are likely to have been restrictive last year.

Many euro area countries are not consolidating their government budget, despite their still high public debt levels (see Figure 1.13). Although a large number of countries far from fully complying with the rules of the European fiscal compact, particularly with regard to the debt-to-GDP ratio (allowing for a maximum of 60 percent relative to GDP) and the structural fiscal deficit (allowing for a maximum of 0.5 percent relative to GDP), a loose fiscal policy course is likely to continue in the euro area this year. The experience of the past few years has shown that these fiscal rules hardly have any disciplinary effect. Last year, the fiscal impulse

Figure 1.12



Source: OECD, OECD Economic Outlook, Vol. 2016 issue 2, November.

Table 1.2

Public finances

	Gross debt[a]				Fiscal balance[a]			
	1999–2007	2008/2009	2010–2015	2016	1999–2007	2008/2009	2010–2015	2016
Germany	62.2	68.7	77.1	68.1	– 2.3	– 1.7	– 0.7	0.6
France	62.6	73.5	90.0	96.4	– 2.5	– 5.2	– 4.7	– 3.3
Italy	102.9	107.5	124.7	133.0	– 2.9	– 4.0	– 3.2	– 2.4
Spain	48.2	46.1	85.1	99.5	0.2	– 7.7	– 7.9	– 4.6
Netherlands	49.0	55.5	64.6	63.0	– 0.5	– 2.6	– 3.3	– 0.8
Belgium	100.6	96.0	104.0	107.0	– 0.5	– 3.2	– 3.5	– 3.0
Austria	66.2	74.1	83.0	83.5	– 2.2	– 3.5	– 2.4	– 1.5
Finland	40.6	37.2	55.0	65.4	3.8	0.8	– 2.4	– 2.4
Greece	103.8	118.1	168.7	181.6	– 6.3	– 12.7	– 9.1	– 2.5
Portugal	59.6	77.6	120.4	130.3	– 4.3	– 6.8	– 6.8	– 2.7
Ireland	30.9	52.0	103.1	75.4	1.6	– 10.4	– 10.7	– 0.9
Slovakia	40.5	32.0	49.5	53.3	– 5.2	– 5.1	– 4.0	– 2.2
Slovenia	25.7	28.2	62.3	80.2	– 2.2	– 3.6	– 6.5	– 2.4
Luxembourg	7.2	15.6	21.5	23.2	2.5	1.3	0.7	1.3
Lithuania	20.1	21.8	39.2	40.8	– 1.7	– 6.1	– 3.7	– 0.5
Latvia	12.2	27.6	41.3	40.0	– 1.7	– 6.6	– 2.7	– 0.8
Cyprus	58.7	49.0	86.2	107.1	– 2.4	– 2.3	– 5.2	– 0.3
Estonia	5.0	5.8	8.9	9.4	0.9	– 2.4	0.3	0.5
Malta	65.5	65.3	67.4	62.1	– 5.0	– 3.7	– 2.6	– 0.7
Euro area	**69.0**	**75.0**	**90.6**	**93.4**	**– 1.9**	**– 4.2**	**– 3.6**	**– 1.9**
United Kingdom	38.1	57.2	84.2	89.2	– 1.7	– 7.6	– 6.9	– 3.5
Sweden	48.9	38.6	40.3	41.6	1.1	0.6	– 0.7	0.0
Denmark	43.6	36.9	44.0	38.9	2.3	0.2	– 1.6	– 0.9
Poland	42.6	47.9	53.1	53.4	– 3.9	– 5.4	– 4.3	– 2.4
Czech Republic	24.6	31.4	41.6	39.7	– 3.7	– 3.8	– 2.5	– 0.2
Romania	19.5	18.2	36.1	38.9	– 2.5	– 7.5	– 3.3	– 2.8
Hungary	58.7	74.7	77.7	73.4	– 6.3	– 4.1	– 3.1	– 1.5
Croatia[b]	38.1	44.3	74.9	85.0	– 3.6	– 4.4	– 5.6	– 2.1
Bulgaria	45.3	13.4	19.5	29.4	0.5	– 1.2	– 2.2	– 0.8
European Union	**61.8**	**67.4**	**84.6**	**86.0**	**– 1.7**	**– 4.5**	**– 4.0**	**– 2.0**
United States[b]	60.7	79.4	101.8	108.2	– 3.1	– 9.9	– 6.7	– 4.1
Japan	167.0	201.0	237.8	250.4	– 5.9	– 7.3	– 8.0	– 5.2
Switzerland	56.0	48.4	46.3	44.7	0.2	1.2	0.3	– 0.3

[a] As a percentage of gross domestic product. For the European countries, definitions according to the Maastricht Treaty. For the United States, Japan and Switzerland, definitions are according to the IMF. – [b] Data on Croatia and the United States are only available from 2001 onwards.

Source: European Commission, Autumn 2016; IMF World Economic Outlook, October 2016.

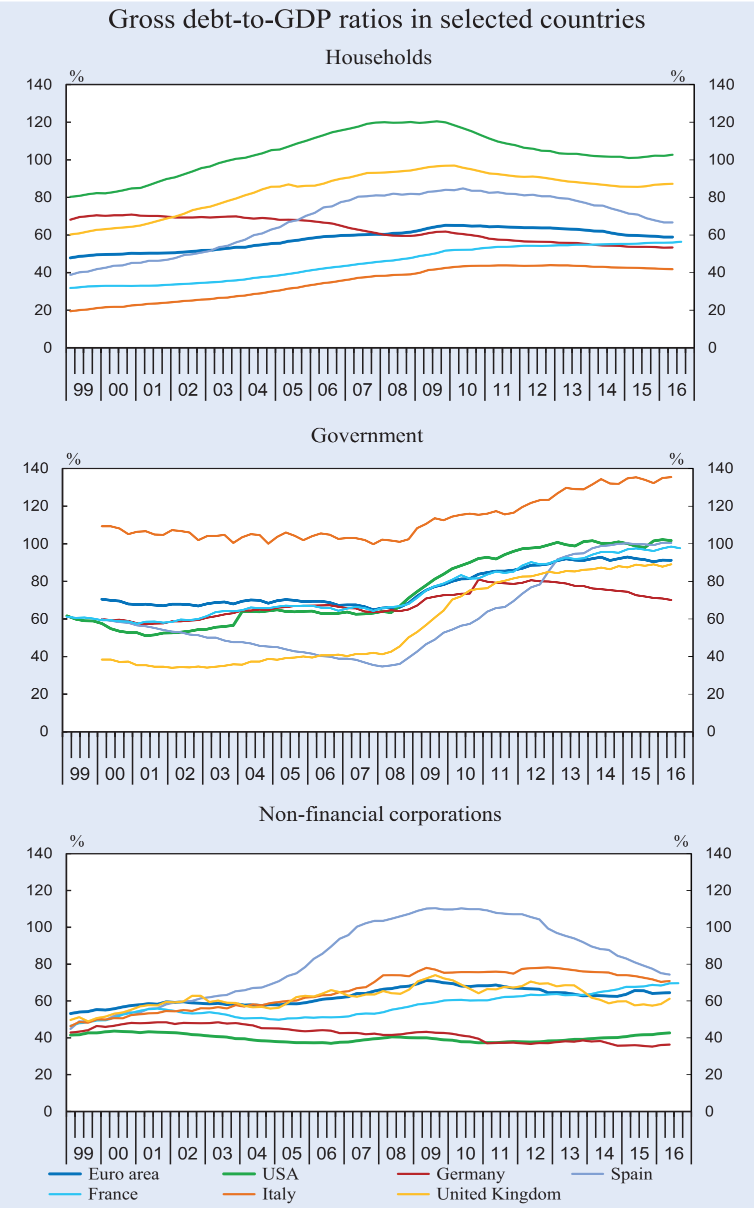
was the largest in those countries that should have had the least fiscal leeway given their high debt-to-GDP ratio. Fiscal policy is also likely to have a slightly positive impact on the economy this year. It is true that in some cases, such as in Germany and Austria, this can be traced back to the additional costs associated with the refugee crisis. However, the bulk of this fiscal easing mainly results from the marked fall in interest rates on governments bonds and the benevolent attitude of the European Commission towards member states that violate the fiscal rules. According to current estimates, the planned discretionary measures for 2017 are far more expansionary than they were a year ago in almost all countries, and particularly in Spain and Italy. For the euro area as a whole, the fiscal impulse is likely to be 0.2 percentage points in relation to GDP this year.

1.3.2 Monetary conditions and financial markets

Monetary conditions

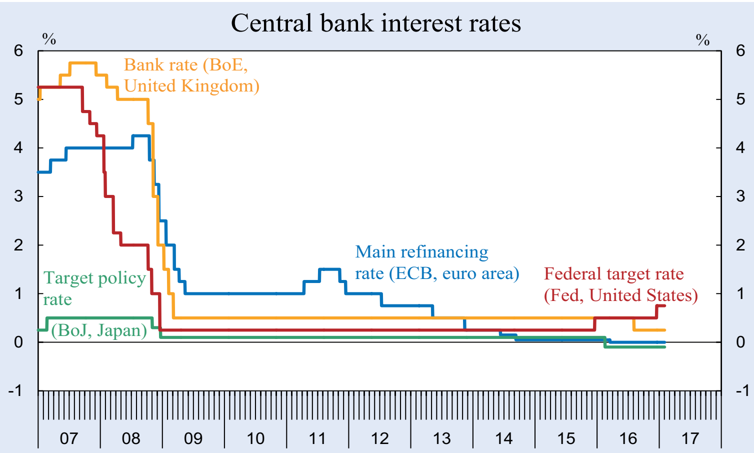
In the major advanced economies, monetary policies remain extremely expansionary. However, their degree of expansion and their focus were adjusted to varying degrees last year. Whereas the Federal Reserve of the United States increased the Federal funds rate in December 2016 for the second time since the financial crisis (see Figure 1.14), the governing council of the ECB decided to extend its asset purchase programme from April 2017 onwards, but reduce the volume. Although the Bank of Japan kept the volume of its asset purchases and the levels of its key interest rates unchanged, in an attempt to increase inflation expecta-

Figure 1.13



Source: Banque de France, last accessed on 31 January 2017.

Figure 1.14



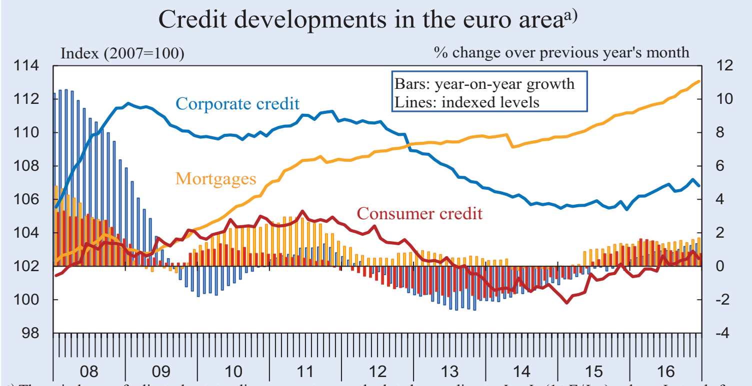
Source: European Central Bank, Federal Reserve Bank of St. Louis, Bank of England, Bank of Japan, last accessed on 31 January 2017.

tions, it adopted a number of adjustments to its objectives and to the communication of its actions. In the United Kingdom, monetary policy was relaxed again after the Brexit referendum.

It took the Federal Reserve a full year to follow up on its first interest rate hike made in December 2015. The reasons for the cautious attitude of the Fed throughout last year were the relatively weak growth of the US economy during the first half of 2016 as well as concerns that the economic slowdown in China and in other emerging markets during the winter of 2015/2016 could aggravate and have a negative impact on the US economy. However, faced with a basically closed output gap, a strong expansion of aggregate economic output during the second half of 2016 and an increasing inflation rate – which is now only slightly below the Fed's target value of two percent – the Federal Reserve increased the target of the federal funds rate by 25 basis points to a range of between 0.5 and 0.75 percent in December. This year the tightening of monetary policy in the United States is likely to continue. However, this will happen at a slow pace, implying that monetary policy will remain accommodative throughout the year.

Monetary policy in the emerging economies was very mixed last year. Despite significantly undershooting its inflation target, the Chinese central bank has not taken any further steps towards monetary easing. Instead, Chinese policy makers turned to fiscal policy in order to stimulate the economy. One reason for this shift was to avoid even stronger overheating in the property market and a further acceleration of lending to the already heavily indebted corporate sector. Another reason was to prevent a further devaluation of the renminbi. The Chinese currency lost value, particularly during the first half of last year, not least because of ongoing capital withdrawal. This development even accelerated in the third quarter of 2016 compared to the first half of 2016. In order to curb the withdrawal of capital, the Chinese central bank introduced macro-prudential measures like a tightening of capital controls and restrictions on the use of credit cards for individuals. Furthermore, it returned to a tight control of the currency market in contrast to earlier announcements of a gradual liberalisation. Despite low inflation, China's monetary policy will, given the risks of overheating in the construction sector and the devaluation pressure on the renminbi, remain largely unchanged this year.

Figure 1.15



[a)] These indexes of adjusted outstanding amounts are calculated according to $I_t = I_{t\text{-}1}(1+F_t/L_{t\text{-}1})$, where L stands for the outstanding nominal amount of credit and F the amount of transactions (credit granted). The transactions F are calculated from differences in outstanding amounts adjusted for reclassifications, other revaluations, exchange rate variations and other changes which do not arise from transactions (see European Central Bank, 2010, for details). A specific securitisation operation in France has led to a downward level shift in mortgages in May 2014.
Source: European Central Bank, last accessed on 31 January 2017.

In the face of declining inflation rates, stable currencies and solid inflows of foreign capital, the central banks in India and Indonesia lowered their interest rates last year. The central banks of Brazil and Russia took the declining inflationary pressures and the current stability of their currencies as an opportunity to also relax monetary policy somewhat again. This year, the major emerging economies are not expected to significantly loosen their mostly already accommodative monetary policy stance any further. The danger of facing undesirable currency devaluations as a result of the turn-around in monetary policy in the United States is too high.

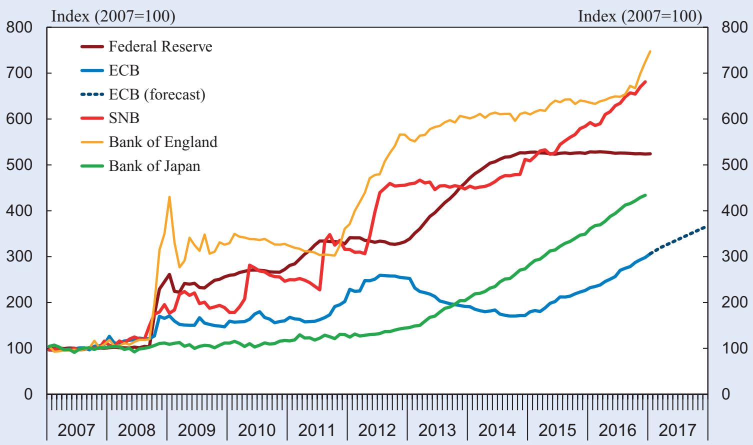
Against a background of low inflation in the euro area, the ECB kept its degree of expansion unchanged until December last year. As of March 2016, the main refinancing rate stands at 0 percent and the deposit rate is –0.4 percent. During this period monthly bond purchases have averaged 80 billion euros. In the context of this asset purchase programme, the ECB provided commercial banks with an amount of 1.532 trillion euros of central bank money by the end of December 2016. At the same time, current ECB holdings of securities for monetary policy purposes amount to a total of 1.654 trillion euros. Expansion of the ECB's balance sheet will continue. In its last meeting of 2016, the Governing Council of the ECB decided to continue its net asset purchases after March 2017 until the end of 2017, or beyond, if necessary. It will, however, reduce its monthly volume of purchases from 80 to 60 billion euros. By keeping interest rates unchanged, the ECB has therefore initiated a gradual phase-out of ultra-loose monetary policy.

Despite the substantial increase in liquidity, credit growth is only slowly picking up in the euro area. Mortgage loans have been steadily increasing for years now and consumer credit growth also returned to positive dynamics in 2015. As of 2016, loans to the corporate sector have also started growing again (see Figure 1.15). The pace at which this is happening is still modest, especially in the light of historically low interest rates and the huge amount of liquidity that the ECB is injecting into the system. In the case of Spain, the substantial reduction in the debt levels of non-financial corporations is noteworthy (see Figure 1.13). This development will support credit growth in Spain in the years to come.

In order to put the different quantitative easing programmes of the major central banks into perspective, a closer look at the development of the size of the respective central banks' balance sheets may be helpful. Although all major central banks have introduced non-standard monetary policy measures in an attempt to keep monetary policy effective despite hitting the zero lower bound, these programmes differ substantially across banks and over time. What they do have in common is that, by buying up assets, they blow up the size of the central bank's balance sheet. Whereas the Federal Reserve's balance sheet has more than quintupled through the implementation of three

Figure 1.16

Balance sheet sizes of major central banks

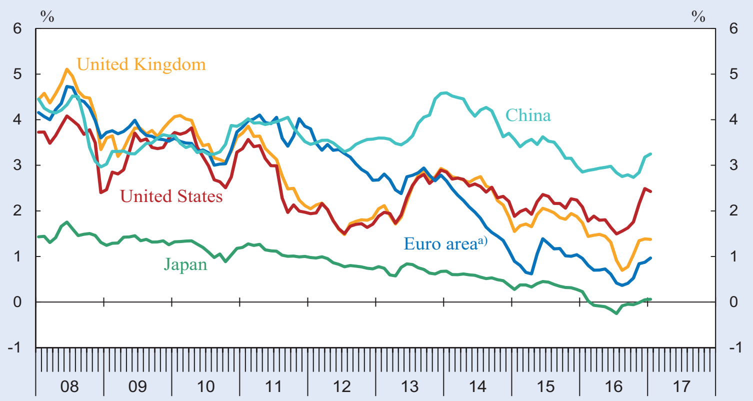


Source: Federal Reserve, Bank of Japan, European Central Bank, Bank of England, Swiss National Bank, last accessed on 31 January 2017; EEAG calculations.

quantitative easing programmes, the balance sheet of the ECB has "only" tripled so far (see Figure 1.16). Although not the first quantitative easing programme in Japan's recent history, the "quantitative and qualitative monetary easing" programme that was introduced in 2013 is the one that really took off the size of the Bank of Japan's balance sheet. Furthermore, although not introduced as quantitative easing programmes, attempts by the Swiss National Bank to circumvent an even stronger appreciation of the Swiss franc have also led to a substantial increase in its balance sheet. The recent jump in the size of the Bank of England's balance sheet reflects its decision to resume the purchase of additional government and corporate bonds and expand its liquidity to commercial banks. The aim of these measures was to mitigate possible financial turmoil and the negative short-term economic effects resulting from the Brexit referendum. In this context, it also decreased interest rates by 25 basis points last summer.

Figure 1.17

10-year government bond yields



[a)] The synthetic euro area benchmark bond refers to the weighted average yield of the benchmark bond series from each European Monetary Union member.
Source: Datastream, last accessed on 31 January 2017.

Bonds, stocks and foreign exchange markets

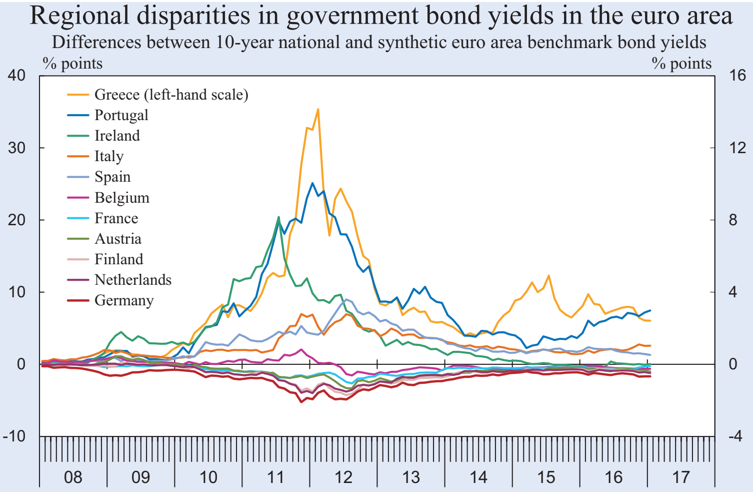
In all major economies, long-term government bond yields were lower on average in 2016 versus 2015. However, the improvement in economic activity in the United States since last summer, the stabilisation of commodity prices, associated expectations of an upturn in inflation, an anticipated increase in government spending following the election of Donald Trump as the new US president, and a reduction in taxes since August have increased US government bond yields. International interest rate linkages have transferred this turnaround to the rest of the world, where government bond interest yields have also started to increase (see Figure 1.17).

With the clear exception of Greece, government bond yields of euro area member states reached historical troughs in August last year. In Germany 10-year government bond yields even turned negative for a couple of months. However, the decline during the first eight months of 2016 in the interest rates on 10-year government bonds with the highest credit rating (AAA) was more or less nullified by the subsequent increase during the remaining four months of the year, whereby the biggest upward jump was realised in November – after the US election. Only Greece experienced a further decline; its economic outlook started to improve and perceived default risks therefore started to abate.

Within the euro area, the normalisation after the peak of the euro area crisis led government bonds with a triple-A status to witness a relative increase in their yields. This trend stopped and even reversed in 2016. At least to some extent, the increased uncertainty initiated a movement of financial capital towards quality. In Ireland, Italy and Portugal in particular country risk premiums increased again (see Figure 1.18).

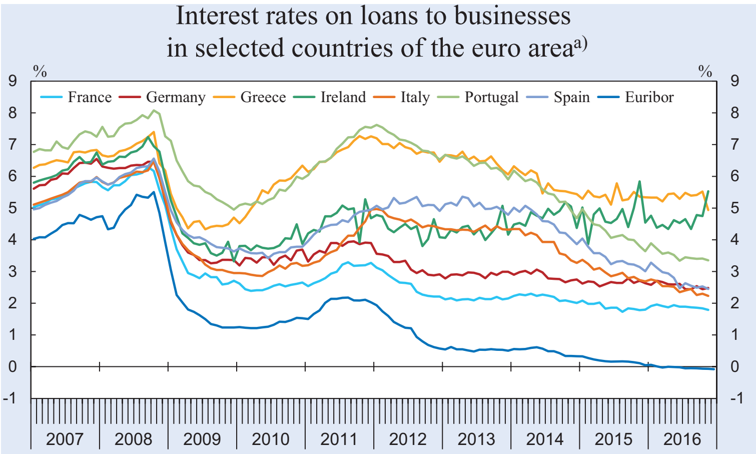
The overall funding costs of the banking sector continued to fall

Figure 1.18



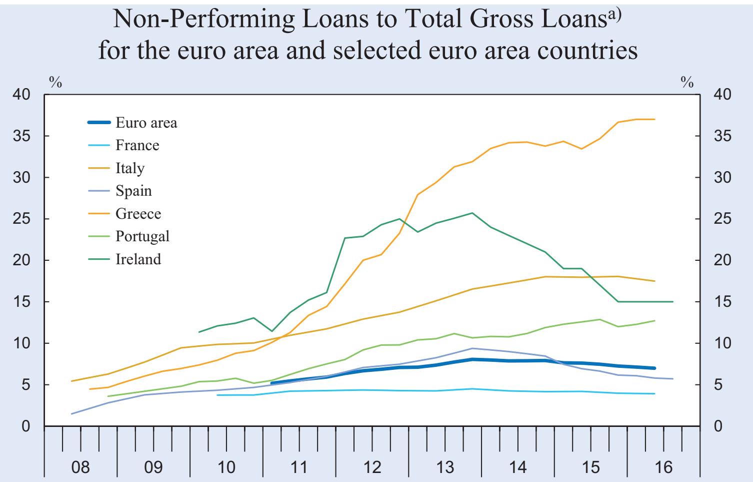
Source: Datastream, last accessed on 31 January 2017.

Figure 1.19



a) New loans to non-financial corporates up to one million euros using floating rates or up to one year initial rate fixation. The Euribor rate is based on secured interbank loans with a maturity of one year.
Source: European Central Bank, last accessed on 31 January 2017.

Figure 1.20



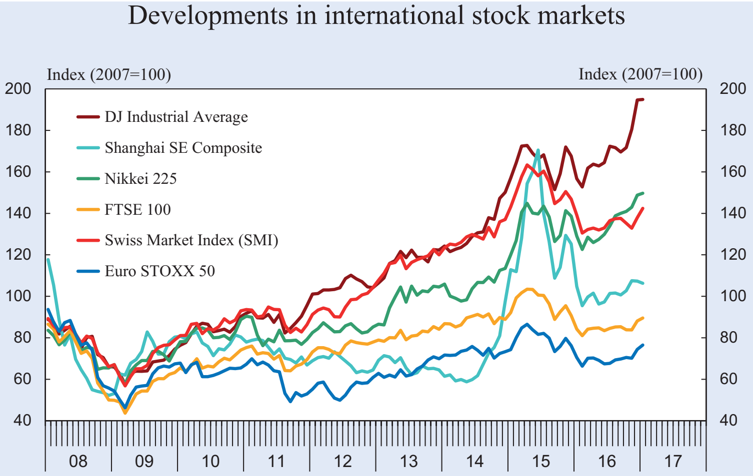
a) Due to lack of data, the euro area average is calculated without Germany and Finland.
Source: IMF, last accessed on 31 January 2017, EEAG calculations.

last year, as indicated, for instance, by a slide in the interest rate on secured interbank loans with a maturity of one year into negative territory. Almost everywhere in the euro area lower funding costs led to lower lending rates for non-financial corporations (see Figure 1.19). In countries like Italy, Portugal and Spain, the decline was too strong to solely be attributed to the reduction in interbank rates, suggesting that the creditworthiness of many companies in those countries improved; and that the supply-side constraints caused by high inventories of impaired loans may have started to abate.

Indeed for the euro area as a whole, but also for Italy and Spain, the share of non-performing loans clearly started to decline in 2016 (see Figure 1.20). The sheer share of non-performing loans in Greece and Italy is nevertheless alarming. Not without reason, concerns over Italy's banking sector have received quite some headwind in recent months. The banking sector faces mounting recapitalisation, which appears a daunting task given new EU rules effective this year that restrain the role of state intervention to support the sector, combined with a record-high public debt-to-GDP ratio in Europe.

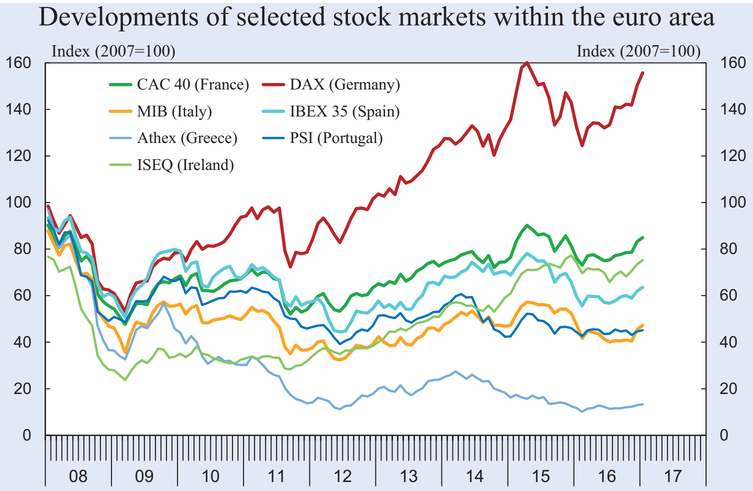
In contrast to 2015, stock markets generally showed a relatively steady upward tendency last year. After the trough reached in February 2016, all major indexes increased until the end of year with mostly two-digit rates. The US stock market in particular saw a strong increase of 21.1 percent when measured in US dollars. The appreciation of the dollar turns this increase into 27.4 percent

Figure 1.21



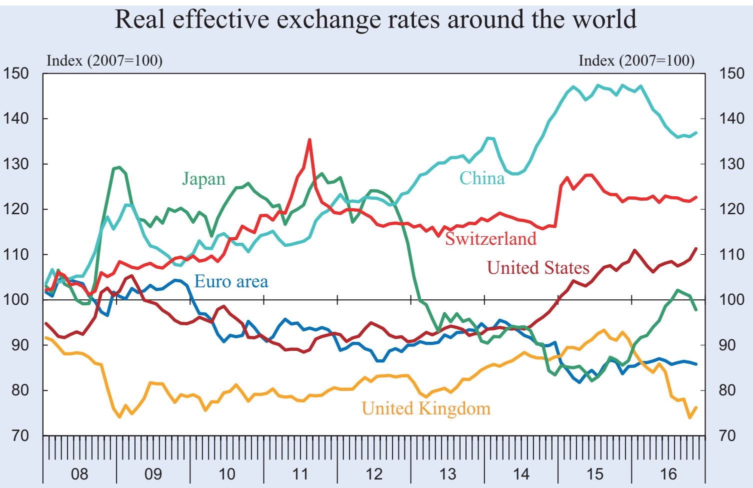
a) Stock market indexes outside the euro area are first converted into euros.
Source: Datastream, last accessed on 31 January 2017.

Figure 1.22



Source: Datastream, last accessed on 31 January 2017.

Figure 1.23



Source: Bank for International Settlements, last accessed on 12 January 2017.

when measured in euros. These increases were also double digit for the Nikkei 225, the Shanghai Stock Exchange Composite and the Euro STOXX 50, and reached, respectively 21.4, 12.4 and 12.1 percent over the same period when measured in euros (see Figure 1.21). By contrast, for the FTSE 100, the increase was a mere 8.8. This lower performance was largely due to the depreciation of the British pound.

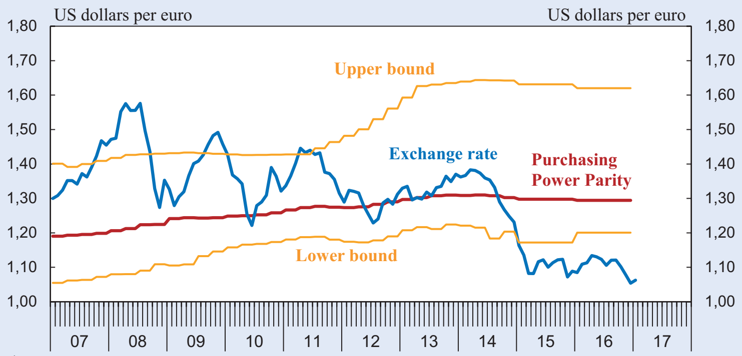
The major stock market indices within the euro area have also improved since February 2016 (see Figure 1.22). Most indices are nevertheless still well below the levels reached before the start of the financial crisis. The Greek Athex reached a new low in February, standing at only 10 percent of its pre-crisis level. Since then, it managed to increase by almost 30 percent. The German DAX performed well, approaching its peak of spring 2015 again in 2016.

Although the ECB has slowly started tapering its asset-buying programme and long-term interest rates are likely to rise further, financing conditions for the private sector will remain favourable throughout the year. The situation in the banking sector and the demand for corporate credit are likely to continue to improve.

In relative terms the real effective values of the US dollar and the euro remained quite stable throughout 2016. The US dollar only strengthened somewhat after the US election and the second interest rate increase by the Federal Reserve since the financial crisis. The Japanese yen and the Chinese renminbi, by contrast, moved substantially during 2016. The yen first reversed

Figure 1.24

Exchange rate of the euro against the US dollar and PPP[a)]



a)(PPP) is given at a quarterly frequency. The US dollar (PPP) is given at a quarterly frequency. The US dollar-euro PPP rate is calculated as the GDP-weighted average of the euro country-specific PPP estimates vis-à-vis the US dollar. The PPP upper bound represents the 90th percentile of the euro country-specific PPP estimates vis-à-vis the US dollar; the lower bound the 10th percentile. In calculating these bounds the 11 euro area member countries with the largest GDP weights are used.
Source: OECD, OECD Economic Outlook, Vol. 2016 issue 2, November, European Central Bank, last accessed on 31 January 2017.

course and gained value as compared to 2015, but lost ground again in November and December 2016. The renminbi experienced a particularly strong downward trend during the first half of 2016 (see Figure 1.23). The British pound also depreciated substantially throughout 2016.

As of November 2016, the euro again depreciated compared to the US dollar (see Figure 1.24). The prospect of even more diverging monetary policy regimes and expected fiscal stimulus in the United States has made the US dollar more attractive and the euro less so. From a purchasing power parity perspective, however, the euro has now been undervalued for two years in a row.

1.4 The macroeconomic outlook

1.4.1 Assumptions, risks and uncertainties

This forecast assumes that the Brexit negotiations between the United Kingdom and the European Union will be without noticeable distortions and that a "soft Brexit" will emerge at an early stage that will not significantly affect the current economic links between the European Union and the United Kingdom.

It is also assumed that the US government will not significantly alter, or even terminate, those free trade agreements already in force; and will not restrict its cross-border exchange of goods, services and capital with the rest of the world. In the absence of concrete plans or even decisions, it is assumed that the fiscal policy orientation of the United States will not change drastically this year. We do, however, take into account that these potential changes in US policy have already induced economic policy uncertainty and thereby affect investment and durable consumption decisions. Finally, a persistently protracted reform process is expected in Italy; and this forecast assumes that the precarious situation of the Italian banking sector does not lead to any major financial turmoil.

A major downside risk to global economic development this year is the departure of the United Kingdom from the European Union. In the run-up to the actual Brexit, the parameters of the bilateral economic relations between the United Kingdom and the European Union, as well as trade agreements with over 50 other countries that are based on EU law, have to be renegotiated. However, it is still neither clear when the formal negotiations will begin and when the Brexit will actually take place, nor are there any indications as to how the new agreements might look.[2] If, for example, these new agreements were to create new barriers to trade in goods and capital movements, there would be a noticeably negative impact on medium-term economic growth in Europe and other regions of the world. A persistently high level of uncertainty among private agents could even weigh on investment activity in the United Kingdom and the European Union this year. This could be the case if, for example, a scenario that is unfavourable for future trade emerges; or the negotiations are characterised by major impasses.

The future economic, foreign and security policy orientation of the United States has also become difficult to predict since the presidential elections; and is therefore a source of numerous both positive and negative risks to global political and economic development.

The newly-elected president has campaigned for a strong expansion of infrastructure investments in conjunction with corporate tax cuts, a markedly more protectionist trade policy, and a significant reduction

[2] At the time of writing, the High Court's decision over whether the government is allowed to issue the exit notification without an explicit act of parliament to authorise is pending. This might further delay the start of these negotiations.

in the international security policy commitment of the United States. To what extent and when such policies can be implemented is still completely uncertain. A strong increase in the degree of fiscal expansion would, for example, give the US economy a positive boost that could spill-over to the rest of the world (see Box 1.1).[3] Negative risks to the global economy are the result of a possible transition of the United States to greater protectionism in its trade policy. This would hamper world trade and reduce the potential for technological spillovers throughout much of the world. Finally, a strong reduction in US security involvement within NATO or in international crises and conflicts could increase political uncertainty and significantly dampen investment activity in many countries.

Figure 1.25

Global Economic Policy Uncertainty (EPU) is calculated as the GDP-weighted average of monthly EPU index values for the United States, Canada, Brazil, Chile, the United Kingdom, Germany, Italy, Spain, France, Netherlands, Russia, India, China, South Korea, Japan, Ireland and Australia using GDP data in current prices from the IMF World Economic Outlook Database.
Source: Baker et al. (2016), www.policyuncertainty.com, last accessed on 31 January 2017.

Another major downside risk for global economic development this year is the electoral success of populist parties in main European countries. Such parties tend to favour more protectionism in their country's external relations, or call for a thorough revision of EU treaties; and, in some cases, even for their country's withdrawal from the EU or the euro area. It cannot be ruled out that such radical political groups emerge as winners in the parliamentary elections that will take place in France, the Netherlands and probably in Italy this year. This could seriously undermine confidence in the political stability and cohesion of the European Union and would have negative economic consequences for the entire world. The economic burdens will be even more pronounced if new trade barriers were to be built within Europe, or if other countries start following the example of the United Kingdom and opting for a withdrawal from the European Union. For instance, a victory on the part of the 5 Star Movement could trigger a referendum on Italy's exit from the euro area that is likely to cause major turbulences in financial markets.

Global economic policy uncertainty has increased over the last two years, and particularly since last summer. This is confirmed by indicators based on newspaper articles in several countries as analysed by Baker et al. (2016) and published on www.policyuncertainty.com (see Figure 1.25).[4] The Brexit decision in June 2016 in the United Kingdom created a very pronounced surge in uncertainty. After a temporary decline to still historically alleviated levels in early autumn, economic policy uncertainty peaked again in November 2016. This increase was probably due to the surprising outcome of the US presidential elections. The overall higher level of uncertainty since 2016 is probably also related to the rise of populist parties in those European countries in which parliamentary elections are to be held this year.

Although numerous sentiment indicators have improved last autumn, it is still quite likely that such a higher level of economic policy uncertainty is clouding the investment moods of consumers and firms in much of the world and thereby dampening economic momentum. In a VAR analysis including real GDP, consumer prices, long-term government yield and economic policy uncertainty, Wollmershäuser et al. (2016) show for the United States, the euro area, Germany and the United Kingdom that the jump in uncertainty as sizeable as that witnessed in the United States between the third and the fourth quarter last year, i.e. an increase in economic policy uncertainty of 67 percent, is followed by a reduction in GDP between 0.3 and 0.5 percentage points during the first year after the shock. Overall, their results suggest that the recent further increase in economic uncertainty will cer-

[3] Such a short-run boost may be achieved at the cost of larger problems in the long run through a stronger accumulation of debt.

[4] The Global Economic Policy Uncertainty Index is a GDP-weighted average of national Economic Policy Uncertainty indices for 16 countries: Australia, Brazil, Canada, China, France, Germany, India, Ireland, Italy, Japan, Russia, South Korea, Spain, the United Kingdom, and the United States. Each national index reflects the relative frequency of own-country newspaper articles that contain a trio of terms pertaining to the economy, policy and uncertainty.

Box 1.1

Short-term impact of Donald Trump's election as the new US president

Economic policy was a major focus of the new US president's election campaign. During the campaign it became clear that Trump is willing to set economic policy impulses that directly influence the economic development of the United States. The large number of announced measures for tax relief for companies, deregulation of the financial sector, more protectionist trade policy, increased infrastructure investments – to name but a few cornerstones – makes it difficult to predict the economic effects. Besides setting positive impulses, these measures may also have the opposite effect: while import-substituting sectors benefit from more restrictions on trade, companies that are specialised in exports, or rely on a large proportion of imported intermediate goods for their production process, will suffer because other countries can be expected to take countermeasures. It is therefore all the more interesting to see how economic indicators have developed since the election of Donald Trump.

While share prices have declined slightly since summer, the Dow Jones rose by 8.2 percent between the election on November 8 and the end of 2016. Over the same period, 10-year government bond yields increased by 0.6 percentage points, continuing their trend reversal since July 2016. Part of the increase in November was possibly linked to the expectation (which materialised) that the Federal Reserve would make its next interest rate move in December 2016. After depreciating in the immediate run-up to the election, the US dollar clearly regained in value afterwards; in nominal terms it appreciated by 4.6 percent against the euro. Business confidence indicators continued to trend upwards. The purchasing managers' indices increased in October and continued to rise after the November election. In November and December consumer confidence rose sharply both in terms of assessments of the current situation and expectations. Economic policy uncertainty rose sharply in connection with the Brexit vote in June, but declined just as quickly in the United Kingdom. The Trump election led to a comparable surge in uncertainty. Although it also faded subsequently, uncertainty has remained at a higher level since the election. Industrial production also fell again towards the end of the year and retail sales lost momentum somewhat in November.

Overall, since the presidential election the indicators do show an improvement in sentiment among both producers and consumers, which is probably due to the expected implementation of certain future economic policy measures. At the same time, however, economic uncertainty has clearly increased, which in itself is likely to weigh on the economic prospects for the United States. Overall, the available indicators have slightly increased GDP – and so have forecasts for the United States. This is illustrated by the distribution of model projections for the fourth quarter of 2016 and the first quarter of 2017. These model projections are based on the IFOCAST approach (see Carstensen et al., 2009), in which a large variety of models are estimated. A comparison of these model projections from November (almost exclusively with indicators published before the Trump election) and December shows that their distribution has shifted slightly to the right. The median of the projected real growth rates of GDP over the previous quarter rose from 0.51 percent to 0.54 percent for the fourth quarter of 2016 and from 0.52 percent to 0.55 percent for the first quarter of 2017.

The positive effects of the anticipated expansive fiscal policy measures in the United States on the euro area can also be quantified. To this end, the Ifo-DSGE model is used (Hristov, 2016). Due to uncertainty over whether the new US government will intervene on the demand side – by increasing government expenditure – or on the supply side – through improved infrastructure or a cut in production costs through tax cuts – two alternative scenarios are simulated. The first scenario assumes that the US fiscal impulse is purely demand-driven and thus boosts overall demand in the United States. In the second scenario, the policy measures are modelled as a positive supply shock that leads to a higher supply in the United States for any given level of demand. It is assumed that the measures will be implemented in the first quarter of 2018. The fourth quarter of 2016, however, will be set as the announcement date regarding these measures. As argued above, Trump's election campaign and his subsequent election have already triggered positive expectations. The level of the shock in each respective scenario is determined in such a way that the resulting nominal effective depreciation of the euro is 0.9 percent. This corresponds to the actual change in the euro's external value against the rest of the world (i.e., a currency basket from the 36 most important trading partners) from the average of the third quarter of 2016 to the end of the fourth quarter.

Table 1.3 shows how much GDP and its growth rate differ from the baseline forecast in the United States and in the euro area in each of the two scenarios. Although the actual fiscal policy measures are taken in 2018, economic agents already react to the announcements of the newly elected US president. These announcements change the expected profitability of various investment opportunities, the expected competitiveness of different industries and the expected income of private households. At the time of announcement, all this leads to a revision of the original plans and thus to shifts in consumption, investment and production behaviour. Through the expectation channel, economic policy decisions can influence the state of an economy before their actual implementation.

Both scenarios are accompanied by higher levels of GDP and corresponding higher growth rates both in the United States and in the euro area this year already. The effect is stronger in the United States where the shocks originate. The export sector of the euro area benefits from increased demand from the United States, which is generated in each of the two scenarios. The resulting interest rate differential already allows the euro to depreciate at the announcement of the change in policy and leads to a transfer of funds from the euro area to the United States. In 2018, however, the economic development of the two scenarios differs. When the policies can be better described as demand-pull shocks, GDP is still higher in the euro area than in the baseline scenario. The opposite is true if the US economy is stimulated through a positive cost shock, as in the supply-side scenario. This is because the relative international competitiveness of the United States improves in the second scenario. This effect reaches its peak approximately three years after the announcement. Although this effect already sets in at the moment of the announcement, the negative effect on euro area GDP in 2017 is more than compensated for by the increase in US demand.

Table 1.3

Effects of alternative scenarios regarding US fiscal policy on US and euro area GDP

	Scenario 1 Demand-pull shock		Scenario 2 Cost-push shock	
	United States	Euro area	United States	Euro area
GDP effect as percentage of baseline forecast				
2017	0.5	0.1	0.5	0.1
2018	0.4	0.1	0.0	– 0.1
GDP growth deviation from baseline in %-points				
2017	0.5	0.1	0.5	0.1
2018	– 0.1	0.0	– 0.5	– 0.2

Source: Wollmershäuser et al. (2016).

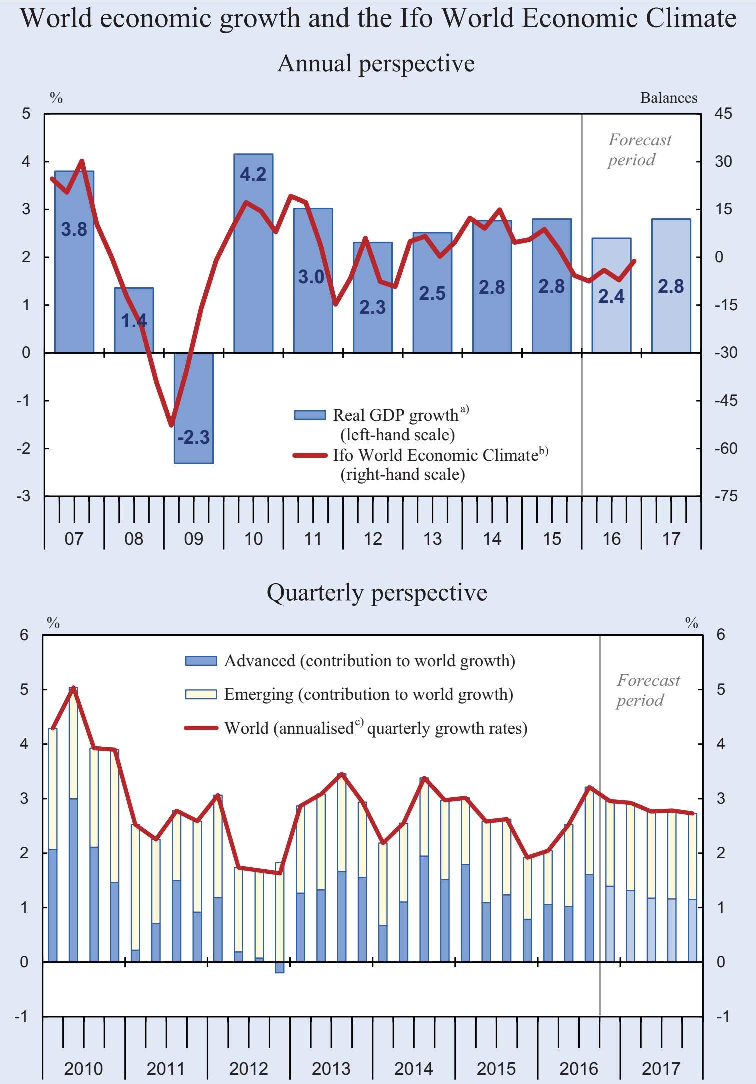
tainly have a dampening effect on overall economic expansion this year.

1.4.2 The global economy

The pace of global economic expansion is expected to have slightly decreased this winter compared to the third quarter of 2016 (see Figure 1.26). Although the results of the Ifo World Economic Survey show an upward tendency in basically all regions of the world (see Figure 1.27), political events with uncertain consequences, 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 massive increase in political uncertainty in many places. This higher uncertainty, together with the continuing slowdown in economic growth in China, is likely to dampen the expansion in global production.

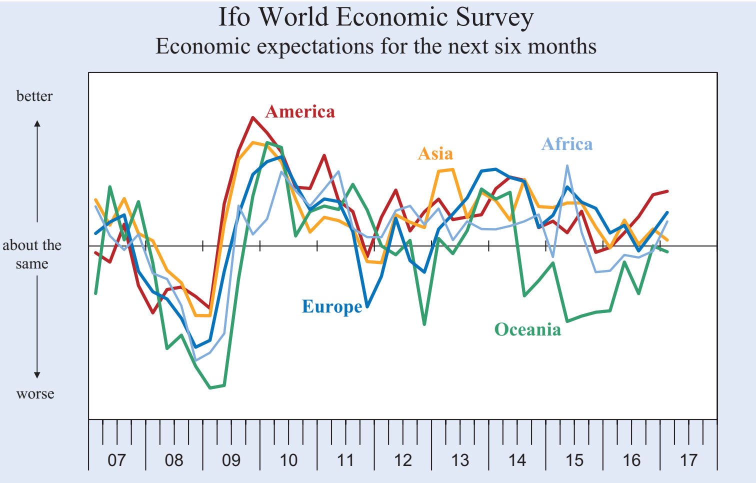
Overall, the world economy is expected to expand more than it did during the first half of 2016 during the forecast period. The growth rates are, however, expected to be only about half as high as in the years before the global financial crisis. This year, the total economic output of the world is forecast to increase by 2.8 percent (see Figure 1.28). World trade is expected to expand by 1.8 percent after 0.8 percent last year. The current accounts of most commodity-exporting emerging markets will thereby improve somewhat, while those of China and the United States are likely to deteriorate slightly in the face of relatively strong domestic economic dynamics.

Figure 1.26



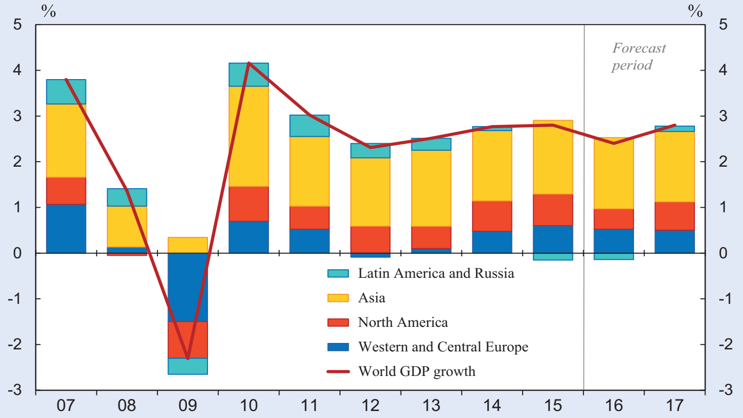
a) Countries are weighted according to previous year's nominal GDP in US dollars. b) Arithmetic mean of judgements of the present and expected economic situation. c) Growth contributions of advanced and emerging economies thereof. Countries are weighted according to previous year's nominal GDP in US dollars.
Source: IMF World Economic Outlook, October 2016; GDP 2016 and 2017: EEAG forecast; Ifo World Economic Survey I/2017.

Figure 1.27



Source: Ifo World Economic Survey I/2017.

Figure 1.28



a) Based on market weights.
Source: IMF World Economic Outlook, October 2016; EEAG calculations. 2016 and 2017: EEAG forecast.

The major economies will continue to develop heterogeneously. The US economy will continue to grow 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. The euro area economy is still characterised by the massive structural weaknesses of some member countries, as indicated by, for example, the large volume of non-performing loans on bank balance sheets in Greece, as well as in Italy and Portugal; and the lack of competitiveness of the French and Italian economies. Accordingly, the recovery will continue, albeit at a moderate pace despite the ECB's extremely accommodating monetary policy. Although monetary policy is highly expansionary and fiscal policy will be supportive until at least the second half of 2017, Japan is also only expected to expand moderately. The stimulus from monetary and fiscal policy is offset by the burden of structural factors such as a shrinking labour force, a rising old-age dependency ratio and tight immigration controls.

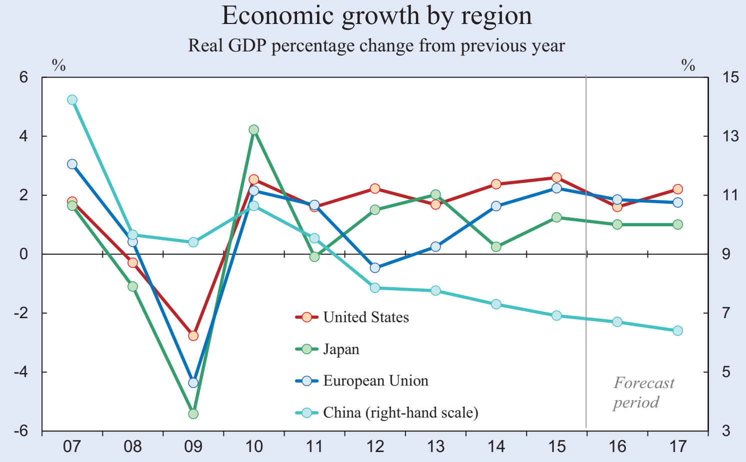
The pace of expansion in emerging markets will gradually slow down over the forecast period, although monetary policy was relaxed somewhat recently in many places. In view of the higher oil prices and the slight recovery of prices of other raw materials, Brazil and Russia will probably pull out of recession in the course of this year. India is also likely to expand rapidly. However, these positive impulses are offset by forces that are preventing a significant economic upturn. The decline in economic growth in China will probably continue. The driving forces here are the declining pool of potential employees, as well as the slowdown of capital accumulation and the gradual reduction of the macroeconomic productivity growth associated with increasing stages of development. In order to achieve its growth target of 6.5 to 7 percent per year, the Chinese economy will need to perform a balancing act between expansionary and contractionary measures. It is probable that those sectors in which a cooling emerges will be supported, while those sectors that risk overheating will be exposed to contractionary economic policy interventions. Finally, rising interest rates in the United States are likely to negatively impact financing conditions in emerging economies. Growth in these emerging markets is nevertheless twice as high as that in advanced economies.

1.4.3 United States

The US economy is likely to pick up again this year. Supported by high real wage growth and good labour market prospects, private consumption expenditure will be particularly strong. Exports are expected to generate some positive impulses. Currently, sentiment indicators point towards an increase in new export orders. On the other hand, hardly any impetus is expected from gross fixed capital formation. A slowing rise in house prices and stagnating building permits since the beginning of last year indicate weak construction activity, while the shrinking order books for investment goods indicate a continuing moderate development in equipment investment. The uncertainty about the economic policy impact of the unexpected outcome of the presidential elections last November should also have a negative impact on investment activity. For the current year, GDP is forecast to grow by 2.2 percent (see Figure 1.29).

Last year's change in consumer prices amounted to 1.2 percent and core inflation without energy and unprocessed food was 2.2 percent. The expiring base effects of earlier energy price reductions are expected to accelerate headline inflation to 1.8 percent in 2017. Rising inflation, good employment prospects and the absence of distortions in the financial markets after the presidential election should allow the US Federal Reserve to increase the federal funds rate to 1.25 percent by the end of the year.

Figure 1.29



Source: US Bureau of Economic Analysis; Eurostat; ESRI; National Bureau of Statistics of China. 2016 and 2017: EEAG forecast.

1.4.4 Asia

The economic growth target of *China* is expected to remain at the current range of between 6.5 and 7.0 percent, while monetary and fiscal policies will likely remain accommodative. Uncertainty rests on the political and thereby economic relationship between the two economically largest countries in the world, the United States and China. The newly elected US president has made several statements, like questioning the "One-China" policy that might lead to a severe cooling down of economic ties. Although China is moving away from its traditional export-led growth strategy, it remains the world's biggest trading nation along with the United States with an export share of 18 percent. The economy will moderate next year on the back of a cooling housing market and a slow, but steady domestic economic rebalancing, though the impact of these factors will be cushioned by the policy support cited above and somewhat stronger global growth.

The recent weakening of the *Japanese* yen following Donald Trump's victory in the US presidential election, together with a modest pick-up in global growth, are supporting Japanese exports and have enabled its economy to make a fairly strong start to the year. On the downside, low wage growth continues to constrain private consumption. As a result, the government is encouraging salary increases and intends to rein in social security costs to boost the country's workforce. Moreover, it has approved a supplementary budget to finance earthquake reconstruction and additional military spending. As a result of a fiscal stimulus program adopted in August last year, public investment is expected to grow temporarily. For this year a growth rate of 1.0 percent is forecast.

In *India*, after the government's announcement of plans to replace the two largest banknotes as legal tender with new notes in November last year, a cash shortage has emerged in the country, and economic momentum faltered, especially in the cash-oriented services sector. The demonetisation is likely to have caused consumers to postpone non-essential purchases. However, supported by a central bank that will continue its stability-oriented course, these effects are expected to be transient and the economy is likely to get back on track. Real GDP growth of 7.3 percent is forecast for 2017.

For the East Asian region as a whole (*South Korea, Indonesia, Taiwan, Thailand, Hong Kong, Malaysia, Singapore* and the *Philippines*) some increase in economic growth is expected. Differences across the individual countries are, however, substantial. Whereas Indonesia, Thailand and the Philippines will witness some acceleration in growth, the economies of Korea, Taiwan, Hong Kong, Malaysia and Singapore face another slight decline, initially at least. The expected pick-up in global trade, together with robust developments in China and India, will in principle support growth in all countries of this region. However, this effect is partly muted by increased global uncertainty, largely originating from a possible increase in trade protectionism triggered by the upcoming US administration and the US interest rate normalisation. The latter could trigger a downturn in the housing market of Hong Kong, for instance. Political uncertainty in South Korea, combined with highly indebted households and problems in some of Korea's flagship industries, will also prevent strong growth in the largest country within this group. On the other hand, households have benefited from low inflation and loosening monetary policy conditions in most of these countries, which will allow domestic demand to gain some steam this year. The firming up of commodity prices (in the cases of Indonesia and Malaysia) and further fiscal stimulus measures (in Indonesia, Thailand and the Philippines) will also support growth. All in all, real GDP is expected to grow by 4.2 percent in these East Asian countries this year.

1.4.5 Latin America and Russia

In 2017, the Latin American region, i.e. *Brazil, Mexico, Argentina, Venezuela, Colombia* and *Chile*, is expected to grow by 1.2 percent. Although in Brazil consumer confidence and business climate have improved significantly in recent months, the ongoing consolidation of public finances and the outflow of capital are expected to continue to dampen economic activity in the coming quarters. The largest economy of this region should nevertheless pull out of recession this year. Argentina is also expected to return to positive growth this year. Whereas Brazil and Argentina are slowly recovering, the Mexican economy has experienced a clear weakening of its growth prospects. Mexico is probably the country to be most heavily affected by any potential changes in US migration and trade policies. The fiscal impulses that the new US administration may set through tax cuts and additional infrastructure spending are not likely to fully compensate for these adverse effects. Although the recovery in oil prices is, in principle, supporting the economy of Venezuela, the country is nevertheless in a tailspin of economic, social and political chaos. Its economy has been contracting since 2014 and is not expected to grow anytime soon. In Colombia, on the other hand, the oil price recovery and the recently reached peace agreement could reignite growth by supporting tourism, oil exploration and foreign direct investment. Chile's economy is also expected to accelerate marginally in 2017.

Russia will exit its recession this year. Business survey and industrial production data signal a strengthening of economic activity this winter. The increase in commodity prices is supporting the economy. On the other hand, fiscal consolidation, which intends to drastically reduce the fiscal deficit through higher taxes on the extraction of minerals and oil, dividend distributions from state-owned enterprises and higher consumption taxes, is constraining Russia's path towards recovery. Real GDP is expected to increase by 0.8 percent in 2017.

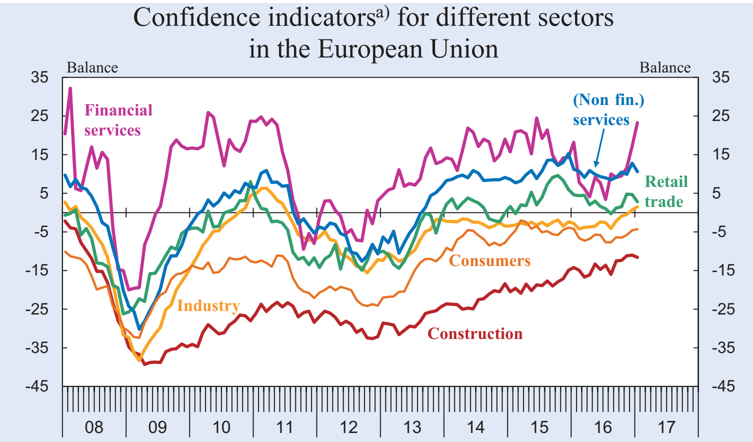
1.4.6 The European economy

The cyclical situation

The noticeable increase in a variety of leading indicators for the euro area in recent months – after some decline in the previous months – points to some acceleration in economic momentum during the winter months (see Figure 1.30). Real GDP in the fourth quarter of 2016 and the first quarter of 2017 is expected to slightly outpace the previous two quarters. Growth rates are then expected to weaken gradually (see Figure 1.31). The positive effects of the fall in oil prices and the euro depreciation in late 2014 and early 2015 are slowly phasing out. Overall, this will result in a slight decline in the annual growth rates for both the European Union and the euro area to 1.8 and 1.6 percent respectively.

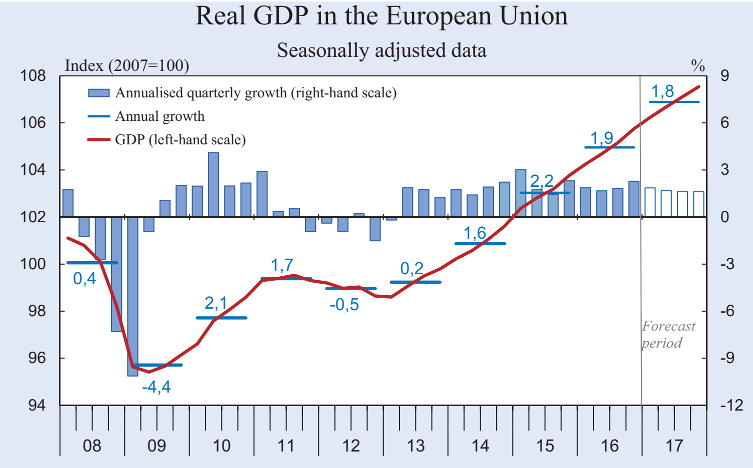
The fact that structural reforms are only being implemented slowly in some member countries speaks against a faster recovery of the European economy. Labour markets that are still characterised by high structural unemployment rates in many places, but also by the sluggish improvement in price competitiveness in some of the crisis-hit countries, are hindering stronger growth. The high level of economic policy uncertainty is also having a clearly dampening effect, as measured by an index based on newspaper articles (www.policyuncertainty.com). Last year the index stood even at a higher level than during the peak of the euro crisis in 2011. This recent rise in uncertainty is largely due to the forthcoming Brexit negotiations, the implications of the new presidency in the United

Figure 1.30



[a)] Arithmetic means of selected (seasonally adjusted) balances on business and consumer tendency survey questions. Balances are constructed as the difference between the percentages of respondents giving positive and negative replies.
Source: European Commission, last accessed on 31 January 2017.

Figure 1.31

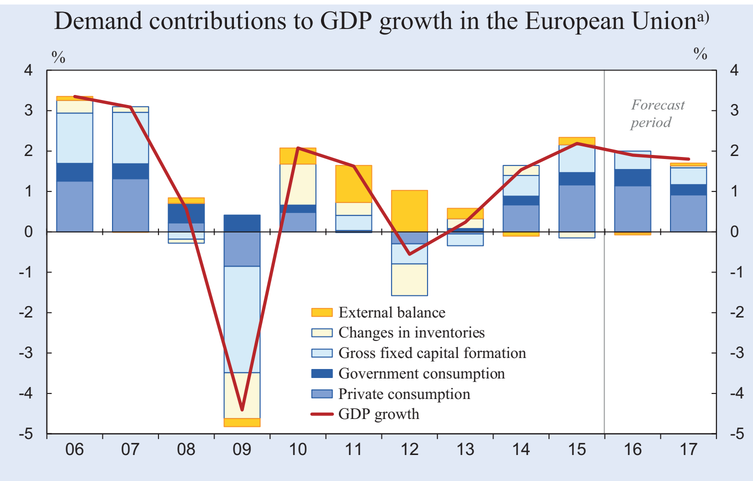


Source: Eurostat; EEAG calculations and forecast.

States, as well as the outcomes of a series of parliamentary elections in member states in 2017. The three largest euro area member countries, Germany, France and (perhaps) Italy, will hold elections. In the fourth largest economy, Spain, the weak minority government that has recently been installed is unlikely to complete its term, while elections are also scheduled in the Netherlands. In each case, populist and thereby Eurosceptic parties are likely to gain growing power, with unknown consequences. The lack of policy guidance from the United Kingdom and the United States complement the uncertain political prospects.

The nevertheless ongoing economic recovery is still mainly driven by developments in private consumption. 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. In principle, government consumption will continue to expand. However, reduced refugee flows will facilitate a decline in related government spending in some countries. This will reduce overall growth rates in government spending as compared to previous years. Gross fixed investment – as compared to previous upswings – is expected to contribute far less than normal to overall economic development. The lower than usual interest rate environment does not seem to fully compensate for the low medium-term growth prospects in a number of countries, and the high level of political and economic uncertainty that is still around. The latter are likely to deter companies from expanding investments. The forecasted global recovery and the weaker euro are allowing exports to grow slightly faster than last year. Exports to the United States in particular are likely to pick up gradually. The increase in the value of the US dollar relative to the euro in recent months makes it attractive for US firms and consumers to import goods and services from the euro area. However, since imports into the euro area are also expected to grow somewhat more strongly, the growth contribution of net exports will remain modest and significantly short of the figures in previous recoveries (see Figure 1.32).

Figure 1.32

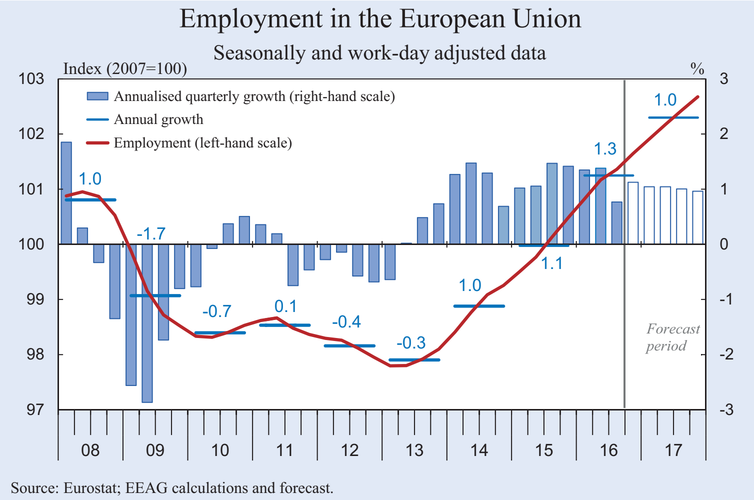


[a)] Gross domestic product at market prices (prices of the previous year). Annual percentage change.
Source: Eurostat; EEAG calculations and forecast.

In this upward spiral, the recovery will allow for the further creation of additional jobs (see Figure 1.33). Although employment growth will not reach the rates seen a year ago, they are still sufficient to further slowly reduce the overall unemployment rate in both the European Union and the euro area to an average of 8.3 and 9.7 percent respectively (see Figure 1.34 and Table 1.A.2).

With oil prices having risen last year instead of falling as in 2015, consumer prices are expected to rise particularly during the first months of 2017. In line with the ongoing recovery that will lead to a further reduction of the output

Figure 1.33



Source: Eurostat; EEAG calculations and forecast.

equipment investment will continue to expand below average as compared to previous recoveries. The main reasons for this weak performance are slow growth in developing sales prospects in many foreign markets and unusually high uncertainty over the future course of economic policy of important trading partners. Residential investment, by contrast, is still benefiting from the favourable interest rate environment and the large number of people searching for a home. Foreign trade is not expected to contribute significantly on aggregate, as exports and imports will continue to expand at similar rates. All in all, total economic output will grow by 1.8 percent in 2017 (see Figure 1.35).

gap during the year, core inflation will also pick up. The inflation rate should therefore gradually approach the ECB's inflation target and on average amount to 1.4 percent this year in the euro area and 1.5 percent in the European Union.

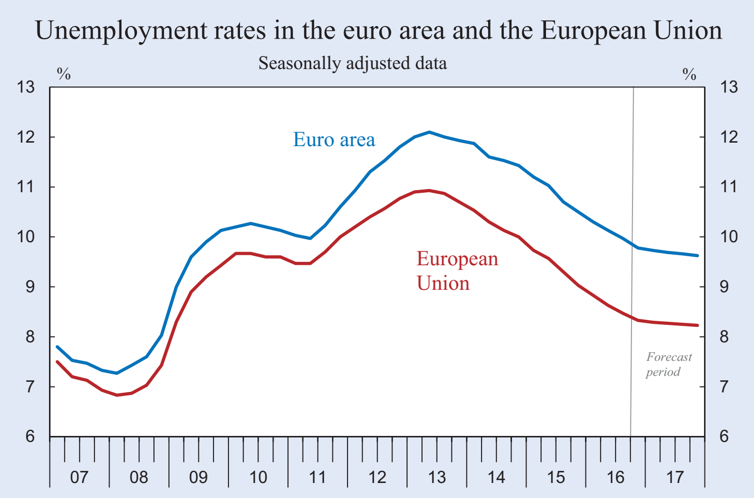
Differences across Europe

The moderate upswing in *Germany* is expected to continue this year at a similar pace as last year. It will mainly be driven by domestic demand. Private consumption growth remains strong and is supported by higher wages, increasing transfer income and increasing employment. The hitherto primarily migration-driven public consumption, however, is losing momentum as the influx of people seeking help is expected to fall and will increasingly be granted financial support instead of benefits in kind. Machinery and

Employment remains directed upward. The level of unemployment, however, will be influenced by refugees entering the labour market. The annual average 2017 unemployment rate is expected to remain at about the level of last year, i.e. 4.2 percent.

This year, domestic inflation pressure will increase. The dampening impulse from oil prices that dominated inflation dynamics last year will also disappear. Taken together, the annual average 2017 consumer price level is expected to increase by 1.6 percent after 0.3 percent last year. Average core inflation is expected to rise from 1.2 to 1.4 percent this year.

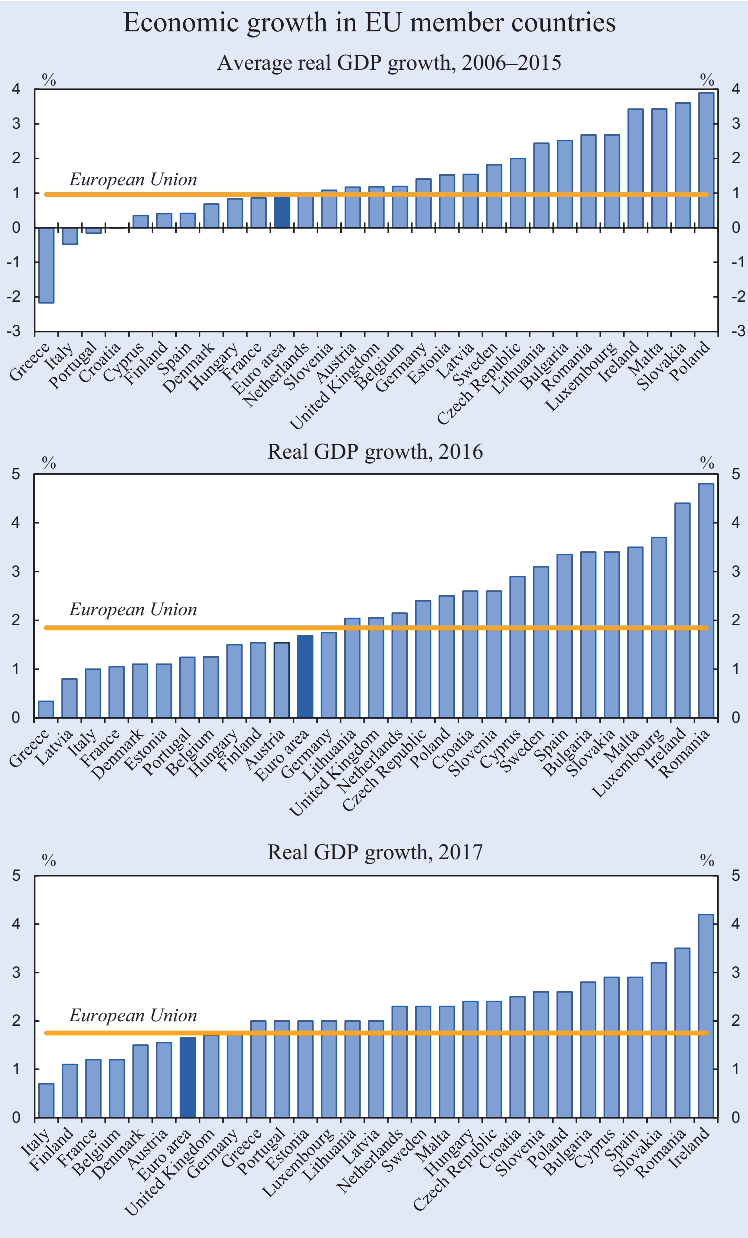
Figure 1.34



Source: Eurostat; EEAG calculations and forecast.

For *France*, the available indicators will point to a slight acceleration in economic momentum in the quarters ahead, not least due to improved consumer sentiment regarding the future economic situation. Consumption is therefore likely to remain the main source of growth in France. Machinery and equipment investment will overcome its temporary weakness, but there are no signs that the high growth rates of the second half of 2015 will be reached again. No impetus is to be expected from foreign trade, as the pick-up in global demand is only mar-

Figure 1.35



Source: Eurostat, last accessed on 31 January 2017. 2016 and 2017: EEAG forecast.

ginal and the French economy has last year lost part of its (previously obtained) price competitiveness again. Overall, GDP growth is projected at 1.3 percent for this year. As the output gap will only close slowly, underlying price dynamics will remain low. Due to energy prices, this year's inflation rate is expected to rise to an average of 1.3 percent.

Although the negative effects of the Brexit decision in the *United Kingdom* are far less pronounced than initially feared, companies are nevertheless likely to postpone long-term projects due to the uncertainty about the future shape of the relationship with the EU and the associated future attractiveness of the United Kingdom as a production location. Some slowdown in the manufacturing sector is already visible. In particular, the order intake for machines has declined noticeably lately and capacity utilisation has decreased. Low unemployment, however, is expected to initially keep private consumption robust. Rising inflation due to the sharp depreciation of the British pound and the rise in energy prices will, on the other hand, supress real disposable incomes. This effect will become more important over the course of the year. Devaluation does support foreign trade. Finally, the economy will continue to be supported by expansive fiscal and monetary policy this year. All in all, the effects of the referendum will be noticeable and GDP will increase by 1.7 percent, as compared to the previous year's slightly reduced rate of 2.1 percent. Inflation is expected to increase to 2.0 percent due to higher import prices.

The *Italian* economy is the main reason why the recovery in the euro area is not taking off quicker. The growth rate of real GDP in Italy is likely to be less than half as high as in the euro area as a whole. The Italian banking sector has been burdened by a high proportion of non-performing loans for several years. Some Italian banks are therefore facing enormous solvency problems and a sustainable solution is not yet in sight. The sharp increase in the Target liabilities of Italy in recent months suggests that there has recently been a massive withdrawal of capital from the Italian banking system similar to the capital flight seen in 2011 and 2012 (see EEAG, 2012, Ch. 2; and EEAG, 2013, Ch.2).

The downward trend in sentiment indicators in Italy that began last year seems to have ground to a halt. At present, most indicators are still standing just above their long-term average, suggesting a weak, but positive expansion in production. However, the political uncertainty behind the failed Constitutional referendum and Italy's lower attractiveness for investment as a result of the anticipated stagnation in reforms are having a negative impact. Real GDP is expected to grow by only 0.7 percent. The value added tax increase of two percentage points that has been postponed to January 2018 may lead to higher consumption growth towards the end of 2017 if it is not postponed again in the next budget. In the quarters ahead, economic stimulus will, however, mainly come from the recovery of the euro area.

The *Spanish* economy will continue to recover with growth rates well above the European average. However, its rate of expansion will moderate somewhat as the beneficial effects of a weak euro and low oil prices dissipate. The economy is expected to grow by 2.9 percent in 2017 and exceed the production level last seen before the financial crisis hit Spain. This strong performance will allow unemployment to continue its downward trend and reach an average rate of 18.8 percent this year.

After Ireland, Portugal and Cyprus, *Greece* will also finally pull out of its GDP trough and start growing again. After basically stagnating since 2013, the Greek economy is forecast to grow by 2.0 percent and thereby keeping pace with *Portugal*. The recovery of the economies of *Cyprus* and *Ireland* remains on an even faster track with growth rates of 2.9 and 4.2 percent respectively.

The economies in the *Central and Eastern European* region will continue to grow at about the same pace as last year. Some stimuli in foreign trade are to be expected from the ongoing recovery in the euro area and the end of the recession in Russia. Positive impulses are expected from domestic demand in all countries of the region. The decline in unemployment and still low (but rising) inflation will support consumers' purchasing power. Historically low interest rates will also continue to support investment dynamics in the region.

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Appendix 1.A
Forecasting Tables

Table 1.A.1

GDP growth, inflation and unemployment in various countries

	Share of total GDP in %	GDP growth			CPI inflation			Unemployment rate[d)]		
		in %						in %		
		2015	2016	2017	2015	2016	2017	2015	2016	2017
Industrialised countries:										
EU-28	27.4	2.2	1.9	1.8	0.0	0.3	1.5	9.4	8.6	8.3
Euro area	20.1	2.0	1.7	1.6	0.0	0.2	1.4	10.9	10.1	9.7
Switzerland	1.0	0.8	1.3	1.6	– 1.1	– 0.4	0.3	3.2	3.3	3.1
Norway	0.7	1.6	0.6	1.2	2.2	3.5	2.3	4.4	4.8	4.8
Western and Central Europe	29.1	2.1	1.8	1.7	0.0	0.3	1.5	9.2	8.4	8.1
US	25.7	2.6	1.6	2.2	0.1	1.2	1.8	5.3	4.9	4.8
Japan	6.8	1.2	1.0	1.0	0.5	– 0.4	0.3	3.4	3.1	2.8
Canada	2.6	0.9	1.3	2.1	1.6	1.7	2.0	6.9	7.0	6.7
Industrialised countries (total)	**64.3**	**2.2**	**1.6**	**1.9**	**0.2**	**0.7**	**1.5**	**7.0**	**6.4**	**6.2**
Newly industrialised countries:										
Russia	3.0	– 3.7	– 0.5	0.8	12.9	6.0	5.0	.	.	.
China	15.3	6.9	6.7	6.4	1.5	2.0	2.2	.	.	.
India	3.0	7.3	7.4	7.3	4.9	5.1	5.0	.	.	.
East Asia[a)]	6.6	3.9	3.7	4.2	2.5	2.0	2.6	.	.	.
Latin America[b)]	7.8	– 0.5	– 1.6	1.2	16.2	34.8	30.2	.	.	.
Newly industrialised countries (total)	**35.7**	**3.9**	**3.8**	**4.5**	**6.1**	**9.8**	**8.9**	.	.	
Total[c)]	**100.0**	**2.8**	**2.4**	**2.8**	.	.	.	.	.	.
World trade, volume		2.0	0.8	1.8	.	.	.	.	.	.

[a)] Weighted average of Indonesia, Korea, Malaysia, Taiwan, Thailand, Philippines, Singapore and Hong Kong. Weighted with the 2014 levels of GDP in US dollars. – [b)] Weighted average of Brasil, Mexico, Argentina, Venezuela, Colombia, Chile. Weighted with the 2013 level of GDP in US dollars. – [c)] Weighted average of the listed groups of countries. – [d)] Standardized unemployment rate.

Source: EU, OECD, IMF, ILO, National Statistical Offices, CPB, 2016 and 2017: forecasts by the EEAG.

Table 1.A.2

GDP growth, inflation and unemployment in the European countries

	Share of total GDP in %	GDP growth[a] in %			Inflation[b] in %			Unemployment rate[c] in %		
		2015	2016	2017	2015	2016	2017	2015	2016	2017
Germany	20.8	1.7	1.8	1.8	0.1	0.3	1.6	4.6	4.2	4.2
France	15.6	1.3	1.1	1.2	0.1	0.3	1.3	10.4	10.0	9.6
Italy	12.0	0.7	1.0	0.7	0.1	– 0.1	1.0	11.9	11.6	11.1
Spain	7.8	3.2	3.3	2.9	– 0.6	– 0.4	1.3	22.1	19.8	18.8
Netherlands	4.8	2.0	2.1	2.3	0.2	0.1	1.4	6.9	6.0	5.4
Belgium	2.9	1.5	1.2	1.2	0.6	1.7	2.1	8.5	8.0	7.7
Austria	2.4	1.0	1.5	1.6	0.8	1.0	1.9	5.7	6.0	5.8
Finland	1.5	0.2	1.5	1.1	– 0.2	0.4	1.1	9.4	8.9	8.5
Greece	1.3	– 0.2	0.3	2.0	– 1.1	0.0	0.5	24.9	23.5	22.9
Ireland	1.3	26.3	4.3	4.2	0.0	– 0.2	0.9	9.4	7.9	7.3
Portugal	1.3	1.6	1.3	2.0	0.5	0.6	1.1	12.6	11.2	10.6
Slovakia	0.5	3.8	3.4	3.2	– 0.3	– 0.5	0.9	11.5	9.7	9.1
Slovenia	0.3	2.3	2.6	2.6	– 0.8	– 0.1	1.3	9.0	7.9	7.6
Luxembourg	0.3	3.5	3.8	2.0	0.1	0.0	1.0	6.5	6.3	5.6
Lithuania	0.3	1.8	2.3	2.2	– 0.7	0.6	1.6	9.1	8.0	7.6
Latvia	0.2	2.7	0.8	2.0	0.2	0.0	1.6	9.9	9.7	9.5
Cyprus	0.1	1.7	2.8	2.9	– 1.5	– 1.2	0.2	15.0	13.3	12.9
Estonia	0.1	1.4	1.0	2.0	0.1	0.7	2.0	6.2	6.9	7.2
Malta	0.1	7.4	3.5	2.3	1.2	0.9	1.2	5.4	4.9	4.7
Euro area[d]	73.5	**2.0**	**1.7**	**1.6**	**0.0**	**0.2**	**1.4**	**10.9**	**10.1**	**9.7**
United Kingdom	14.9	2.2	2.1	1.7	0.0	0.6	2.0	5.3	4.9	4.9
Sweden	3.2	4.1	3.1	2.3	0.7	1.1	2.0	7.4	6.9	6.4
Denmark	1.9	1.6	1.1	1.5	0.2	0.0	0.9	6.2	6.2	6.3
EU-22[d]	93.5	**2.1**	**1.8**	**1.7**	**0.0**	**0.3**	**1.5**	**9.8**	**9.1**	**8.8**
Poland	2.9	3.9	2.5	2.6	– 0.7	– 0.2	1.2	7.5	6.3	5.8
Czech Rpublic	1.2	4.5	2.4	2.4	0.3	0.6	1.4	5.1	4.0	3.9
Romania	1.1	3.9	4.8	3.5	– 0.4	– 1.1	0.9	6.8	6.0	5.6
Hungary	0.7	3.1	1.5	2.4	0.1	0.4	1.7	6.8	5.1	4.7
Croatia	0.3	1.6	2.6	2.5	– 0.3	– 0.8	1.1	16.3	12.7	12.0
Bulgaria	0.3	3.6	3.4	2.8	– 1.1	– 1.3	0.7	9.2	7.6	7.1
New Members[e]	7.9	**3.6**	**2.7**	**2.7**	**– 0.4**	**– 0.2**	**1.2**	**7.8**	**6.6**	**6.2**
EU-28[d]	100.0	**2.2**	**1.9**	**1.8**	**0.0**	**0.3**	**1.5**	**9.4**	**8.6**	**8.3**

[a] GDP growth rates are based on the calender adjusted series except for Ireland, Slovakia and Romania for which EUROSTAT does not provide working-day adjusted GDP series. – [b] Harmonised consumer price index (HICP). – [c] Standardised unemployment rate. – [d] Weighted average of the listed countries. – [e] Weighted average over Slovakia, Slovenia, Lithuania, Latvia, Estonia, Poland, the Czech Republic, Romania, Hungary, Croatia and Bulgaria.

Source: EUROSTAT, 2016 and 2017: forecasts by the EEAG.

Table 1.A.3

Key forecast figures for the European Union

	2015	2016	2017
	Percentage change over previous year		
Real gross domestic product	2.2	1.9	1.8
Private consumption	2.1	2.1	1.6
Government consumption	1.4	1.9	1.2
Gross fixed capital formation	3.5	2.3	2.1
Exports of goods and services	6.2	2.7	3.7
Imports of goods and services	6.2	3.4	4.0
Net exports[a)]	0.2	0.0	0.1
Consumer prices[b)]	0.0	0.3	1.5
	Percentage of nominal gross domestic product		
Government fiscal balance[c)]	– 2.4	– 2.0	– 1.7
	Percentage of labour force		
Unemployment rate[d)]	9.4	8.6	8.3

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2016 and 2017: forecasts of the European Commission. – [d)] Standardised unemployment rate.

Source: Eurostat; 2016 and 2017: forecasts by the EEAG.

Table 1.A.4

Key forecast figures for the euro area

	2015	2016	2017
	Percentage change over previous year		
Real gross domestic product	2.0	1.7	1.6
Private consumption	1.8	1.7	1.4
Government consumption	1.4	1.9	1.2
Gross fixed capital formation	3.2	2.9	2.8
Exports of goods and services	6.5	2.4	3.5
Imports of goods and services	6.4	3.1	4.1
Net exports[a)]	0.3	– 0.1	0.0
Consumer prices[b)]	0.0	0.2	1.4
	Percentage of nominal gross domestic product		
Government fiscal balance[c)]	– 2.1	– 1.8	– 1.5
	Percentage of labour force		
Unemployment rate[d)]	10.9	10.1	9.7

[a)] Contributions to changes in real GDP (percentage of real GDP in previous year). – [b)] Harmonised consumer price index (HCPI). – [c)] 2016 and 2017: forecasts of the European Commission. – [d)] Standardised unemployment rate.

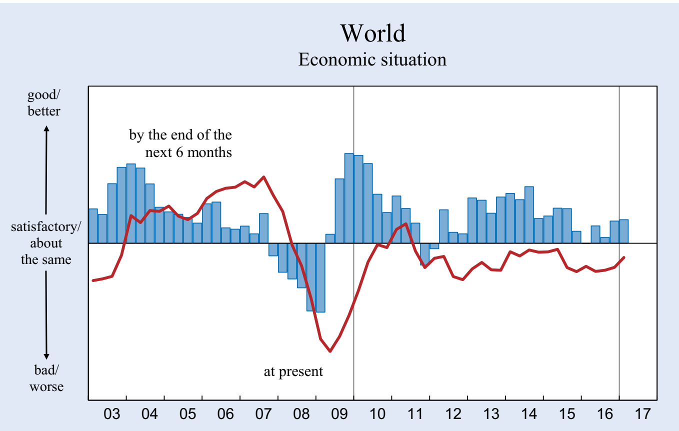
Source: Eurostat; 2016 and 2017 forecasts by the EEAG.

Appendix 1.B
Ifo World Economic Survey (WES)

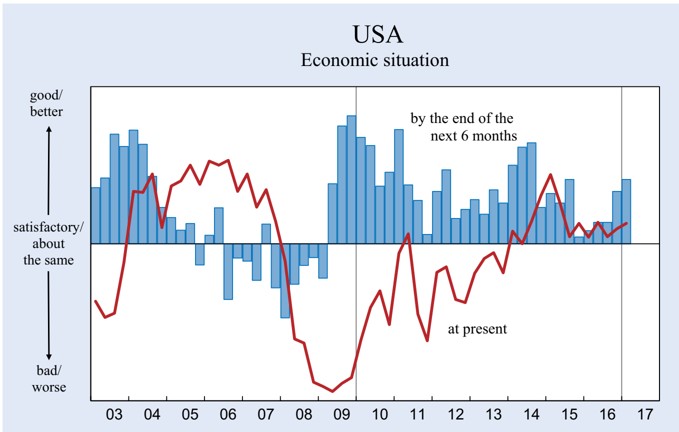
The Ifo World Economic Survey (WES) assesses worldwide economic trends by polling transnational as well as national organisations worldwide about current economic developments in the respective country. This allows for a rapid, up-to-date assessment of the economic situation prevailing around the world. In January 2017, 1,147 economic experts in 118 countries were polled.

The survey questionnaire focuses on qualitative information: on assessment of a country's general economic situation and expectations regarding important economic indicators. It has proved to be a useful tool, since economic changes are revealed earlier than by traditional business statistics. The individual replies are combined for each country without weighting. The "grading" procedure consists in giving a grade of 9 to positive replies (+), a grade of 5 to indifferent replies (=) and a grade of 1 to negative (–) replies. Grades within the range of 5 to 9 indicate that positive answers prevail or that a majority expects trends to increase, whereas grades within the range of 1 to 5 reveal predominantly negative replies or expectations of decreasing trends. The survey results are published as aggregated data. The aggregation procedure is based on country classifications. Within each country group or region, the country results are weighted according to the share of the specific country's exports and imports in total world trade.

Ifo World Economic Survey (WES)



Source: Ifo World Economic Survey (WES) I/2017.



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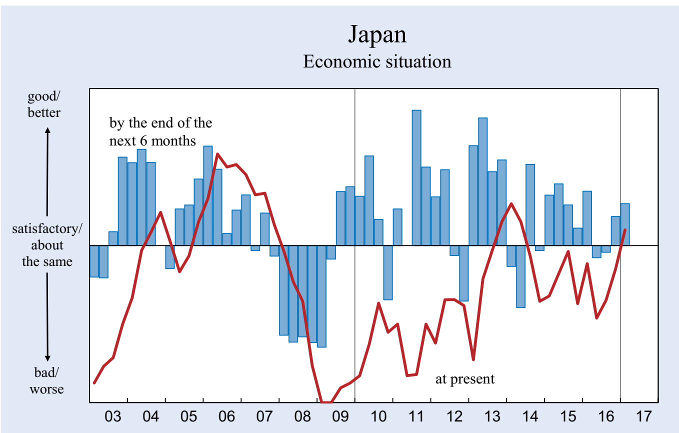
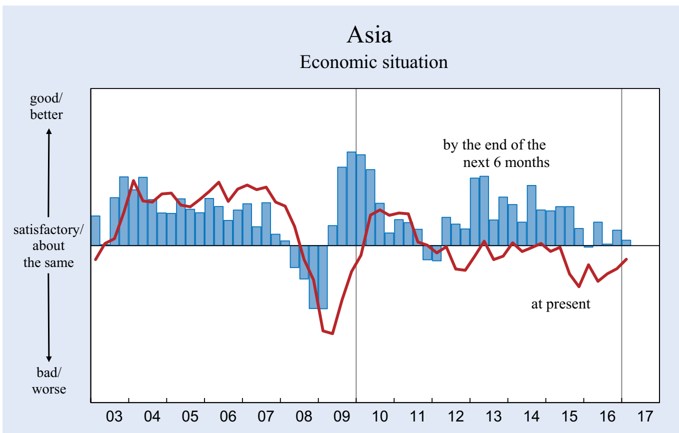


Source: Ifo World Economic Survey (WES) I/2017.

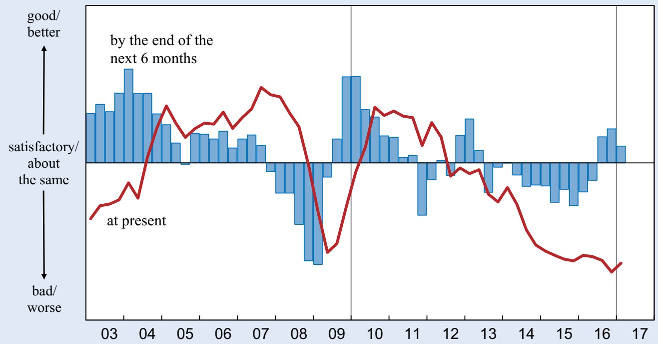


Source: Ifo World Economic Survey (WES) I/2017.

CIS
Economic situation

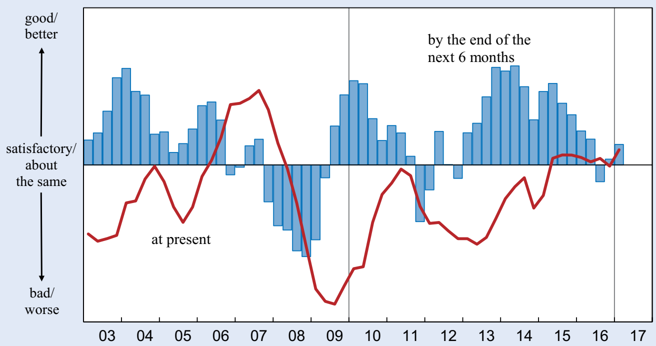
Source: Ifo World Economic Survey (WES) I/2017.

Latin America
Economic situation



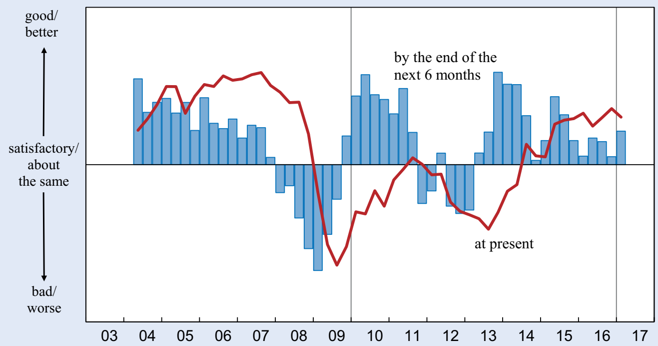
Source: Ifo World Economic Survey (WES) I/2017.

European Union (old members)
Economic situation



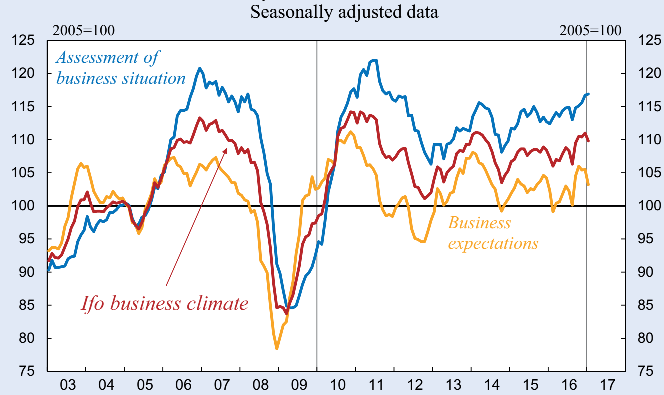
Source: Ifo World Economic Survey (WES) I/2017.

European Union (new members)
Economic situation



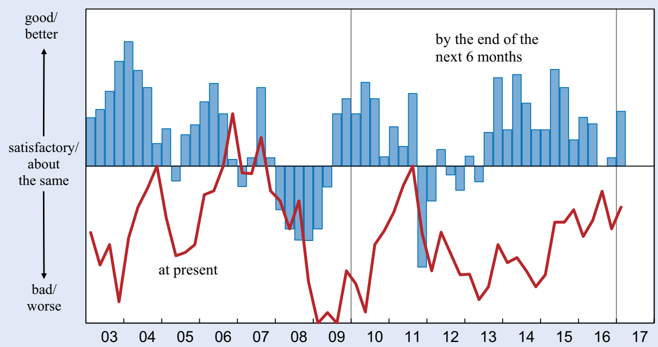
Source: Ifo World Economic Survey (WES) I/2017.

Germany: Ifo business climate[a)]
Seasonally adjusted data



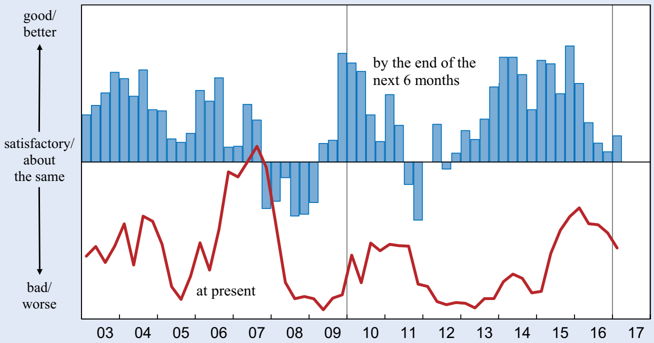
[a)] Manufacturing industry, construction, wholesale and retail trade.
Source: Ifo Business Survey, January 2017.

France
Economic situation



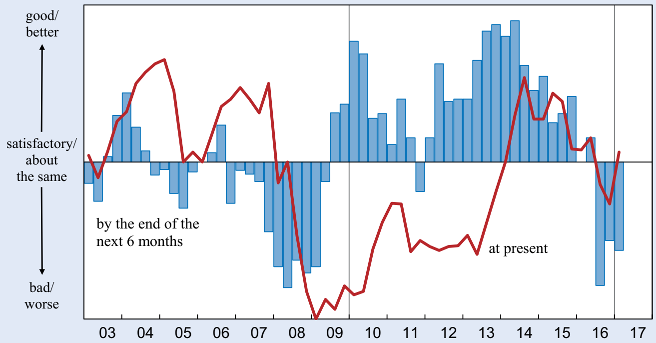
Source: Ifo World Economic Survey (WES) I/2017.

Italy
Economic situation



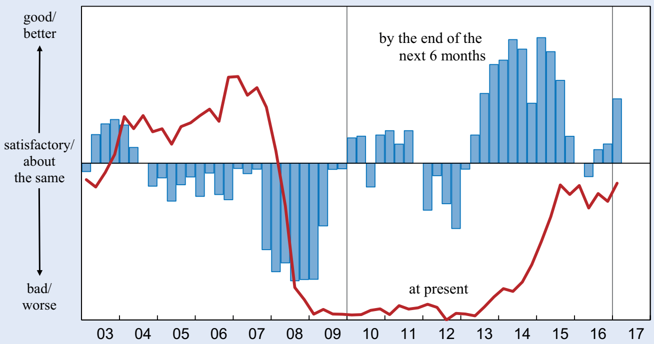
Source: Ifo World Economic Survey (WES) I/2017.

United Kingdom
Economic situation



Source: Ifo World Economic Survey (WES) I/2017.

Spain
Economic situation



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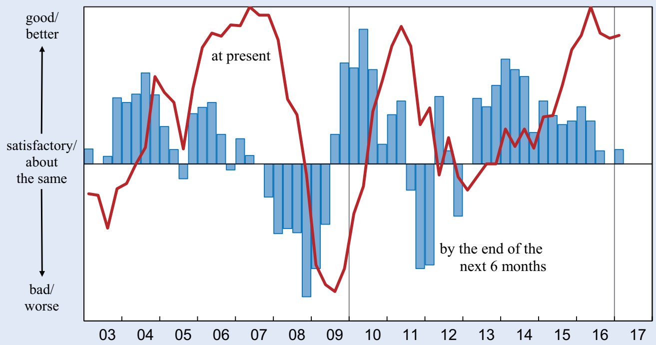
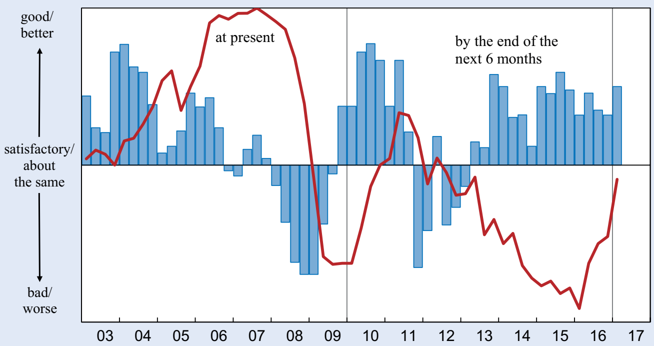
Sweden
Economic situation



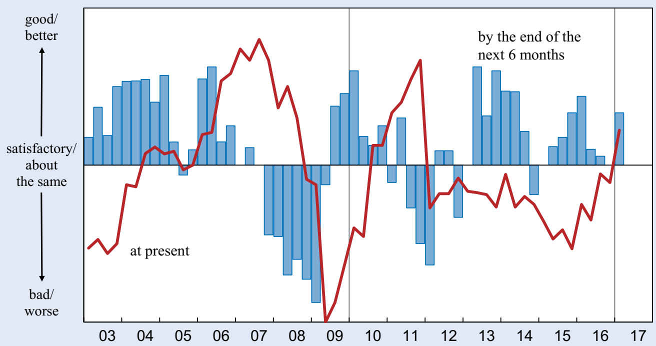
Source: Ifo World Economic Survey (WES) I/2017.

Finland
Economic situation



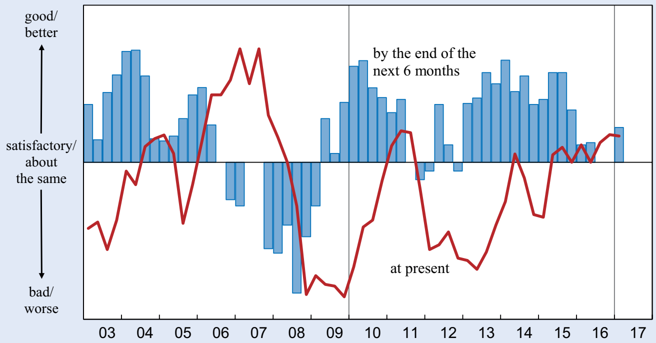
Source: Ifo World Economic Survey (WES) I/2017.

Austria
Economic situation



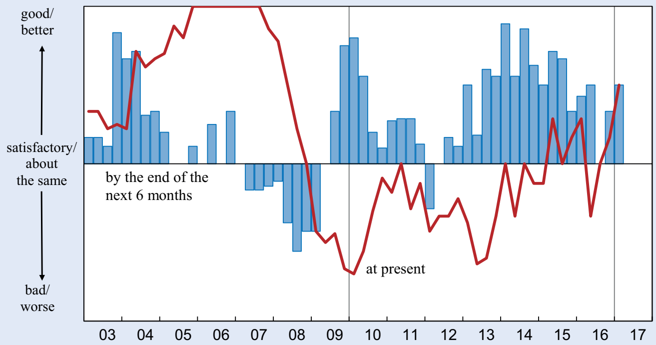
Source: Ifo World Economic Survey (WES) I/2017.

Belgium
Economic situation



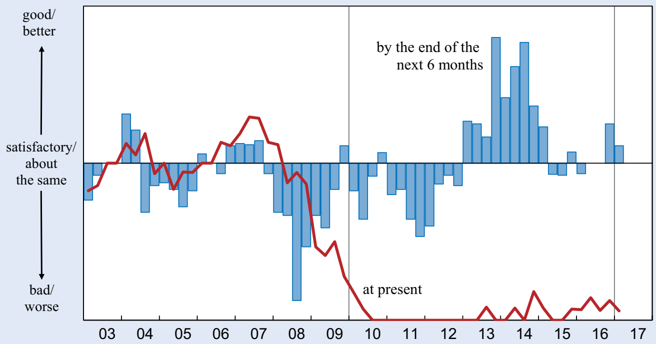
Source: Ifo World Economic Survey (WES) I/2017.

Denmark
Economic situation



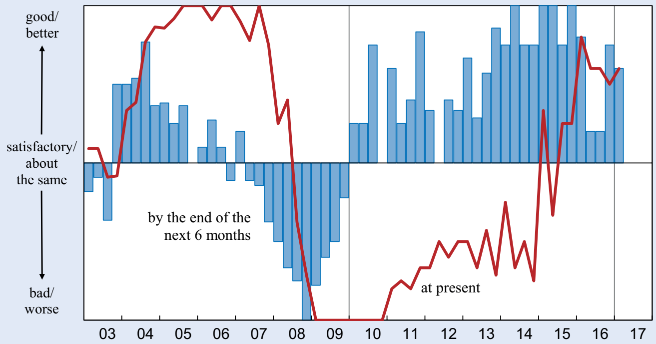
Source: Ifo World Economic Survey (WES) I/2017.

Greece
Economic situation



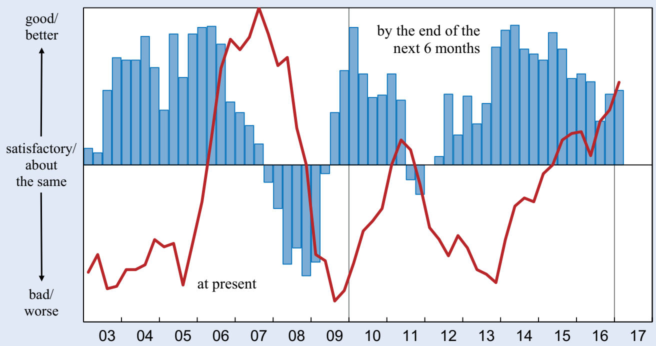
Source: Ifo World Economic Survey (WES) I/2017.

Ireland
Economic situation



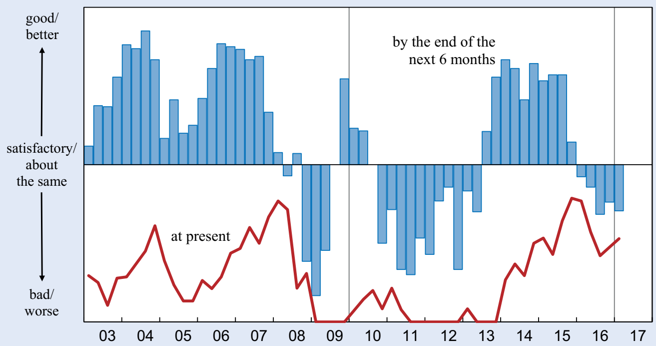
Source: Ifo World Economic Survey (WES) I/2017.

Netherlands
Economic situation



Source: Ifo World Economic Survey (WES) I/2017.

Portugal
Economic situation



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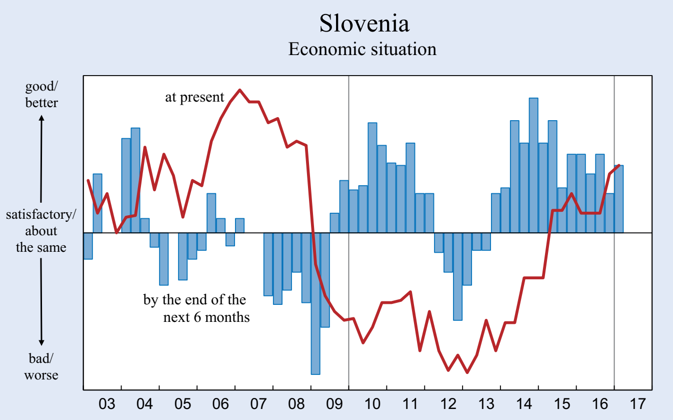

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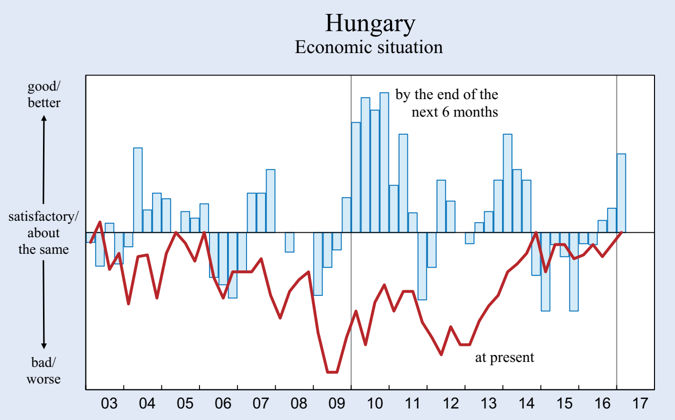

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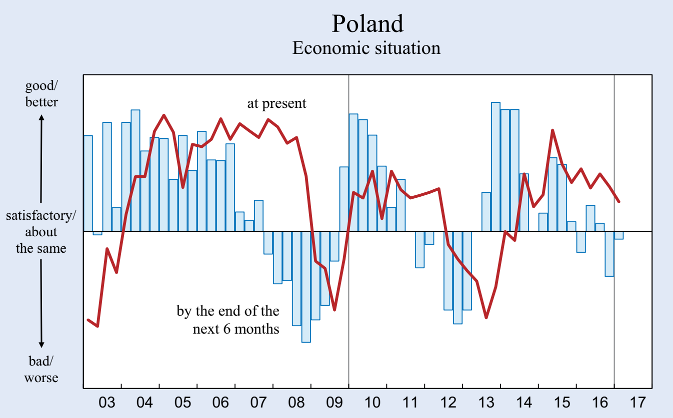

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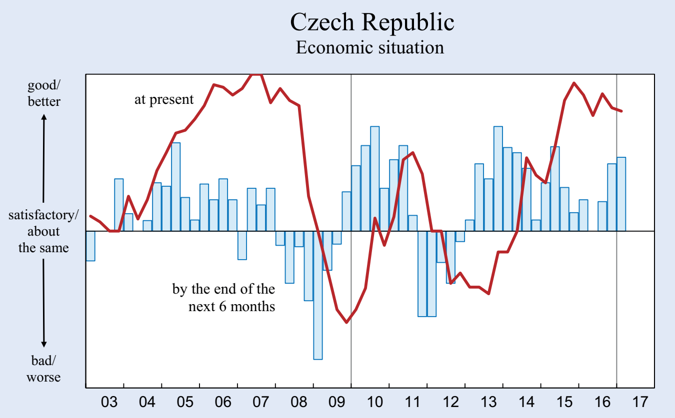

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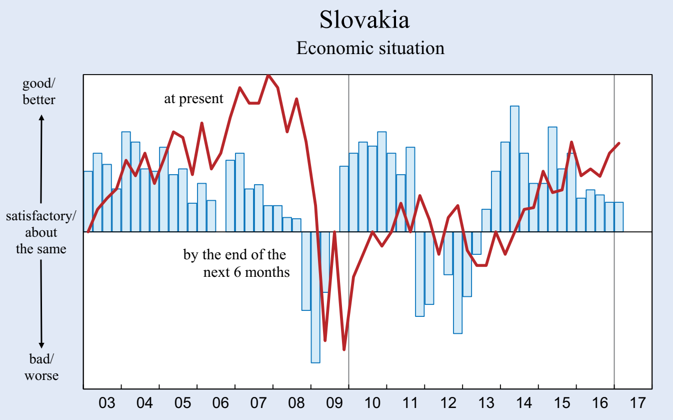

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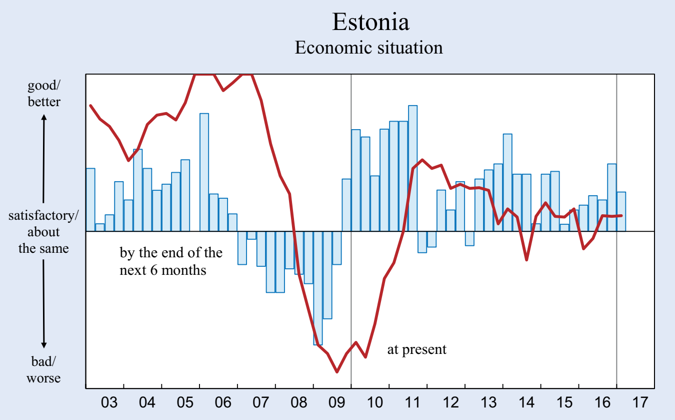

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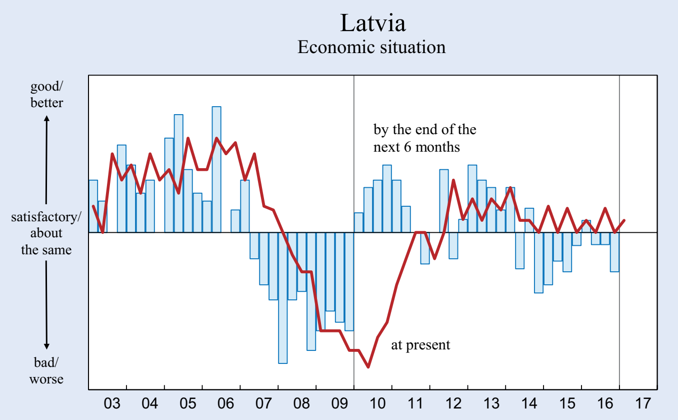

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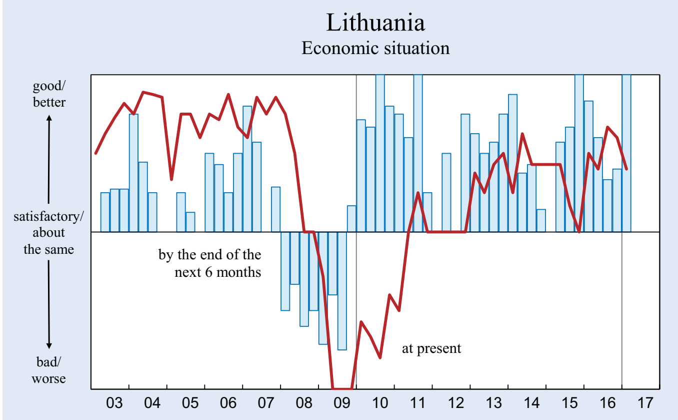

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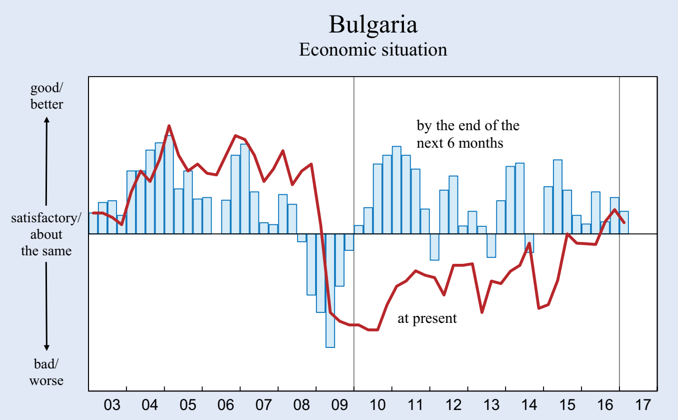

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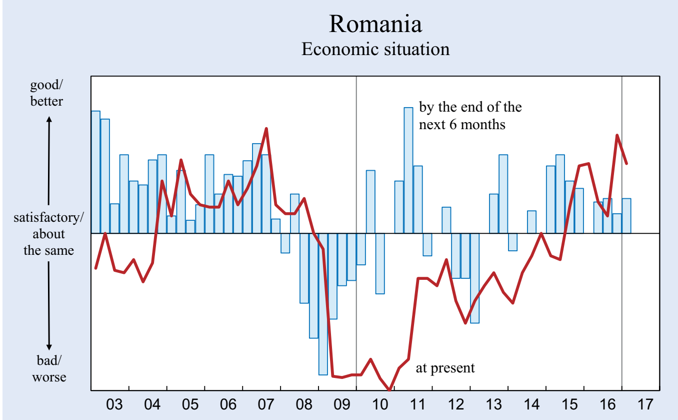


Source: Ifo World Economic Survey (WES) I/2017.

EEAG (2017), *The EEAG Report on the European Economy,* "Economic Policy and the Rise of Populism – It's Not So Simple," CESifo, Munich 2017, pp. 50–66.

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

2.1 Introduction

A wave of populism is sweeping across Europe and North America. The year 2016 threw up two extraordinary upsets: the first in the shape of Brexit on 24 June; and the second, the earth-shattering election of Donald Trump to the US presidency. The forces of openness, tolerance, diversity, multiculturalism, and globalisation have been left reeling at, overwhelmed by and at a loss to understand this new wave. Parties, politicans, ideologies, and opinions that formerly lurked in the shadows have emerged into the broad light of day, gathering support, winning seats in legislatures, and influencing the policies of the mainstream. What is more, Donald Trump has become the President of the US. A political outsider, Trump set himself up as the populist candidate and voice of the unrepresented. He swept aside other candidates for the nomination, took over the Republicans, a hitherto mainstream political party; and finally, to the horror and disbelief of the political establishment and now-reviled elites everywhere, won the election. His victory marks the triumph of divisive rhetoric, disregard for facts, promises of simple cures for all ills, nativism, demagoguery, and the power of seductive slogans, which are common features of the new populism.

Trump was elected on the back of promises on immigration, international trade, taxation and public spending, and healthcare. On immigration, Trump promised to restrict flows of Muslims into the US, to build a wall along the Mexican border, and deport millions of illegal immigrants living in the US. On international trade, he promised to reject the Trans-Pacific Partnership (TPP) on his first day in office; and to impose swinging tariffs on some Chinese imports, while accusing China of dumping. The Transatlantic Trade and Investment Partnership (TTIP) will almost certainly be abandoned. He has claimed that his policies will repatriate manufacturing jobs to America. He promised tax cuts, and increases in public infrastructure spending, which will clearly lead to substantially higher Federal borrowing. Obamacare is likely to be repealed or substantially watered down. He has claimed the media and the electoral system were rigged against him, and threatened to contest the election outcome if he lost in statements that have been interpreted as undermining the democratic political institutions of the US.

The pollsters failed to predict the scale of Trump's election victory, instead giving Hilary Clinton a slight lead and expecting her to win. Following much pained dissection of the voting data and follow-up surveys, it seems many "shy" voters did not admit to their intentions in advance.

By electing Trump, the US has passed up the opportunity of electing its first female president to the despair of many, who see this as the turning of a progressive tide. But how much despondency is in order? Could this simply be business as usual? It is relatively rare for an incumbent party to win a third term in office: a change of party after two terms is more the rule than the exception.[1]

Brexit shares many features of the Trump success. The campaign was propelled by calls to "give us our country back" and "take back control". It promised that an illusory 350 million British pounds per week in savings gained from ending Britain's contributions to the EU budget would be spent on the National Health Service. One of the leading Brexiteers, Michael Gove, declared that the people "have had enough of experts." Informed analysis of the effects of Brexit was dismissed as the self-serving work of interested parties. In the post-Brexit debate, populist and xenophobic views are even creeping into mainstream politics. The UK Prime Minister Theresa May, for instance, has started talking about a contrast between the "spirit of

[1] Exceptions in recent decades include: Harry Truman (Democrat) succeeding F. D. Roosevelt (Democrat) in 1945, but Roosevelt died in office; and George H. W. Bush (Republican) succeeding Ronald Reagan (Republican) in 1989 after the latter's two terms in office. There were, however, long spells of Republican presidency in the early part of the 20th century.

citizenship" and "international elites" who are "cizitens of nowhere".[2] As will be explained further below, rhetoric that pits ordinary citizens against a ruling elite is a typical element of populist slogans.

These are merely Anglo-Saxon manifestations of a Europe-wide phenomenon. Matteo Renzi, Italy's former progressive prime minister, decisively lost a referendum on the Italian constitution in December 2016.[3] In France the Front Nationale's Marine le Pen is likely to perform very well and might even win the presidential elections in 2017. After a succession of dismal defeats for reason and good sense, a brief respite came with the clear rejection of Norbert Hofer, the extreme right-wing candidate, in the second-round elections for the Austrian presidency in December 2016.

Victor Orbán, prime minister of Hungary, and leader of the Fidesz party, calls for asylum seekers in Europe to be rounded-up and deported;[4] and fences have been built between Hungary and Serbia to keep people out. Poland's conservative Law and Justice Party (PiS), headed by Jaroslaw Kaczyński, argues against accepting refugees. A more extremist movement, Kukiz'15, is campaigning to build a wall between Poland and the Ukraine. France's Front National, under Marine Le Pen, took over 28 percent of the vote in the first round of local elections in 2015, campaigning against what the party sees as the islamification of France, promoting greater independence from the EU and the protection of national industries and agriculture. Geert Wilders' Freedom Party (Partij voor de Vrijheid – PVV) attracts around 30 percent of the votes in the Netherlands, on an anti-islam, leave-the-EU platform. The Austrian Freedom Party (Freiheitliche Partei Österreichs – FPÖ) is fairly similar insofar as it is critical of the EU and the euro, and takes an anti-islam and anti-immigration position. Denmark has the Dansk Folkeparti (DV), the Danish People's party; while Greece boasts the extreme right-wing Golden Dawn – Chrisy Avgi, and the far-left Syriza (although its status as a populist party is contested). In Italy the Lega Nord has been revived by its anti-migration stance in the recent crisis; while the 5-Star movement is gaining influence on the left. The UK has the UK Independence Party (UKIP), and the British National Party (BNP); Germany has Alternative für Deutschland – AfD. And so the list goes on.

This populist growth, or resurgence, has taken place against a background of growing flows of migrants from Mexico into the US, the seemingly uncontrollable flows of migrants, refugees and asylum seekers from the Middle East and North Africa into Europe, and a rising number of terrorist attacks executed in the name of Islamic fundamentalism. As regards the economic sphere, the period is marked by austerity policies, with no obvious end in sight, lingering high unemployment, the near stagnation of the Eurozone economy (with the exception of a buoyant Germany), and a perception of growing disparities in income and wealth in many countries. There appears to be a push-back against further globalisation. Nearly completed trade deals between Europe and the US are likely to fail. The US is very likely to abandon TTIP, as mentioned above. The EU-Canada deal, the Comprehensive Economic and Trade Agreement (CETA), very nearly failed in the face of opposition from the regional government of Wallonia, Belgium. The leaders of the EU are seen as being too remote from ordinary people, pursuing a project of an ever-deeper union without regard for the concerns of the typical voter, unable to meet the challenges of the financial crisis, the euro crisis and the refugee crisis.

These developments represent a huge challenge for established and moderate political parties, and they bear the risk of severe political and economic disruptions. At the same time, the growth of populist power may have the positive effect of forcing governments to address economic issues they have failed to take into account so far. Dealing appropriately with the challenge of populism requires an understanding of the factors driving populist movements, as well as the consequences of populist influence. In this introductory chapter we discuss definitions of populism; we describe experiences with populist economic policies and views on economic developments, which seem to favour populism. We conclude with a brief discussion of what can be done to limit the influence of harmful populist ideas.

2.2 What is Populism?

This report is primarily interested in the economic implications of populism. But populism is a concept

[2] "[…] Too many people in positions of power behave as though they have more in common with international elites than with the people down the road, the people they employ, the people they pass in the street […]. But if you believe you're a citizen of the world, you're a citizen of nowhere." Theresa May, *Speech delivered at the Conservative Party Conference in Birmingham*, 5 October 2016.

[3] However, to what extent this rejection represents populist influence is subject to debate.

[4] A. Byrne, "Viktor Orban Calls For 'Round-Up' of Migrants in EU," *Financial Times*, 23 September 2016, http://on.ft.com/2d96nRi.

that is widely discussed beyond the economic policy debate. The word populism goes back to the Latin word *populus*, which means "people" in the collectivist sense of the word. The Oxford English Dictionary defines the word "populist" as "aiming to appeal to ordinary people". By definition, therefore, populism is an inherent part of democracy. In the social sciences, views as to whether or not populism is a useful concept for analytical purposes diverge widely. The reason is that it is difficult to draw a clear line between populist and non-populist ideas, parties or political regimes.

Nevertheless, political populism can be characterised as a particular ideology and political style. Albertazzi and McDonnell (2008, p. 3) define populism as "an ideology which pits a virtuous and homogeneous people against a set of elites and dangerous 'others' who are together depicted as depriving (or attempting to deprive) the sovereign people of their rights, values, prosperity, identity and voice." Along similar lines, Kaltwasser and Taggart (2016, p. 204) suggest the following definition: populism is "a thin-centred ideology that considers society to be separated into two homogenous and antagonistic groups: 'the pure people' and 'the corrupt elite', and argues that politics should be an expression of the *volonté generale* (general will) of the people."

The dichotomy between the people and the ruling elite is the main idea underlying a large share of populist critique of political decisions in representative democracies. Representative democracies are by definition political systems where "the people" is represented by politicians who make decisions as members of parliament or members of the government. In this context, political or economic problems can easily be criticised as reflecting a divergence between the will of the people and the will of those representing the people.

In the public debate, politicians often use the adjective "populist" simply to discredit their opponents or to attack ideas they do not like. If the opposition argues that it would provide more public services and cut taxes at the same time, those in the government will often argue that these are populist arguments, which will not stand the test of reality. However, if politicians in government raise public debt to increase public spending or cut taxes before elections, they will justify this as an effort to stimulate the economy and would reject that this is a form of populism. Parties or politicians that are commonly considered as populist would normally avoid calling themselves populists. As Canovan (1981, p. 5) notes, they differ in this sense from mainstream parties and politicians, who normally do no hesitate to refer to themselves as socialist, liberal or conservative.

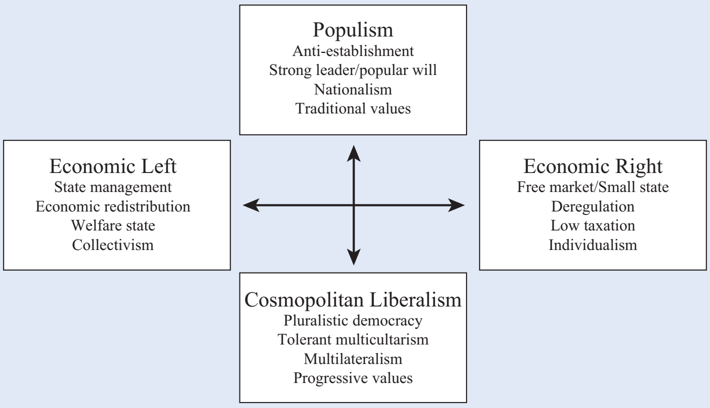
Political populism occurs across the entire political spectrum. Recent examples of left-wing populism include the Greek Syriza Party, at least during the first six months of its government, or, as a more extreme case, the rule of Hugo Chávez and his successor Nicolás Maduro in Venezuela. Right-wing populism is particularly on the rise in various Middle and Northern European countries and represented by political parties like the Front National in France or the Liberty Party in the Netherlands. Donald Trump is probably best characterised as a right-wing populist too. While some populist parties on the right wing have outright fascist tendencies, with a strong emphasis on xenophobia, this by no means applies to all of the parties that would be considered populist.

Kaltwasser and Taggart (2016) point out that there are two approaches that are directly opposed to populism: "elitism" and "pluralism". Elitism shares the view of society as consisting of the elite and the people, but unlike in the case of populism, the elite is seen as intellectually and morally superior whereas the people is seen as a dangerous mob. Pluralism rejects the dichotomy between the elite and the people, as well as the concept of a fixed *volonté generale*. It takes for granted the diversity of interests and ideas in society. Political decision-making is seen as an open and dynamic process. Populism is also often seen as opposing the order of liberal democracy, where the will of the majority is combined with institutional checks and balances that protect fundamental individual rights.

Somewhat akin to this delineation, but possibly conflating elitism and pluralism, and putting a more positive construction on them, Inglehart and Norris (2016) classify political parties in two dimensions, as shown by Figure 2.1 below. In the vertical dimension, Populism stands at the opposite pole from Cosmopolitan Liberalism, (which represents pluralistic democracy, tolerant mulitculturalism, multilateralism and progressive values). Along the horizontal dimension, parties may range from the Economic Left (which favours state management, economic redistribution, the welfare state and collectivism) to the Economic Right (which favours free markets, a small state, deregulation, low taxation and individualism). Using the 2014 Chapel Hill expert survey, they have

Figure 2.1

Four-way classification of political parties



Source: Inglehart and Norris (2016).

classified nearly 300 political parties along these two dimensions, and identified the populist parties from among them. Their classification shows a swathe of populism running across the political spectrum from left to right (as shown below in Figure 2.2).

2.3 Populist economic policies

What are the economic implications of populism and which economic policies are linked to populist ideologies? We will use the following definition of populist economic policy:

Populist economic policy claims to design policies for people who fear to lose status in society and who have been abandoned by the political establishment. The populist economic agenda is characterised by short termism, the denial of intertemporal budget constraints, the failure to evaluate the pros and cons of different policy options as well as trade-offs between them. It often focuses on single and salient political issues, overemphasises negative aspects of international economic exchange and immigration, and blames foreigners or international institutions for economic difficulties. The populist economic agenda rejects compromise as well as checks and balances and favours simplistic solutions.

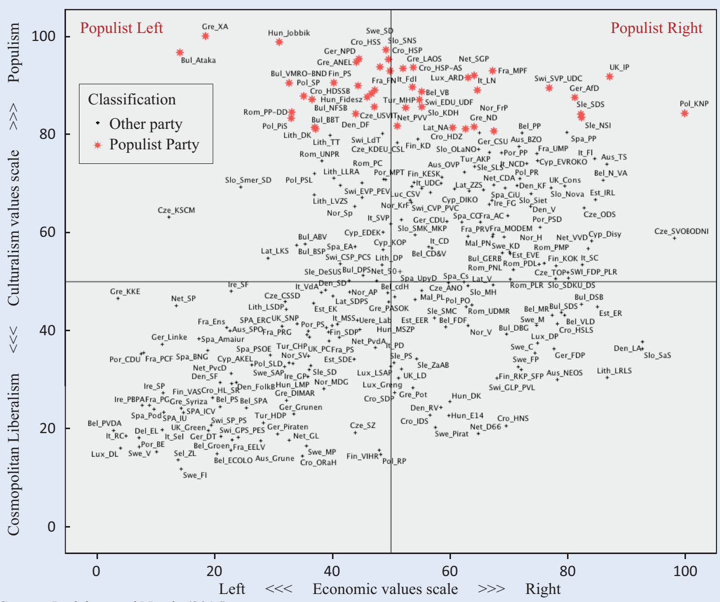
While there is a large body of literature on populism in political science, some of which was cited in Section 2.2, economists have devoted relatively little attention to the subject. Exceptions include Dornbusch and Edwards (1990, 1991) and Acemoglu et al. (2011). Dornbusch and Edwards (1990) focus on populist macroeconomic policies, which they associate with various historical episodes in Latin America. The type of economic policy they describe and explain is usually associated with left-wing populism and bears similarities with policies favoured by recent left-wing populist movements in Europe. Acemoglu et al. (2011) ask why populist policies are implemented, although they usually lead to poor economic outcomes. In the following, we discuss the characteristics of the populist economic agenda in the most important policy areas.

2.3.1 Populist macroeconomic policies: Ignoring intertemporal budget constraints and capacity limitations

Populist macroeconomic policy is expansionary. It emphasises the benefits of more public spending or lower taxes and plays down the adverse consequences

Figure 2.2

European political parties



Source: Inglehart and Norris (2016).

of growing public debt or inflation. While the benefits of expansionary fiscal and monetary policy are felt quickly, some time will usually pass before the adverse consequences of growing debt burdens, or even financial destabilisation, are felt. This reflects the short termism associated with populism. Populist macroeconomic policy neglects the adverse consequences of fiscal expansion or claims they do not exist, either because the demand stimulus is expected to increase economic growth so that the fiscal expansion is self-financing, or because improved incentives, particularly due to lower taxes, generate more economic activity. It is no surprise that Donald Trump has announced expansionary fiscal policies for the US, despite the growing level of public debt, which would call for fiscal consolidation, and despite the fact that the US economy is close to full employment.

Latin America is a region where populist governments have repeatedly chosen to engage in expansionary fiscal and monetary policies, frequently with disastrous consequences. Against the backdrop of the Latin American experience, Dornbusch and Edwards (1990, 1991) have identified a number of common factors characterising populist macroeconomic programs. These include particular *initial conditions*, the *rejection* of the idea that economic policy operates under *constraints*, and a typical *policy prescription*.

Initial conditions include dissatisfaction with the growth performance of the economy, stagnation or even a recession after previous and failed stabilisation attempts – often but not always after an International Monetary Fund (IMF) programme. Declining living standards and growing inequality generate political support for radical change in economic policies. Sometimes previous stabilisations have created some room for expansionary fiscal and monetary policies.

Populist politicians often *reject* the idea that economic policy operates under *constraints*. They usually argue that enough idle capacity is available so that expansionary policies financed via deficit spending can be implemented without running the risk of raising inflation. The populist *policy prescription* is a mix of debt financed expansionary policies, higher wages, and foreign exchange, as well as domestic price controls to prevent inflation.

According to Dornbusch and Edwards (1990), the economic consequences of these policies typically evolve in four phases. In the first phase, which usually covers the first year of the new policy or less, the new macroeconomic policy seems successful. Output and employment growth accelerate, while inflation is held back by price controls. In phase 2 shortages occur as price and foreign exchange controls reduce supply. The government budget deficit soars as goods with price controls need larger and larger subsidies. Inflation increases, pressures for devaluation rise. Wages stay high, but price controls and protectionist measures are extended massively. Consequently, a large shadow economy emerges. In phase 3 shortages become dramatic, inflation accelerates, a massive capital flight sets in, real wages decline and the economy collapses. It becomes clear that the populist economic policy programme has failed. In the fourth phase, another government takes over and conventional stabilisation policies are pursued, possibly with the support of the IMF. Real wages and living standards are significantly lower than before the populist policy experiment; and will remain so for a long time because investment in local firms is depressed, capital has left, trust in the country's institutions and its economy is undermined.

The detrimental effects of populist economic policies raise the question of why these policies receive any political support in the first place. Dornbusch and Edwards argue that the poor results of populist policies are the result of policy errors. They suggest that expansionary policies may work under certain circumstances. According to them, governments "need to be aware of capacity constraints and have to rely for their financing on an extremely orthodox fiscal policy and rigorous tax administration. Within those restrictions it would appear that there is room left for achieving redistributive objectives in an effective way."[5]

Acemoglu et al. (2011) also start from the view that populist macroeconomic policies are ultimately harmful and raise the question of why these policies are nevertheless pursued. Without explicitly rejecting the idea that policy errors may be at work here they argue that the "key challenge is […] to understand why politicians adopt such policies and receive electoral support after doing so."[6] Their answer is that, to be elected, politicians need to signal that they are not captured by the elite. The only way to do so is to adopt redistributive and interventionist policies so radical that a politician who is controlled by the ruling elite would never implement them, even if he wants to

[5] Dornbusch and Edwards (1990), p. 274.
[6] Acemoglu et al. (2011), p. 2.

make voters believe that he is not controlled by the elite. According to this view, populist economic policies are a signal that is very costly for the economy as a whole, but they are the outcome of individually rational policy choices, given the informational constraints of the political process.

2.3.2 Immigration

For many populist parties, especially in Europe, immigration is the single most important political issue. Some populist parties on the right wing of the political spectrum have features of single issue parties, focusing almost entirely on immigration. The Sweden Democrats (SD) are a good example. Table 4 shows the correlation between Google searches for the terms "SD" and "immigration".

Right-wing populist parties reject immigration for a number of reasons including cultural and religious considerations. The key economic arguments against immigration claim that immigrants: *(i)* compete with natives in the labour market, take away their jobs and depress wages; and *(ii)* benefit from the welfare state and contribute little in the form of taxes. Populist parties also tend to reject the notion that migrants are refugees who leave their countries because of war and political prosecution. Instead, they claim that migrants are motivated by economic incentives and that many immigrants have entered the country illegally. This gives rise to calls for policy measures to reduce immigration. As a result, these parties propose radical changes in immigration policies. How radical these proposals are, differs considerably across populist parties. A typical example of comparatively moderate proposals is the following list published by the UKIP in its 2015 elections manifesto (pp. 11–3):

"To reform our immigration system UKIP will:

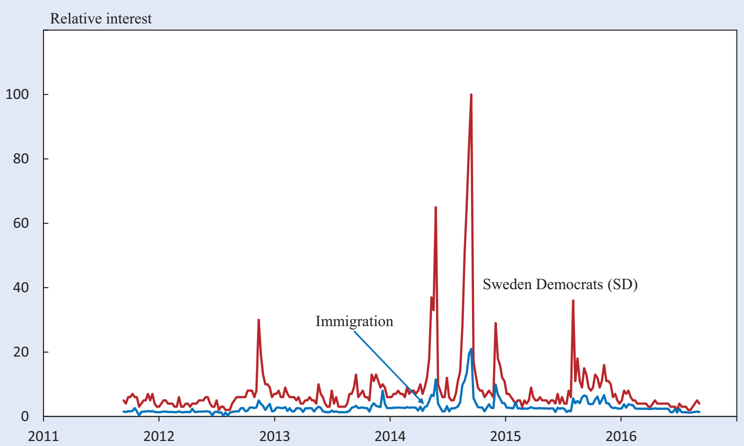
- End immigration for unskilled jobs for a five-year period to re-balance our work economy.
- Introduce an Australian-style points-based immigration system to assess all potential migrants to Britain on a fair, ethical and equal basis.
- Tackle the problem of sham marriages […].
- All new migrants to Britain will have to make tax and national insurance contributions for five consecutive years before they will become eligible to claim UK benefits, or access to more than non-urgent NHS services, save for any exceptions stipulated by the Migration Control Commission.
- Resident migrants who commit crimes resulting in custodial sentence will have their visa revoked and they will be subject to a deportation order. They will be detained until they are removed from the UK."

The Front National is an example of more radical policy proposals. The party argues that immigration is abused by employer organisations to keep wages low, a "weapon in the service of capitalists".[7] The party proposes to reduce immigration drastically and to deport foreigners residing in France if their presence in the country is "no longer justified",[8] that is for instance if they are unemployed for more than one year.

Economic research on the impact of migration shows that its effects on the labour market and public finances in the host country are diverse and depend on characteristics of the immigrants, as well as on the labour market and welfare state institutions of the host country. For instance, OECD (2013) concludes that the net fiscal contribution of immigrants in the period 2007–2009 was on average positive in the OECD countries, but that there is significant divergence across countries. In some coun-

Figure 2.3

Google Searches for "Sweden Democrats" (SD) and for "Immigration"



Source: Google and EEAG calculations.

[7] Front National Website, Immigration, *Stopper l'immigration, renforcer l'identité française,* http://www.frontnational.com/le-projet-de-marine-le-pen/autorite-de-letat/immigration/, last accessed 19 September 2016.

[8] Ibid.

tries including France, Germany, and Poland, the contribution was negative. Clearly, a negative net fiscal contribution is more likely in countries with a generous welfare state, rigid labour markets that make it difficult for immigrants to find employment, and is also likely in countries that attract low-skilled immigrants. These findings suggest that portraying the impact of immigration on the host country as generally negative is misleading, as is the opposite view according to which immigration is always beneficial. We will discuss the immigration issue in greater detail in Chapter 4 of this EEAG report.

2.3.3 Globalisation and international trade

Globalisation and international trade is another issue on which populist parties usually share a strongly critical attitude. Economic developments like structural change and the associated costs in terms of uncertainty and job losses are seen as the outcome of international economic integration. Populists frequently accuse foreign companies or governments of engaging in dumping and other forms of unfair competition. Globalisation is presented by populist parties as a process whereby large parts of the domestic population lose out, while the elite benefits and disseminates false information through biased "experts". Donald Trump describes this phenomenon as follows:

> "It is no great secret that many of the special interests funding my opponent's campaign are the same people profiting from these terrible trade deals. The same so-called experts advising Hillary Clinton are the same people who gave us NAFTA, China's entry into the World Trade Organization, the job-killing trade deal with South Korea, and now the Trans-Pacific Partnership."[9]

International trade has always been a highly charged topic. While it may be capable of making everyone better off, a move towards free trade generally benefits people who work in the export industries, while people in industries that compete with imports lose. China's exports have provided Europe and America with inexpensive goods that held down prices and sustained the "great moderation" in the US, but at the same time, they have threatened consumer goods industries and held the earnings of low-skilled manual workers in check. Effectively, China and India's integration into world markets has caused a massive increase in the global supply of less-skilled labour relative to higher-skilled labour and capital. Industries that use a lot of relatively unskilled labour have shifted production to China and India. Less-skilled workers in Europe and North America have lost out; jobs are scarce and wages have stagnated. The winners from freer trade have not compensated the losers. The accounts given by Krugman (2008) and Haskel et al. (2012) are more nuanced, but essentially also demonstrate these effects. The IMF's World Economic Outlook for October 2016 acknowledges the importance of compensating those who would stand to lose from freer trade, if there is not to be a slide towards protectionism (IMF, 2016, p. 87):

> "But to sustain popular support for trade integration and preserve its economic and welfare benefits, policymakers should be mindful of the adjustment costs that deepening trade integration entails. Although the analysis of these effects is beyond the scope of the chapter, a number of studies document significant and long-lasting adjustment costs for those whose employment prospects were adversely affected by the structural changes associated with trade, even if the gains from trade from lower prices may tend to favor those at the bottom of the income distribution. An increasingly popular narrative that sees the benefits of globalization and trade accrue only to a fortunate few is also gaining traction. Policymakers need to address the concerns of trade-affected workers, including through effective support for re-training, skill building, and occupational and geographic mobility, to mitigate the downsides of further trade integration for the trade agenda to revive."

Another setback to the free trade agenda has come from opposition to large regional agreements, a backlash response to lobbying by big business, particularly US big business, perceived to be manipulating free trade to serve its own interests at the expense of ordinary households. The TPP between the US and a number of East Asian countries, including Japan, came close to being signed and implemented, but the opportunity to finalise a deal now seems to have slipped out of reach following Donald Trump's vow to stop TPP.

TTIP, the trade and investment partnership under negotiation between the US and the EU, is losing momentum in the face of growing opposition in Europe, and Donald Trump is likely to reject it. The Canada-

[9] D. Trump, *Speech deliverd at New York Economic Club,* 15 September 2016, https://www.donaldjtrump.com/press-releases/trump-delivers-speech-on-jobs-at-new-york-economic-club.

EU trade deal, CETA, narrowly avoided defeat by opposition from Wallonia. The mystery and secrecy surrounding the negotiation of these deals has aroused suspicion that they represent a corporate conspiracy against the interests of the general public. There is also widespread scepticism about the provisions for investment protection and investor-state tribunals.[10] They give large corporations access to secretive arbitration panels through which they may be able to enforce claims against governments. The spectacle of a lawsuit brought by the tobacco company Philip Morris against Uruguay on account of Uruguay's vigorous anti-smoking policies was most unedifying, even if Uruguay won in the end.[11] It stokes fears that large companies will use these trade agreements to sue countries for environmental legislation and for other socially desirable policies, which firms believe will damage their interests. Various European countries have been sued under other trade treaties with investor-state clauses in them.

It is worth noting that opposition to TTIP and other treaties that privilege corporate interests comes not only from populist politicians, but from the left-wing elite. In the UK, the left-of-centre Guardian newspaper is a vigorous opponent. In its view, these trade agreements are so egregious that populist and mainstream public opinion is largely opposed to them.

While the British intelligentsia politely and reasonably demur from TPP, TTIP, and CETA, Donald Trump has declared that

> "as president he would 'rip up' international trade deals such as the North American Free Trade Agreement, withdraw from the World Trade Organization and sharply raise the tariffs charged on goods imported from China and Mexico."[12]

And, as Justin Wolfers goes on to note,

> "As president he could pretty much do it. And there's very little Congress can do to stop him, even if the result is a costly trade war."[13]

It is a notable fact that Wolfers does not hesitate to mention the possibility of trade wars, which are usually highly damaging for all involved. He does not, however, seem to expect this to undermine support for the anti free trade agenda.

Whether these statements mainly represent campaign rhetoric, and to what extent the government under President Trump will really embrace protectionism is an open question; although, as mentioned above, Trump has confirmed that he will stop TPP.

2.3.4 European integration and the euro crisis

Most populist parties are opposed to European integration, including the creation of supranational institutions in the EU, the internal market and the euro. They reject the loss of sovereignty for member states implied by European integration, and particularly challenge the freedom of EU citizens to live and work in other EU countries, and dispute the fact that external trade policy is an EU competence.

The populist dislike of the EU as an institution extends to other supra- and international institutions. This is partly related to the perception that these institutions evade democratic control. While this is not true in a formal sense, there is an issue of how democratic control of these institutions can be ensured. There is a longstanding debate about the "democratic deficit" of the EU. With respect to international institutions Dahl (1999, p. 16) argues that "although international organizations have become the locus of important decisions and will doubtless be even more so in the future, they are not now and probably will not be governed democratically. Instead, they will continue to be governed mainly by bargaining among bureaucratic and political elites, operating within extremely wide limits set by treaties and international agreements."

While this critique of international and supranational organisations is justified to some extent, it does not offer alternative and better ways to achieve the objectives pursued with the creation of these organisations. As will be discussed in greater detail below, the EU can be seen as an institution that provides checks and balances that prevent national governments from engaging in populist and short-sighted policies like the introduction of trade protection or subsidies for politically influential domestic indus-

[10] Cf. G. Monbiot, "The TTIP Trade Deal Will Throw Equality before the Law on the Corporate Bonfire," *The Guardian,* 13 January 2015, https://www.theguardian.com/commentisfree/2015/jan/13/ttip-trade-deal-transatlantic-trade-investment-treaty.
[11] Cf. B. Mander, "Uruguay Defeats Philip Morris Test Case Lawsuit," *Financial Times*, 8 July 2016, http://on.ft.com/2dtj1uO.
[12] J. Wolfers, "Why a President Trump Could Start a Trade War With Surprising Ease," *New York Times,* 19 September 2016, http://www.nytimes.com/2016/09/20/upshot/why-a-president-trump-could-start-a-trade-war-with-surprising-ease.html?_r=0.
[13] Ibid.

tries that discriminate against foreign individuals or companies.

The euro is rejected by the populist parties in most Eurozone member countries, albeit for different reasons. In southern Europe, the euro is widely seen as a major reason for the current economic crisis and European fiscal rules, as well as adjustment programmes overseen by the Troika, are perceived as preventing a recovery.

In Italy, the 5 Star movement wants to abolish the euro. In Greece, the former finance minister Yannis Varoufakis denounced the Troika as a "committee built on rotten foundations."[14] The Spanish movement Podemos rejects the view that fiscal consolidation is necessary and denounces "the false idea that in Spain there is an excess of public resources, too many civil servants or public sector employees in the administration, and excessive spending on public goods and services."[15] Instead, it proposes to default on national debt and to give national governments in the Eurozone access to monetary financing through the ECB.

In Northern European countries, populist parties attack the euro for different reasons. They argue that the zero interest rate policy harms their country or that stable public finances are impossible to achieve in the Eurozone. For instance, Geert Wilders, the leader of the Dutch Freedom Party recently argued that leaving the euro would allow the Netherlands to return to normal interest rates:

> "That's exactly the problem: The European Central Bank in Frankfurt with its idiotic zero interest rate policy. By doing so, the banks have slashed our pensions, and this concept is toxic for our economy. We want to determine our own monetary policy."[16]

In the same interview, he refers to Switzerland as a positive example of a country that lives well outside the Eurozone and the EU. He does not mention the fact, however, that Swiss interest rates are even lower than Eurozone rates.

The French Front National argues:

"The common currency has become the symbol of a federalist European policy and of the most absurd brinkmanship of financial elites who are ready to sacrifice the people on the altar of their interests. […] France should veto useless and ruinous bailout plans for the countries that are victims of the euro. The money of the French people should stay in France."[17]

While it is reasonable to ask whether Eurozone bailout-policies are effective, or whether the disadvantages of the zero interest rate policy of the ECB outweigh the advantages, the typically populist elements in the positions described above represent the denial of tradeoffs, and the presentation of overly simplistic solutions.

2.4 Why do populist parties receive political support and who votes for them?

Who supports populist parties, and why do they do it? One of the questions we address in this chapter is the extent to which economic developments, including economic policies, have led directly or indirectly, to the rise of populism. In many of the widely circulating accounts, economic factors are a major ingredient. Have economic factors actually been a major driver of populist support?

There is a widespread view that the effects of globalisation, including international trade, capital mobility and notably migration, as well as the perception that the middle class is losing out, are key drivers of populist movements. Economic crises, which lead to high levels of debt, unemployment and stagnating incomes, are another relevant factor. Populist support, however, may also have non-economic roots. It may be related to more fundamental views and values like a low tolerance level of foreigners or different cultures and religions, or simply to a lack of education.

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[14] Cf. D. A. Wade, "Greece: Finance Minister Yanis Varoufakis Rejects Debt Talks with Troika," *Belle News,* 30 January 2015, http://www.bellenews.com/2015/01/30/world/europe-news/greece-finance-minister-yanis-varoufakis-rejects-debt-talks-troika/.

[15] Cf. V. Scarpetta, "Podemos Gears Up for Next Year's Spanish Elections with Revamped Economic Plan, *Open Europe,* December 2016, http://openeurope.org.uk/today/blog/podemos-economic-proposals/.

[16] Interview with Geert Wilders, S. Koelbl, "Why Dutch Populists Want to Leave the EU,“ *Spiegel*, 1 July 2016, http://www.spiegel.de/international/europe/dutch-populist-geert-wilders-wants-to-leave-the-eu-a-1100931.html.

[17] "La monnaie unique est devenue le symbole d'une politique européenne fédéraliste d'un jusqu'au-boutisme absurde d'élites financières prêtes à sacrifier le peuple sur l'autel de leurs intérêts. […] La France doit donc mettre son véto aux inutiles et ruineux plans de renflouement des pays victimes de l'euro. L'argent des Français doit rester en France." Front National Website, Euro, *Une fin maitrisée pour libérer la croissance,* http://www.frontnational.com/le-projet-de-marine-le-pen/redressement-economique-et-social/euro/, last accessed 19 September 2016.

2.4.1 Economic factors versus values

Based on an analysis of Eurobarometer survey data, Kriesi (1999) argues that among the populist supporters, people with lower educational attainment, farmers, artisans and low-skilled workers are disproportionately represented. Swank and Betz (2003) investigate whether the election results of populist parties are related to growing globalisation that is increasing trade and migration. They consider the election results of populist parties in Western Europe in the period 1981 to 1998 and find that immigration waves and growing international trade are correlated with high levels of support for right-wing populist parties. They also find that the correlation is less significant in well-developed welfare states. Their interpretation of the evidence is that competitive pressure and uncertainty are moderated by strong welfare states, which offer a degree of insurance and protection.

While much of the discussion about populism centres on the political parties who represent it, those parties have to respond to the attitudes and preferences of voters. Political science literature describes this as the "demand side" of populism. "Populist parties or politicians have to address and positively resonate with sentiments and views already held in some form by a significant part of the population" as Spruyt et al. (2016, p. 335) remark. Spruyt et al.'s examination of a survey in Belgium finds that populism, by using "empty signifiers" (such as "the people") manages to unite inidviduals with many different grievances. A lack of external political efficacy is one of the main drivers of populist support. However, they find that (p. 345) "it is not actual vulnerability per se that matters (i.e., material wealth, educational attainment, cultural capital, and internal political efficacy) but subjectively experienced vulnerability (i.e., relative deprivation, anomie, perceived lack of political efficacy)." They conclude that one of the key lessons is that parties and politicians who aim to reduce the demand for populism need to counter the widespread feeling that they are unresponsive to the concerns and grievances of voters.

Inglehart and Norris (2016) examine whether populist support is associated with economic variables or cultural ones. They find that cultural value scales are consistent predictors of support for populist parties: their support is strengthened by anti-immigrant attitudes, mistrust of global and national governance, support for authoritarian values, and left-right ideological self-placement. Meanwhile, economic indicators are not reliable predictors. They write (p. 4):

> "Looking more directly at evidence for the economic insecurity thesis, the results of the empirical analysis are mixed and inconsistent. Thus, populist parties did receive significantly greater support among the less well-off (reporting difficulties in making ends meet) and among those with experience of unemployment, supporting the economic insecurity interpretation. But other measures do not consistently confirm the claim that populist support is due to resentment of economic inequality and social deprivation; for example, in terms of occupational class, populist voting was strongest among the petty bourgeoisie, not unskilled manual workers. Populists also received significantly less support (not more) among sectors dependent on social welfare benefits as their main source of household income and among those living in urban areas."

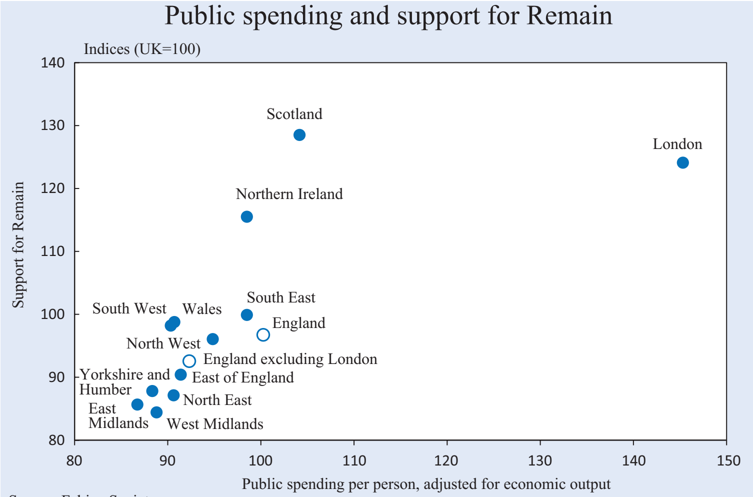
So it seems likely that economic policies have not directly led to a populist backlash, but have indirectly reinforced it by creating a world of greater labour mobility, and growing prominence of supranational government.

2.4.2 Lessons from the Brexit referendum

The Brexit referendum is widely seen as a case where support for the Leave campaign shows patterns that are similar to those driving support for populist parties. Arnorsson and Zoega (2016) investigate the extent to which economic variables are correlated with vote outcomes. They also use data on values like tolerance with respect to other religions, acceptance of immigrants as neighbours and the perceptions of the dangers of immigration for society. They find that regions that voted Leave have a large share of unskilled workers, a high average age and a low per capita GDP. These characteristics are correlated with values that reject immigration.

Data on voting patterns in electoral districts indicates that social attitudes were important, maybe more so than economic conditions. Brexit support was strong among the old, the less educated, people outside the workforce (pensioners, middle-aged homemakers, and men with low educational qualifications receiving disability payments). Support for Brexit was highly cor-

Figure 2.4



Source: Fabian Society.

Remain. Fidrmuc et al. (2016) find no correlation in either direction.

However, after analysis of voting by electoral district in the UK's Brexit referendum, Becker et al. (2016) argue that a small reduction in public spending cuts would have been enough to sway the vote, whereas major reductions in immigration would not have affected the result.

related with support for the death penalty (Kaletsky, 2016). Kaletsky views this as:

> "The latest battles in the culture wars that have split Western societies since the late 1960s. The main relevance of economics is that the 2008 financial crisis created conditions for a political backlash by older, more conservative voters, who have been losing the cultural battles over race, gender, and social identity."

Progressives may take comfort from the ageing demographic that supports Trump and Brexit. The young were overwhelmingly in favour of Remain. In other words, we may have seen a rearguard action whose supporters will die out.

What is the impact of public policies on the vote pattern? There is a correlation between support for Remain and public spending in the UK, as Figure 2.4 shows. This pattern is consistent with the view that some regions voted for Leave because they felt neglected by the UK government.

Fidrmuc et al. (2016) investigate the relationship between EU cohesion policy spending and regional voting behaviour. Of course, it is not quite clear what to expect here. On the one hand, regions that failed to benefit from European economic integration should be those that receive EU funds. These funds are unlikely to be sufficient to compensate the regions for their losses. That would suggest a positive relationship between Leave votes and regional policy funds. On the other hand, people in lagging regions may appreciate help from the EU and therefore be more likely to vote

2.4.3 Economic crises as a trigger of populism

Among the economic factors that trigger populism, economic crises figure prominently. Events like the financial crisis, the subsequent worldwide recession and the outbreak of the debt crisis in the Eurozone have harsh consequences for people who lose employment, or experience a decline in their pensions or other forms of support they receive. Crises will inevitably lead to a debate about the failure of the ruling elites and the fact that the costs of the crisis are not borne by those deemed responsible for it. For instance, there is a widespread consensus that managers and firm owners in the financial sector benefitted considerably during the bubble preceding the financial crisis, while the losses incurred in the crisis were passed onto taxpayers. This creates the impression that the "elites" are protecting themselves at the cost of "ordinary people".[18]

Tables 2.1a–2.1c offer an overview over election results of parties classified as populist before and after the financial crisis. Table 2.1a shows the results of populist parties in Northern Europe including the UK. The election results of populist parties improved considerably after the crisis, particularly in France, the Netherlands, Austria and Finland.

Table 2.1b shows that populist parties have also strongly gained support in southern Europe. In Greece, the Syriza party defeated the incumbent and more moderate New Democracy party in the January

[18] Funke et al. (2015) study the political consequences of financial crises over the past 140 years and show that financial crises have often led to growing political support for extreme right-wing parties.

Table 2.1a

Electrolal results of populist parties in Nordic regions, continental Europe and the UK[a)]

	Pre-crisis (A)	Post-crisis (B)	Difference (B-A)	EU-2014
Dansk Folkeparti (DF, Denmark)	13.9 (2007)	12.3 (2011) 21.1 (2015)	– 1.6 (2011) + 7.2 (2015)	26.6
Fremskrittspartiet (FrP, Norway)	22.1 (2005)	22.9 (2009) 16.3 (2013)	+ 0.8 (2009) – 5.8 (2013)	
Sverigedemokraterna (SD, Sweden)	2.9 (2006)	5.7 (2010) 12.9 (2014)	+ 2.8 (2010) + 10.0 (2014)	9.8
Perussuomalaiset (PS, Finland)	4.1 (2007)	19.1 (2011) 17.6 (2015)	+ 15.0 (2011) + 13.5 (2015)	12.9
Front National (FN, France)	4.3 (2007)	13.6 (2012)	+ 9.3	24.9
Vlaams Belang (VB, Belgium)	12.0 (2007)	7.8 (2010) 3.7 (2014)	– 4.2 (2010) – 8.3 (2014)	4.3
Partij voor de Vrijheid (PVV, Netherlands)	5.9 (2006)	15.5 (2010) 10.1 (2012)	+ 9.6 (2010) + 4.2 (2012)	13.3
Socialistische Partij (SP, Netherlands)	16.6 (2006)	9.9 (2010) 9.7 (2012)	– 6.7 (2010) – 6.9 (2012)	9.6
Freiheitliche Partei Österreichs (FPÖ, Austria)	11.0 (2006) 17.5 (2008)	20.5 (2013)	+ 9.5 (2006) + 3.0 (2008)	19.7
Bündnis Zukunft Österreich (BZÖ, Austria)	4.1 (2006) 10.7 (2008)	3.5 (2013)	– 0.6 (2006) – 7.2 (2008)	0.5
Schweizerische Volkspartei (SVP, Switzerland)	28.9 (2007)	26.6 (2011) 29.4 (2015)	– 2.3 (2011) + 0.5 (2015)	
Alternative für Deutschland (AfD, Germany)		4.7 (2013)	+ 4.7	7.1
UK Independence Party (UKIP, UK)	2.2 (2005)	3.1 (2010) 12.6 (2015)	+ 0.9 (2010) + 10.4 (2015)	26.8

[a)] In %; election years in parentheses.

Source: Parties and Elections in Europe, http://www.parties-and-elections.eu/countries.html; European Parliament, *Results of the 2014 European elections*, Results by Country, http://www.europarl.europa.eu/elections2014-results/en/country-introduction-2014.html. This is an updated version of a table in Pappas and Kriesi (2015).

2015 elections and formed a coalition with the right-wing populist party ANEL. In Spain and Italy populist parties were so far less successful, but they nevertheless gained support and transformed the political landscape as well.

Table 2.1c summarises the emergence of populist parties in Central and Eastern Europe. Here the most striking development is that of Hungary and Poland, where parties with clearly populist profiles have taken over power. While many Eastern European countries did experience an economic slowdown after the financial crisis, their overall economic development during the last decade was mostly very positive, and particularly so in the case of Poland. The crisis explanation for growing populist support is therefore not equally relevant across countries.

2.5 How should societies respond to the rise of populism?

As explained in the preceding sections, populist parties and political movements often raise relevant issues, but the policies they suggest to address these issues are usually counterproductive because they fail to take into account important aspects and tradeoffs between different policy objectives. There is a danger that increasing populist influence leads to protectionism and conflicts between countries.

2.5.1 Political responses: demonise or integrate populist parties?

Political science literature discusses various strategies to prevent populist parties from taking over power. One such stragey is "militant democracy": if populist parties threaten to overthrow the democratic order, "militant democracy" would imply that democratic institutions do not tolerate parties or political movements that aim to destroy democracy and the rule of law and replacing it with an authoritarian order.

But not all populist parties attack democratic institutions. Most of the current populist movements try to achieve power within the existing political system and they do not, openly at least, express intentions to change that system. In these cases, a possible strategy

Table 2.1b

Electoral results of populist parties in Mediterranean region[a)]

	Pre-crisis (A)	Post-crisis (B)	Difference (B-A)	EU-2014
Forza Italia (FI Italy; formerly PDL)	23.7 (2006) 37.4 (2008)	21.6 (2013)	– 2.1 (2006) – 15.8 (2008)	16.8
Lega Nord (LN, Italy)	4.6 (2006) 8.3 (2008)	4.1 (2013)	– 0.5 (2006) – 4.2 (2008)	6.1
Movimento Cinque Stelle (M5S, Italy)		25.6 (2013)	+ 25.6	21.1
Anexartitoi Elline (ANEL, Greece)		10.6 (2012-I) 7.5 (2012-II) 4.8 (2015-I) 3.7 (2015-II)	+ 10.6 (2012-I) + 7.5 (2012-II) + 4.8 (2015-I) + 3.7 (2015-II)	3.5
Popular Orthodox Rally - G. Karatzaferis (LAOS, Greece)	3.8 (2007)	5.6 (2009) 2.9 (2012-I) 1.6 (2012-II) 1.0 (2015-I)	+ 1.8 (2009) – 0.9 (2012-I) – 2.2 (2012-II) – 2.8 (2015-I)	2.7
Chrysi Avyi (ChA, Greece; Golden Dawn)		0.3 (2009) 7.0 (2012-I) 6.9 (2012-II) 6.3 (2015-I) 7.0 (2015-II)	+ 0.3 (2009) + 7.0 (2012-I) + 6.9 (2012-II) + 6.3 (2015-I) + 7.0 (2015-II)	9.4
Synaspismos Rizospastikis Aristeras (SYRIZA, Greece)	5.0 (2007)	4.6 (2009) 16.8 (2012-I) 26.9 (2012-II) 36.3 (2015-I) 35.5 (2015-II)	– 0.4 (2009) + 11.8 (2012-I) + 21.9 (2012-II) + 31.3 (2015-I) + 30.5 (2015-II)	26.6

[a)] In %; election years in parentheses.

Source: Parties and Elections in Europe, http://www.parties-and-elections.eu/countries.html; European Parliament, *Results of the 2014 European elections*, Results by Country, http://www.europarl.europa.eu/elections2014-results/en/country-introduction-2014.html. This is an updated version of a table in Pappas and Kriesi (2015).

is to isolate and ignore, or demonise, populist parties. An alternative strategy is to integrate populist parties, and even let them be part of coalitions, provided they accept the rules of democratic policymaking. In a recent study of extremist and populist parties in Europe, Downs (2012) argues that policies of isolation and demonisation are much less effective as a strategy to contain political parties than polices of conditional integration.

2.5.2 Is it time to change economic policies?

If populism remains on the margins and the mainstream retains power, governments may have room to address the causes of support for populism, and keep it at bay. Insofar as populist support is fuelled by economics – low incomes, poor housing, pressure on public services, inadequate public infrastructure – governments can respond with policies to improve matters. More redistributive taxes and higher minimum wages can boost the income of low-earners. Of course, these policies face tradeoffs. Higher minimum wages may help low skilled workers who find employment, but they may also increase unemployment. If it is true that globalisation subjects low skilled labour in developed countries to competitive pressures, minimum wages cannot help them. However, higher investment in education and vocational training would give the less-skilled more competences and enable them to find better paying jobs. Norway uses collective bargaining (co-ordinated nationally) to enforce higher wages. Finland is going to experiment with a basic income. Greater public investment in building housing would help poorer people in the UK by relieving shortages and bringing down prices. Public transport infrastructure in the UK also requires more investment.

If such policies are successful, they may sap populist support, insofar as economic conditions are responsible. If, on the other hand, the cultural values identified by Inglehart and Norris (2016) are responsible, the problem may be harder to solve.

2.5.3 Recapturing the narrative

Populism has arisen in the context of a political convergence among the mainstream parties, and the response to it in Europe has been an accommodation of populist policies, but some thinkers argue that such attempts to offer “populism lite” will fail.

Table 2.1c

Electoral results of populist parties in CEE region[a)]

	Pre-crisis (A)	Post-crisis (B)	Difference (B-A)	EU-2014
Věci Veřejné (VV, Czech Republic)		10.9 (2010)	+ 10.9	0.5
ANO 2011 (ANO, Czech Republic)		18.7 (2013)	+ 18.7	16.1
Úsvit - Národní Koalice (ÚSVIT, Czech Republic; The Dawn)		6.9 (2013)	+ 6.9	3.1
Sloboda a Solidarita (SAS, Slovakia)		12.1 (2010) 5.9 (2012) 12.1 (2016)	+ 12.1 (2010) + 5.9 (2012) + 12.1 (2016)	6.7
Slovenská Národná Strana (SNS, Slovakia)	11.7 (2006)	5.1 (2010) 4.6 (2012) 8.6 (2016)	– 6.6 (2010) – 7.1 (2012) – 3.1 (2016)	3.6
L'udová strana – Hnutie za demokratické Slovensko (L'S-HZDS or HZDS, Slovakia)	8.8 (2006)	4.3 (2010) 0.9 (2012)	– 4.5 (2010) – 7.9 (2012)	
Prawo i Sprawiedliwość (PiS, Poland)	32.1 (2007)	29.9 (2011) 37.6 (2015)	– 2.2 (2011) + 5.5 (2015)	31.8
Kukiz'15 (K, Poland)		8.8 (2015)	+ 8.8	
Magyar Polgári Szövetség (FIDESZ, Hungary)	42.0 (2006)	52.7 (2010) 44.9 (2014)[b)]	+ 10.7 (2010) + 2.9 (2014)	51.5[b)]
Jobbik Magyarországért Mozgalom (JOBBIK, Hungary)	2.2 (2006)	16.7 (2010) 20.2 (2014)	+ 14.5 (2010) + 18.0 (2014)	14.7

[a)] In %; election years in parentheses.
[b)] Together with KDNP.

Source: Parties and Elections in Europe, http://www.parties-and-elections.eu/countries.html; European Parliament, *Results of the 2014 European elections*, Results by Country, http://www.europarl.europa.eu/elections2014-results/en/country-introduction-2014.html. This is an updated version of a table in Pappas and Kriesi (2015).

Jürgen Habermas, distinguished sociologist and one of the thought leaders of the political left in Germany, criticises politics for being "grey on grey":

> "[…] the left-wing pro-globalisation agenda of giving a political shape to a global society growing together economically and digitally can no longer be distinguished from the neoliberal agenda of political abdication to the blackmailing power of the banks and of the unregulated markets."

Instead, he argues that the policial left needs to re-establish a distinct position:[19]

> "One would therefore have to make contrasting political programmes recognisable again, including the contrast between the – in a political and cultural sense – liberal open-mindedness of the left, and the nativist fug of right-wing critiques of an unfettered economic globalisation. In a word: political polarisation should be re-crystallised between the established parties on substantive conflicts. Parties that grant right-wing populists attention rather than contempt should not expect civil society to disdain right-wing phrases and violence."

While Habermas' distinction between what he believes to be the "open-mindedness of the left" and "nativist fug" of the right has itself a populist flavour, his point that mainstream democratic parties should be distinguishable is certainly relevant to the debate. The German chancellor Angela Merkel is widely seen as pursuing an extreme strategy of depolarisation sometimes refereed to as "asymmetric demobilisation". This strategy blurs the differences between mainstream political parties, demobilises voters of all parties, but achieves a stronger demobilisation effect on other parties than Angela Merkel's CDU.

This policy is often criticised as favouring the emergence of the AfD. According to this view, mainstream parties could crowd back populism by offering a larger spectrum of political programmes and views, which includes real alternatives to existing economic policies.

[19] Habermas, "For a Democratic Polarisation: How to Pull the Ground from Under Right-Wing Populism," *Social Europe*, 17 November 2016, https://www.socialeurope.eu/2016/11/democratic-polarisation-pull-ground-right-wing-populism/.

2.5.4 Information versus voter manipulation and independent expert evaluation of political agendas

Next to the "real" economic conditions, political support for populist parties may be driven by the perception of these conditions, which may differ from the reality of the situation. Voters are frequently poorly informed of the general economic situation, as well as the content of economic policy agendas presented by populist and other parties. In a world dominated by television, tabloid newspapers and social media, where attention spans are short and emotions dominate the debate, efforts need to be be made to better inform voters and educate them to be more objective.

One approach is to give a neutral institution the task of analysing the economic policy agendas of all political parties. In the Netherlands, the Central Planning Bureau (CPB), an economic research institute, regularly analyses the manifestos of the different political parties running in national elections. For instance, in the run-up to the general elections in 2012, it published a study of the likely impact of the policies proposed by ten different political parties on a wide range of variables ranging from GDP and the public debt to the housing market, pensions and the environment. This did not prevent the populist Freedom Party from winning over ten percent of the votes, making it the third largest group in the Dutch Parliament.[20]

Nevertheless, the Dutch approach has the advantage of forcing political parties to submit an economic policy agenda, which is at least complete and consistent enough to be evaluated. The evaluation study itself may be difficult for most voters to digest, but it gives journalists a basis for informing the public about existing political alternatives.

2.5.5 The role of referenda

Recent experiences with referenda have led to a debate over whether they facilitate the increased impact of populism on politics. These experiences include not only the Brexit decision but also, for instance, the Dutch referendum on the EU-Ukraine Association Agreement. The agreement was rejected with 61 percent of votes. In July 2015, the Greek government organised a referendum on the adjustment programme suggested by the Troika. Clearly, this was a tactical move to improve the bargaining position of the Greek government. The British referendum is seen by many as a result of a power struggle within the Conservative party. In both cases, the options available to voters were not clearly defined. It was unclear what would happen if the Greek people rejected the adjustment programme – in the end not much happened and the adjustment programme came despite the fact that the people had rejected it. In Britain, the terms of exit from the EU were unclear, and neither the government nor its oponents expected Brexit to win. The result led to a swathe of resignations, not only within the government, but also among prominent Brexit campaigners, leaving a prolonged power vacuum and a sense of chaos. The administration of Theresa May, who eventually emerged as prime minister, has found itself implementing a radical change in which many ministers do not believe, assisted by an unprepared and clearly highly sceptical civil service.

What are the implications of these events for the desirability of referenda? Fundamentally, referenda reflect that there is a principal-agent problem between the citizens and their agents, namely politicians and bureaucrats. Since the interests of politicians and bureaucrats may differ considerably from those of the citizens, it is important that citizens have instruments to stop politicians if necessary. One such instrument is a general election, but these do not happen often and general elections are about multiple issues. It is therefore perfectly rational to see referenda as way of making democratic decisions in certain cases. There are many countries where referenda constitute a central element of the democratic political culture. The best-known example is Switzerland, but there are many others.

However, governments should not be allowed to use referenda as ad hoc instruments to achieve their goals. Referenda should be part of a constitutional framework where their conditions of use are clearly specified, and where the initiative comes from the citizens, not from the government. Referenda should also be about choices between clearly defined alternatives.

2.5.6 The EU as a device to rein in populism

While populists dislike supra- and international institutions and exploit the weaknesses of these institutions to question their existence, these same institu-

[20] Somewhat surprisingly, the study finds that the economic program of the Freedom party would lead to higher levels of GDP than that of any other political party, see Centraalplanbureau and Planbureau voor de Leefomgeving, *Effecte op economie en milieu,* Keuzes in Kaart 2012–2017.

tions can be seen as a safeguard against populism. Of course, if supranational institutions lack democratic control they can become a cause of popular resentment. It is also true that governments can abuse supranational institutions to pursue their own interests or make deals with lobby groups in a way that could not be done at the national level.

At the same time, however, being part of a confederation of countries limits the power of national governments and creates a system of checks and balances whereby the supranational level can protect citizens against the failures of the national political process and vice versa. Being part of the EU can be seen as a long-term contract, which specifies that the member states and their governments will respect a set of rules on democracy, the legal system, human rights, social standards, and the freedom to move and trade across borders.

Against this background, EU membership itself can be considered a device to rein in populism. One example is the current conflict between the EU and Poland, whereby the EU is accusing Poland of undermining the rule of law. In December 2015, the Polish Parliament passed a law that makes it more difficult for the constitutional court to reach decisions. For instance, the law introduces a majority of two thirds for court decisions and increases the minimum number of judges that must be present from 9 to 13 of the 15 judges. In addition, judges can be dismissed at parliament's request. On 16 January 2016, the European Commission launched a formal "rule of law assessment" based on Article 7 of the Lisbon Treaty. This assessment could lead to Poland losing its voting rights in the EU.

If the EU wants to be credible as an institution that allows member states to bind themselves to certain rules and commitment, the EU needs to be careful to act strictly within the limits of the powers that have been bestowed upon it. From this perspective, making the European Commission a more political actor as desired by the current Commission President is problematic and undermines the function of the European Commission as a guardian of the European Treaties. Since democratic legitimacy is indirect and derived primarily from the member states and the national political processes,[21] it is of key importance to avoid the impression that European institutions are acting beyond the remits of their mandates. This also applies to the ECB.

2.6 Conclusions

The current surge of populism in Europe and the US is a significant challenge not only for mainstream political parties but, more importantly, for the prosperity and political stability of advanced economies across the world. Implementing some of the policies they favour, particularly the dismantling of international trade agreements, would generate significant costs and may lead to economic crises that further undermine rational and balanced policymaking.

Many populist parties do raise important questions and issues. These include the widespread perception of increasing economic uncertainty, unfairness in the distribution of the costs of recent crises, particularly the financial crisis, and growing concerns about the economic impact of globalisation on parts of the population, as well as its implications for democratic control. However, the answers provided by the populist economic agenda are overly simplistic and partly based on false information. Of course, this is not to say that arguments made by mainstream parties are always based on an appropriate and balanced presentation of the relevant facts. Their economic policies can be shortsighted or dominated by electoral cycles too. In fact, populist policies are not limited to political parties usually classified as populist. Mainstream political parties sometimes pursue populist policies as well. In this respect populism is essentially a characteristic of the political process itself, not of certain political parties or politicians.

What can be done to stop the surge of populism? The complexity of the factors driving populism implies that there are no easy and simple answers to this question. Societies will need to counter populism at various levels:

[21] Of course, the process of European integration could be seen as leading to an institutional setting where sovereignty is increasingly passed onto the EU level. Habermas, for instance, would have the EU cast itself in the role of supranational defender of society and individual well-being against the march of globalisation, although he admits that this a tall order:
"[…] there is only a supranational form of co-operation that pursues the goal of shaping a socially acceptable political reconfiguration of economic globalisation. International treaty regimes are insufficient here; for, putting aside completely their dubious democratic legitimacy, political decisions over questions of redistribution can only be carried out within a strict institutional framework. That leaves only the stony path to an institutional deepening and embedding of democratically legitimised co-operation across national borders. The European Union was once such a project – and a Political Union of the Eurozone could still be one. But the hurdles within the domestic decision-making process are rather high for that" (Habermas, op. cit.).

1. *Politics*: It is important that the democratic political process leaves scope for disagreement among different people, groups, and political parties in society. At the same time, mechanisms for compromise, based on credible, transparent information and an articulate facts-based debate are needed. Disagreement and debates are fruitful. Too much consensus can backfire.
2. *Political decision-making processes*: Governments should refrain from using referenda as an instrument in the political power struggle. Referenda should provide an opportunity for political initiatives coming from the population, and their role should be clearly defined in the constitution. A drawback of referenda is that they usually imply isolated decision-making on single issues, rather than the comparison of comprehensive policy programmes.
3. *Economic policy*: Economic policy should recognise that political decisions and economic developments create winners and losers; and that the losers have a right to disagree. In most cases, however, the losers are difficult to identify and the losses are hard to measure. Those who think they are losing out should not be allowed to veto if a policy is expected to increase total welfare. Welfare states offer protection to those groups of society negatively affected by economic developments.
4. *Delegation*: Delegating clearly defined tasks and responsibilities to independent institutions like central banks or supranational institutions like the EU can rein in populism and allow the productive use of expert knowledge and judgement. The EU can be seen as a long-term commitment by its member states to adhere to fundamental principles of democracy, openness and the rule of law. Mainstream political forces should stop using the EU as a scapegoat for internal economic and political problems. Meanwhile, EU policies should be transparent and strictly adhere to the principle of subsidiarity. EU institutions, including the ECB, should strictly adhere to their mandate. The European Commission should focus on its role as a guardian of the European treaties. This is incompatible with making the Commission a more political institution.

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Britain and EUexit – The People Versus the EU

3.1 Introduction

The outcome of the UK referendum of 23 June 2016, which sent shockwaves across the nation, Europe, and indeed the industrialized world, was widely interpreted as the manifestation of a new wave of "populism". The British government certainly did not reckon with a "no" to continued EU membership when it called the referendum. David Cameron's cabinet was shockingly unprepared for a "Brexit" (Britain's exit from the EU) and had no specific plan as to how it might be implemented. Opinion polls, financial markets, and even betting markets had anticipated a win for the establishment, and, as in the case of the US presidential election in November 2016, they were proven wrong.

The unexpected "Leave" majority and the process that will ultimately terminate Britain's membership of the EU initially produced a substantial body of commentary and analysis.[1] But much remains to be understood, and Brexit is only one symptom of a deeper, broader, and complicated malaise. The prospect of Brexit is not only proving difficult to digest in the UK, but across Europe. It poses an existential challenge to the European integration process. Angela Merkel remarked in response to Brexit, "We must face the consequences [of Brexit] and consider the future of the EU," adding that "Citizens will only accept the EU if it makes it possible for them to prosper."[2] In the wake of Brexit, and after Donald Trump's election, the EU seems to be the only viable and powerful defender of the principles of a liberal international order.

This chapter examines the determinants and consequences of Brexit, as well as of more general, negative views of the EU's past development and future configuration. We discuss the reasons why the British electorate voted in favour of Brexit, and the implications of that outcome for the country's own economic well-being, as well as that of other EU member states. We interpret Brexit as an extreme instance of more general scepticism about European integration, and hence as an opportunity to reflect upon the interaction of narrow and short-term political perspectives with the cumbersome and incomplete economic policy framework of the EU.

3.2 What does Brexit actually mean?

Theresa May, Prime Minister of the new British government formed after the referendum result that prompted David Cameron's resignation, has tried to minimise speculation over Britain's negotiating strategy, and over whether the government may choose to ignore the mandate of the British people. She has repeatedly asserted that "Brexit means Brexit," but this obvious tautology has not helped citizens or markets to better understand what is likely to ensue.

The referendum outcome initially induced a widespread fear of an immediate economic meltdown, comparable to the aftermath of the 2008 Lehman collapse. Stock markets instantly fell all over the world, and the British exchange rate depreciated. The UK stock market then recovered, and growth for the second half of 2016 was surprisingly strong.

Sober estimates of the purely economic costs of UK exit from the EU do not generally predict the kind of catastrophe that would justify the dramatic reactions seen immediately after the Brexit referendum. Large stock market declines may have foreseen much broader and deeper disruption, perhaps because traders (if not the majority of voters) were persuaded by the main theme of the Remain campaign in the UK, and by the far more dramatic estimates of the costs of Brexit produced by the UK Treasury (2016a, 2016b) before the election. The UK Treasury summarised these costs in the spuriously precise headline figure that Brexit would cost each British household an annual 4,300 British pounds by 2030. These figures combine a negative view of the long term consequences of Brexit with a dramatic warning as to the severity of

[1] See in particular Begg (2016) and Baldwin (2016).

[2] Foy, H., "Merkel says Brexit could be a 'breaking point' for EU," *Financial Times*, 26 August 2016, https://www.ft.com/content/ad3d4cc9-5c8b-36cd-b6c5-efd57842909b.

the immediate shock, with a 3.6 percent fall in GDP after 2 years and 500,000 jobs lost (or, in the case of a severe shock, a 6 percent fall in GDP and 800,000 additional unemployed).

The forecasts depended heavily on *ceteris paribus* assumptions. The UK Treasury's publications looked as if they were politically tweaked, because they did not allow for a fiscal and monetary effort to offset the contractionary effects of the immediate shock, while in reality the Bank of England cut rates and the new government announced a large fiscal expansion programme.[3] Moreover, in the long term, the Treasury's figures were based on a gravity model of the trade effects, which may have over-estimated the extent of losses and under-estimated the possibilities of new trade creation (Blake, 2016). Conversely, the more optimistic estimates only considered trade effects (which hardly ever exceed one or two percent) without allowing migration to change, even although restrictions on migration had been a core element of the campaign for Brexit.

It is not so much that forecasts are "wrong," but that the models used did not cover all of the uncertainties that apply in reality. As a result, it is easy to conclude that economists are simply not good at predictions, and that the popular or populist suspicion of experts is fully justified. The Remain campaign's reliance on scare stories about a Brexit – what was termed "Project Fear" – miscalculated its own impact on voter opinion in the UK. As was the case in the US presidential election, the final stages of the campaign saw stock market prices climb with Hillary Clinton's estimated probability of winning; but they rose even further when voters elected Donald Trump. No major catastrophe occurred immediately after the referendum. The markets have recovered recently, and the UK economy is doing well, which is at least partly due to the pound's depreciation. This is not to say that Brexit has little impact, because in an obvious sense Brexit has not yet happened. The formal mechanism to discuss the UK's departure from the EU will only begin when the UK government declares its intention to withdraw by invoking Article 50 of the EU Treaty.[4] The institutional setting in which Brexit will take place remains nebulous. As we discuss below, EU membership means far more than free trade, but the UK government has not yet announced any plan on how to extricate the country from its deep integration with the EU's single market.

Various options for managing the UK's future relations with the EU have been floated, including membership of the European Economic Area (which would require making payments and accepting freedom of movement), or a trade and investment treaty of the kind currently being negotiated by EU and Canada. The first option is attractive to financial interests in the City of London who would like to keep "passporting" rights in the EU, but it is unlikely to satisfy the voters and politicians who supported Brexit. The EU is also reticent about negotiating new trade treaties, and there is even controversy over the Canada treaty and the proposed TTIP agreement. To complicate matters, alternative trade agreements cannot be negotiated while the UK is still an EU member, and certainly not before the UK has invoked Article 50.

The economic test of what Brexit precisely means is still to come, and the politics are fuzzy. How the remaining EU members will respond – and the extent to which voters in these countries will see parallels to their grievances – is also unclear.

3.3 Exit, from which EU?

There are many UK particularities that distinguish it from continental EU members. Not only does the UK have no written constitution or identity card system, it also has a rather lightly regulated labour market, far more developed financial markets than continental bank-centric systems, and a welfare state that is less generous, but more easily accessible than continental contribution-based schemes.

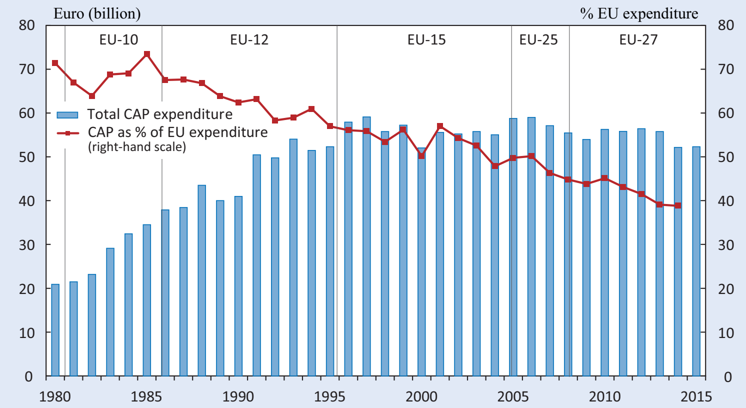
Britain's vision of the EU differs from that of other members, and the UK interprets its interests as diverging in fundamental ways from those of most continental European countries. The UK tradition is less regulated, hostile to the idea of Europe-wide fiscal centralisation, less concerned with the fortunes of the agri-

[3] Giles, C. and G. Tetlow, "Fact-Checking the Treasury's Latest Brexit Report," *Financial Times*, 23 May 2016, https://www.ft.com/content/d05c4b60-20d8-11e6-9d4d-c11776a5124d.

[4] "A Member State which decides to withdraw shall notify the European Council of its intention. In the light of the guidelines provided by the European Council, the Union shall negotiate and conclude an agreement with that State, setting out the arrangements for its withdrawal, taking account of the framework for its future relationship with the Union. […] The Treaties shall cease to apply to the State in question from the date of entry into force of the withdrawal agreement or, failing that, two years after the notification referred to in paragraph 2, unless the European Council, in agreement with the Member State concerned, unanimously decides to extend this period."

Figure 3.1

CAP expenditure in total EU expenditure [a)]



[a)] Annual expenditure in 2011 constant prices.
Source: CAP expenditure: European Commission, DG Agriculture and Rural Development (Financial Report); EU expenditure: European Commission, DG BUDG-2008 EU Budget Financial Report for 1980-1999, DG BUDG-2015 EU Budget Financial Report from 2000; Annual expenditure in 2011 constant prices; https://ec.europa.eu/agriculture/sites/agriculture/files/cap-post-2013/graphs/graph1_en.pdf.

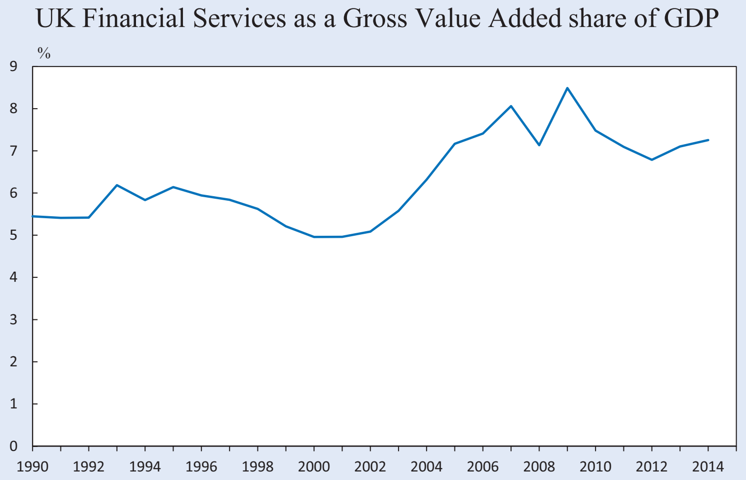
cultural sector, and more dependent on financial services.

The structure of the EU's economic policy framework was established long before the UK's accession in 1973 and is based on the model of European nation states, where market interactions are framed by a pervasive institutional infrastructure. The EU wants market competition to transcend boundaries and prevent inefficient competition among policymakers, but at the same time recognises that markets need to be supervised. Antitrust policies are needed to prevent monopolistic inefficiencies. The regulation and standardisation of product specifications helps to ensure that market participants are well informed. In all advanced countries, and all EU member states including the UK, welfare schemes shelter individuals from the risk inherent in participating in complex and wide-ranging market interactions, fiscal and monetary policies offset aggregate demand fluctuations, and deposit insurance prevents runs on bank deposits.

The challenge for the EU is to maintain and develop these safeguards in cases where markets span national borders. This calls for complex compromises because, even when market structure and institutional frameworks are broadly similar across countries, traditions differ, especially in terms of social and labour policies that remain a pillar of industrial and post-industrial nation-states. The EU's ever-closer-union trajectory uses economic instruments to promote stability, cohesion and growth; and emphasizes cultural convergence around democratic common values. For continental European countries, integration was primarily meant to heal the scars of war and rule out the possibility of future armed conflict.

The British perspective on the need for regulatory and redistributive policies and the historical process leading to European integration differs significantly. For the people and the political leaders of a country that has not, in the relatively recent past, experienced dictatorship, revolution, or serious macroeconomic instability it is natural to value growth more highly than stability or cohesion. It is therefore unsurprising that the UK opted out of the single European currency project, which had been intended to foster market integration and price stability, but also to strengthen identification with Europe. The UK strongly supported enlargement, rather than any deepening of the EU. The logic underlying this strategy was that the accession of heterogeneous, relatively poor countries in Central Europe would make it more difficult to envision a stronger and more cohesive policy framework on the one hand, and would dilute public support for integration with relative strangers on the other. The UK vetoed proposals to harmonise capital taxation. It also declined to sign the Social Charter accompanying European treaties, ensuring that social, labour, and fiscal policies were squarely assigned to the national level, and hence exposed to race-to-bottom tensions. In most of Continental Europe, EU efforts to harmonise and constrain these policies tend to be unpopular with left-wing parties, and attract support for their market orientation from business and elites. In the UK, conversely, EU regulations on working hours and union rights have proven binding enough to draw the criticism from those who feel they unduly constrain individual freedom. The fiscal component of EU economic policies is both underdeveloped (the budget is less than 1 percent of EU GDP) and imbalanced, in that the Common Agricultural Policy still swallows up almost 40 percent of the overall budget (see Figure 3.1). The focus on agriculture is rooted in the history of France and Germany and other continental European economies. In the interwar period, farmers worldwide saw their incomes plunge as new areas started to produce. Food prices, and then farm prices, collapsed. Over-indebted farmers lost their farms, and the banks to which they

Figure 3.2



Source: Bank of England and EEAG calculations.

owed money cut off their credit lines. The interwar period remedies – trade protection through tariffs and quotas – proved ineffective. The European Economic Community's prime fiscal mechanism, the Common Agricultural Policy, set prices for farmers, and offered an elaborate system of subsidies. Managing rural decline proved the most important political payoff of the European process. The UK, by contrast, did not really need this peasant class management system, with only 9.2 percent of employment in agriculture in 1900 and 4.1 percent in 1958. For France, agriculture accounted for 42.2 percent of employment in 1900, a figure that was still high at 22 percent, when the European Economic Community was founded in 1958. Today, only 2.8 percent of French workers are employed in agriculture (2010). For Germany, the equivalent figures are 33.8 percent in 1900, 16.1 percent in 1958, and 1.6 percent in 2010; while for Italy they are 58.7 percent, 32.9 percent and 4.0 percent (Wingender, 2014). A reform should be based on significantly lowering the importance of agricultural transfers.

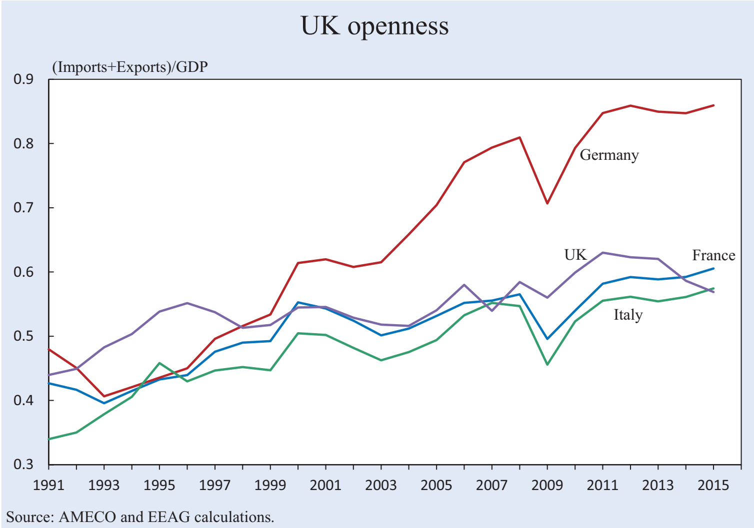
Britain has consistently pursued a half-hearted or semi-detached position with respect to European fiscal integration. The issue of European fiscal capacity surfaced during the Greek rescue package in 2015, when Prime Minister David Cameron refused to participate in financing via the European Financial Stability Mechanism, and Chancellor George Osborne noted that, "the euro area needs to foot its own bill." Cameron had deeply internalised the "money back" lesson established by Margaret Thatcher in the 1980s: Great Britain needs to defend itself against budgetary claims from Europe. At the same time, he and George Osborne were also impressed by American economists who told them that a monetary union without a full fiscal union was inherently unstable, and, as a result, Europe could only save itself by proceeding quickly towards a real fiscal union. The UK therefore found itself in the awkward position of arguing in favour of a drive towards the very fiscal centralisation that it had previously sought to undermine.

The fiscal debate embodied an increasingly apparent policy incoherence that highlighted the anomaly of the British position. As signatories of the Maastricht Treaty, or as later accessories, all EU members without an opt-out (the UK and Denmark obtained an exemption) were obliged to eventually join the monetary union. The euro area itself had no fiscal capacity at all – only the EU did. Thus, in pushing for an approach to the European debt crisis modelled on Alexander Hamilton's system of the early years of the American Republic, the UK was setting itself up for the fundamental choice about whether it should really be part of an ever-closer union along Hamiltonian lines.

There is another key area of policy incoherence in which the UK and continental Europe appear to have conflicting traditions and interests. Financial services form a large part of the UK economy (see Figure 3.2). In terms of value added, the share of financial services in the UK economy rose in the 2000s, but contracted somewhat in the aftermath of the financial crisis. One of the first moments of tension between David Cameron and the other European heads of government occurred in December 2011 when Cameron vetoed proposed treaty changes because they did not provide adequate safeguards for the City of London.

There are two conflicting views of the future of UK financial services and their interaction with the European market. In one interpretation, the UK is successful as a European financial centre, but needs access to the European market. The most straightforward way to grant such access would be the passporting of UK-based institutions in Europe, but this outcome would require UK compliance with Europe's bundling of four freedoms: the free movement of goods, services, and capital accompanied by the free movement of persons. Some argue that there is no logic to this association, and that many societies in a globalised world are open to the first three forms of movement, but not the latter (Pisany-Ferry et al., 2016). Alternatively, in the other vision, the UK's future is as a provider of global financial services, and it would be limited or constrained if it accepted the European regulations that would come with passporting. It could rely on the EU's acceptance of a principle of equivalence, whereby US, Japa-nese, and even Chinese financial institutions have access to the European market when their regulations are accepted as being equivalent to those of the EU. This view suffers from the problem that equivalence is currently being redefined, partly as a response to the Brexit debate, and partly reflecting a trend towards growing nationalism in financial regulation. The out-option for financial services may also draw on the experiences of other small offshore financial centres: Hong Kong and Singapore depend on a good relationship with China, as do Switzerland and Liechtenstein with Europe. In the future Europe would be likely to react with scepticism and hostility to a UK attempt to build a very lightly regulated (and thus potentially risky) offshore financial centre to work with and in Europe.

Figure 3.3



Source: AMECO and EEAG calculations.

It is also questionable whether the focus on UK financial services reflects the aspirations of most Brexit voters, who largely disapproved of London's economic, financial and social liberalism, and favour traditional values to the glittering dynamism of a global mega-city.

3.4 British visions of exit

The UK electorate's policy views and referendum vote did not really reflect the difficult relationship between the UK and the EU's complex and nuanced approach to regulation and the market economy. Most British voters own no stocks directly and may be blissfully ignorant of the indirect impact of market interactions on their welfare. Their decision, like the renaming of the South African national rugby team criticised by Nelson Mandela in the movie *Invictus*, was perhaps "based on insufficient information and foresight." Cameron's initial move to hold a referendum on EU membership was driven by concern over electoral competition to the Conservative Party from the radical populist party, UKIP (which participated in and promoted an international spin campaign of the "alt-right" which relied on the distortion of news and the propagation of catchy misrepresentation (Shipman, 2016).

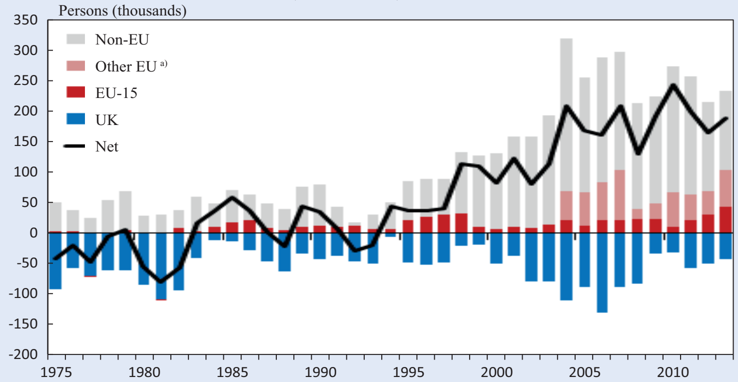
The consequences of Brexit are potentially far more dramatic for British citizens than they perceived when voting. This is because the UK is an exceptionally globalised country in terms of its integration in capital markets (Figure 3.3), and due to large migration flows (Figure 3.4).

In terms of trade integration, Figure 3.3 shows that the UK is comparable with other large EU countries. As of 2000, however, Germany's openness stands out in this group of comparably sized countries. Interestingly, the single currency, enlargement, and the great recession that challenge the EU's institutional structure and decision-making processes are also associated with the far more important role played by international trade in Germany's economy.

Dwelling on aggregate statistics, however, does not help us to understand the revolt against integration expressed by the referendum results. It is far more fruitful to consider what sort of information is available to individual voters and how that informs their point of view.

Figure 3.4

Net migration flows for the UK: Movements from EU-15, other EU, non-EU, and from UK



[a)] Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Slovakia, and Slovenia.
Source: Nickell and Saleheen (2015).

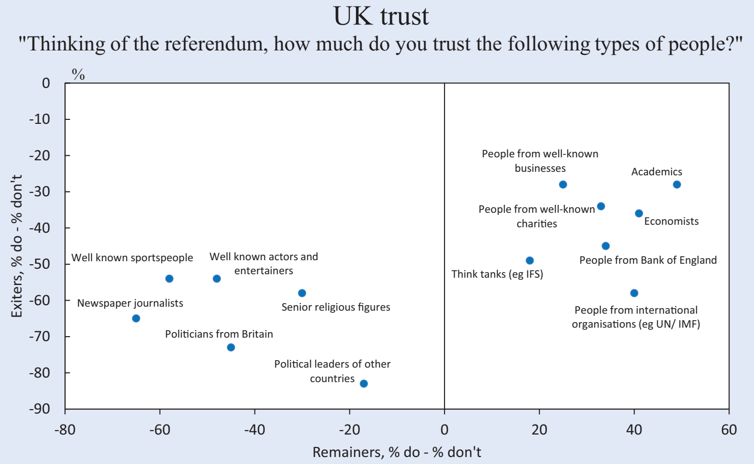
To comprehend why many voters rationally chose "leave", despite the threat of a potential overall economic losses, it is worth remembering that much larger individual consequences tend to be included in an overall average of gains or losses. Economic integration opens up goods and factor markets to foreign competition. Competition increases efficiency and lowers the cost of final products, but also displaces those producers who could supply relatively scarce and expensive services in autarky. Removing import barriers generates widespread benefits, for example in the form of cheaper clothing, and concentrates damages, such as job losses for clothing manufacturers. Survey evidence reveals that international economic integration is perceived to be risky, and that attitudes towards it are related to individual characteristics in ways compatible with the theory of competitive advantage (e.g. Mayda et al., 2007). In advanced countries with more generous welfare schemes, highly-skilled individuals are less in favour of immigration, quite possibly because, as relatively high-income taxpayers, they feel threatened by redistribution towards relatively poor immigrants. More intense foreign direct investment activity is also associated with satisfaction or dissatisfaction with the respondent's present job security in the British worker survey analysed by Scheve and Slaughter (2004). They find that variation over time within a sector of indicators of Foreign Direct Investment activity, controlling for the aggregate cycle, has an effect on perceptions of job security that is statistically very significant and roughly twice as strong as that of worker unionisation, education, and income.

Differences of opinion within the UK are not difficult to rationalise in terms of these simple economic insights into integration's distributional impact, and voters' socio-economic characteristics. Low-skilled workers are theoretically expected to oppose immigration more strongly than high skill workers in countries where immigrants are more markedly less skilled than residents; in the UK, more educated voters voted Remain and geographic and demographic factors also played a significant role (see e.g. Darvas, 2016). Although workers in heavily export-dependent manufacturing areas that enjoy large-scale European corporate investment, such as the aerospace manufacturing city of Derby, opted for Brexit, it makes sense to remain in the EU for Londoners and other city dwellers who can rely on the help of unskilled immigrants if they are not themselves immigrants, and who derive their income from the international sales of financial services. Conversely, short-termist populist positions are coherent choices for elderly voters who will not be around in the longer run, and do not worry about large future demographic and skills imbalances as a result.

Diverse views are very imperfectly aggregated by a narrow overall majority on a single yes/no issue. In fact, leaving the EU appealed to Brexit supporters for a broad spectrum of very different reasons. The coalition that narrowly won the referendum included pro-business, market-oriented voters who resent the EU as a source of bureaucracy and regulation, as well as the elderly and the poor, who support social welfare policies and fear competition. It is far from clear that the Brexit supporters agreed on much else. Interestingly, Prime Minister May has expressed views that are aligned more closely with those of Brexit supporters who fear competition than with those of free-trader business, but her government has also (drawing a sharp rebuke from Germany) outlined plans to sharply reduce corporate income tax rates.

Let us now consider the information on which voting was based. Many myths published by the British tabloid press and propagated by UKIP and other EU critics are collected at the Euromyths index, where European Commission officials patiently explain the rationale of regulations that, in any case, are not as extreme as eurosceptics are led to believe by their infor-

Figure 3.5



Source: YouGov, A. Kirk and D. Dunford, "EU Referendum: Leave Supporters Trust Ordinary 'Common Sense' more than Academics and Experts," Telegraph, 22 June 2016, http://www.telegraph.co.uk/news/2016/06/16/eu-referendum-leave-supporters-trust-ordinary-common-sense-than/; and EEAG calculations.

mation sources.[5] The results of a YouGov survey help to address the perplexing issue of why voters chose Brexit (cf. Figure 3.5), despite the fact that not only most experts and financial markets, but also most of their political leaders and democratic representatives thought it was bad for Britain.

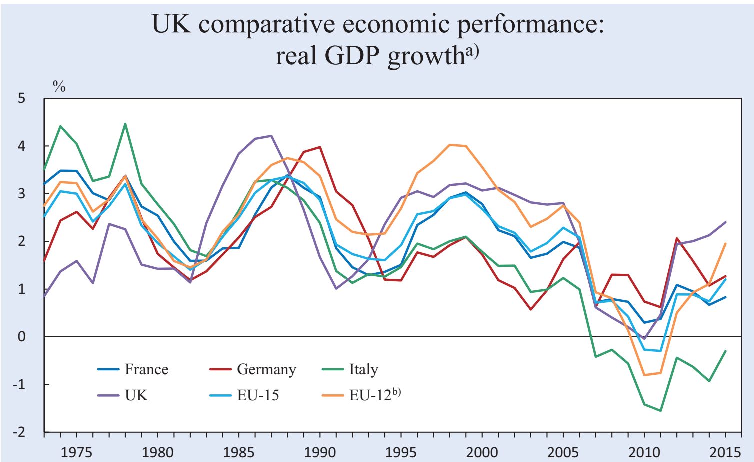
Even among voters who voted for Remain, the figure that expressed trust in academics, economists, businessmen, the Bank of England, the International Monetary Fund, and other policy research organisations was only around 30 percentage points higher than the number of Remain voters who distrust such expert advice. Among Brexit supporters, distrust dominates trust by between 30 and 60 percentage points, putting international organisations on the same level as actors, entertainers, and sports champions; with journalists, UK and foreign politicians, earning the almost unanimous distrust of Leave voters. One common criticism in the campaign was that the experts were part of an international elite, whose advocacy of globalization was preeminently self-interested. It appears that the referendum vote was indeed chiefly motivated by individual gut feelings and that, perhaps as a result of previous communication mistakes, efforts to inform voters were doomed to fail.

3.5 The bottom line: what will Brexit cost Britain?

The UK has apparently been slightly more successful or dynamic in terms of GDP growth than most European economies in recent decades, but over the last ten years it has performed relatively poorly in terms of productivity (Figure 3.6) and wage growth (Figure 3.7), with the gap between the UK and other major economies (France, Germany, or indeed the US) widening in recent decades. These facts are interpreted differently by Brexiteers, who think productivity would improve if it were free of EU shackles, and by Remainers, who think the UK has largely benefited from membership of the European Community/EU. Indeed, the Remainers believe that Britain may stand to benefit even more from additional labour market regulation, not least because Britain's relatively strong employment performance relies on low wages and job insecurity, which fuel discontent and political populism; and hence may cause present and future protest votes against the British government (Tilford, 2016).

The critical question is thus how far EU market access, and integration in a labour market that allows or encourages the free mobility of labour, affects Britain's economic performance. There may be major weaknesses that make life outside the EU problematic, including low historical investment in infrastructure,

Figure 3.6

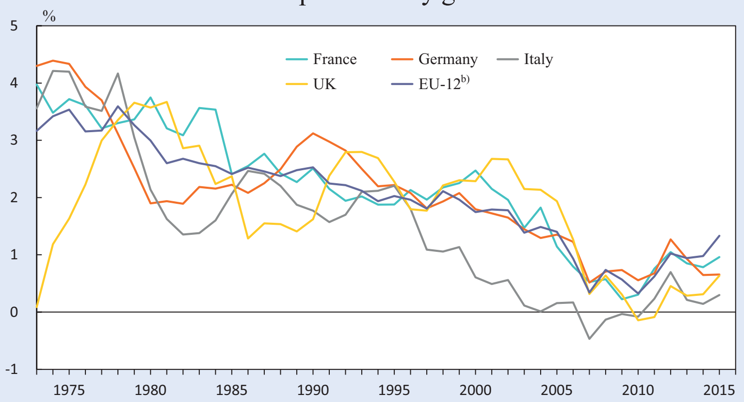


a) Moving averages (5 years, unless restricted by data).
b) Calculated as unweighted arithmetic mean.
Source: OECD and EEAG calculations.

5 The Euromyths A-Z index is available at http://blogs.ec.europa.eu/ECintheUK/euromyths-a-z-index/.

Figure 3.7

UK comparative economic performance:
labour productivity growth[a)]



[a)] Moving averages (5 years, unless restricted by data).
[b)] Calculated as unweighted arithmetic mean.
Source: OECD and EEAG calculations.

low investment in housing (leading to a housing shortage and very high prices that largely exclude first time buyers), and low educational attainment (see Tilford, 2016). The last shortfall, in particular, points to foreign skilled and unskilled workers as an essential driver of UK dynamism in the future.

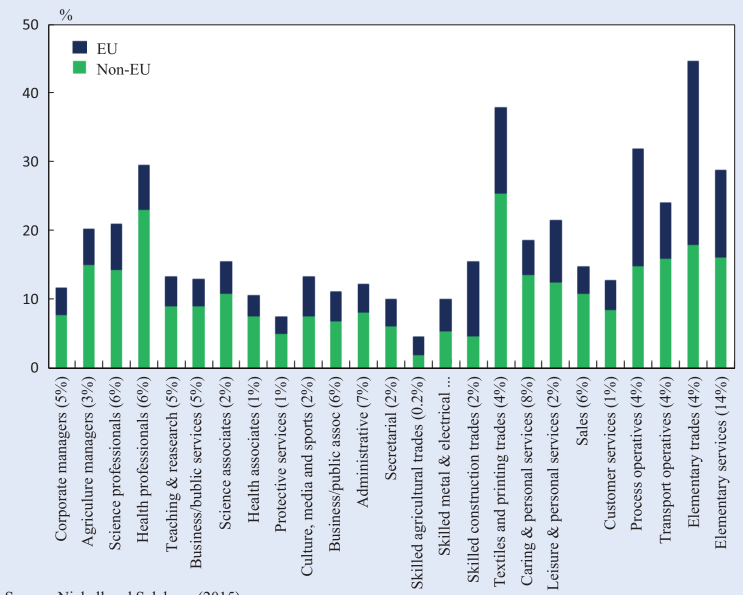
The longer uncertainty prevails over the UK's access to markets, and the nature of its future migration policy (including the position of current EU nationals working in the UK), the higher the costs to the UK economy will be.

Of the UK population (63.7 million), 5.3 million (8 percent) are non-British, and just over half of this figure i.e. 2.9 million (5 percent) are from the EU. 2.15 million of these Europeans have a job. The by far largest group of European immigrants is from Poland (853,000), followed by the Irish (331,000).[6] These large numbers can easily be seen by natives as congesting their common goods, straining infrastructure, health services, and housing, as well as threatening their cultural or national identity. However a dramatic reduction in the number of immigrants would cost everybody in Britain. A repatriation of these migrants would lead to substantial labour shortages in some sectors (cf. Figure 3.8), including the National Health Service, but also in the hotel and hospitality industry, and in agriculture. 45 percent of workers in elementary trades are foreign, with the vast majority coming from the EU (the famous Polish plumbers and carpenters). Nickell and Saleheen (2015) have tried to calculate the wage effects of their presence, and noted only a modest decrease during the period of immigration. There are also substantial numbers of Europeans working in highly-skilled jobs in financial services. Over 30 percent of health professionals are immigrants, although mostly non-EU. Their departure would presumably lead to higher wages for UK natives with the appropriate skills or inclination, but also to higher prices for services.

The status of these migrants is unclear, partly because the UK government would like to obtain concessions regarding the position of UK nationals in other European countries, primarily in Spain, Ireland and France. A total of just under 1.2 million UK nationals live elsewhere in the EU. So a very substantial part of

Figure 3.8

Immigrant native ratio by two-digit occupation (2012–14)



Source: Nickell and Saleheen (2015).

[6] Data from UK Office for National Statistics, *Population of the United Kingdom by Country of Birth and Nationality*, http://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/internationalmigration/datasets/populationoftheunitedkingdombycountryofbirthandnationality.

the UK economy is being held hostage to the bargaining process.

3.6 Euroscepticism in the rest of the EU

The British ballot choice was narrow-minded and short-termist; or "populist" by this EEAG report's definition, and based on very imperfect information. The UK peculiarities discussed above make it unsurprising that, of all member countries, it would be this one to make the unprecedented choice to leave the EU. Some features of the anti-EU vote in Brexit, however, reflect the more general populist wave that is sweeping many industrialised countries, including the US. The migration debate is a focus for criticism of the EU in the UK, where it explains both Britain's longstanding refusal to join the Schengen border-free group of countries and recent popular support for Brexit. But the same debate is dividing other countries: Angela Merkel's post-2015 refugee policy attracted a great deal of criticism in the UK referendum campaign. Opposition to her policy has also fuelled anti-EU sentiment in Germany, where the populist and xenophobic AfD party is doing remarkably well in Länder elections, and will run in Federal elections on a promise of calling for a Dexit (German exit from the EU) referendum, as well as in France, where each foreign populist success (Brexit, Trump) strengthens Marine Le Pen's Front National.

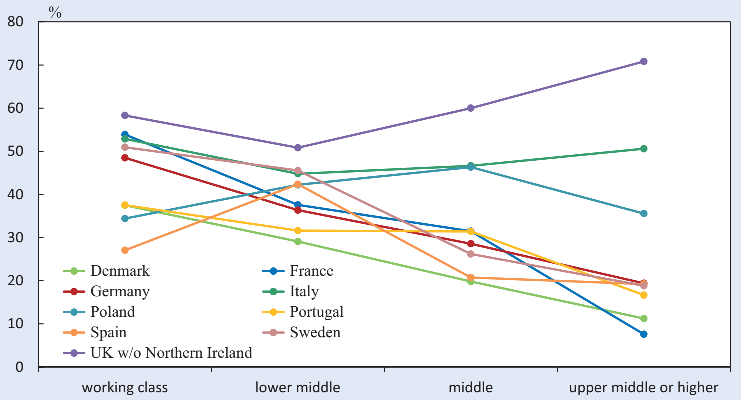
Other countries' citizens have not yet been asked to vote in a referendum, but the Eurobarometer survey elicits the opinions of about 1,000 respondents in each country or region (cf. Figure 3.9; a smaller sample is polled separately in East Germany and Northern Ireland). The most relevant Eurobarometer question asks respondents whether they more or less strongly agree or disagree with the notion that their country would be better off outside the EU. The question does not explicitly ask whether respondents are personally in favour of leaving the EU. As in the UK referendum, however, that is a natural interpretation, and opinions are effectively strongly related to the respondents' socio-economic status.

Higher-class individuals are generally more likely than their less privileged peers to think that EU membership is a good thing within most of the countries shown in Figure 3.9 (but not in the UK, where Brexit already loomed clearly in the 2015 Eurobarometer, and to a lesser extent in Italy and Poland). This gradient is strong enough to make opinions differ as much across classes within countries as they do across country averages. Middle-class French, Italian, Swedish, and German respondents like belonging to the EU just as much as Spanish, Polish, Portuguese, and Danish working-class respondents, even although their working-class compatriots are far less enthusiastic about EU membership.

A similar heterogeneity of opinions is undoubtedly present along other dimensions. Some are also observable in the Eurobarometer survey, where age makes a noticeable difference in many respects. For example, when asked "QA11: what does the EU mean to you personally?", one-third of respondents aged 60+ mention "Peace", but only one quarter or those aged 30 or under do so, suggesting that the crisis of the original EU project may also reflect fading memories of war.

Figure 3.9

Exit EU sentiments[a)]



[a)] Proportion ("don't know" responses excluded) of respondents who Agree or Tend to Agree with qa18a_5 "(OUR COUNTRY) could better face the future outside the EU" plotted against the response to d63 "Do you see yourself and your household belonging to…?" … class of society.

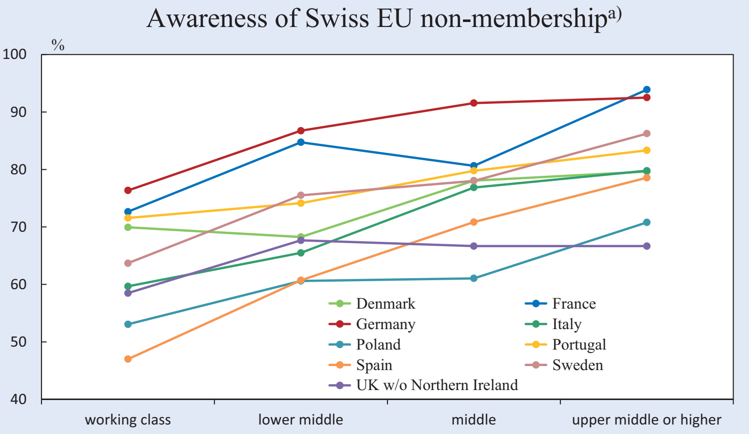
Source: Eurobarometer 84.3 (November 2015) and EEAG calculations.

Opinions on EU membership are likely to be far more similar among well-educated residents of large cities across the EU than the views of Londoners and rural English people. However, the absence of Europe-wide political debates and decision processes makes it difficult, if at all possible, for the opinions of international groups to be heard; or indeed voiced in a mutually comprehensible language.

An interesting feature of opinion polls on EU membership is that even in relatively poor countries, where integration should be most beneficial to the lower classes, the rich support the EU more than the poor. As in the case of the Brexit referendum results, so everywhere else in Europe individual opinions may in fact reflect not only an objective assessment of personal pros and cons, but also a degree of ignorance (or misinformation) about the issues at stake.

The Eurobarometer asks respondents some questions about the EU's structure and institutions. It finds that a substantial proportion of European citizens do not know that Switzerland is not an EU member. Figure 3.10 shows that such ignorance is interestingly correlated with negative views about EU membership. To some extent this is the case across countries, with British respondents (especially in the more privileged strata of the population) displaying both the most negative views about the EU and the lowest familiarity with what the EU means. More interestingly, the correlation is similar across social classes: in each country, those higher up the social ladder tend to be better informed (which may explain why they more strongly favour EU membership even in relatively poor countries). Within each class ignorance also seems to beget rejection of the EU. In both Denmark and Portugal, for example, 37.5 percent of working-class respondents think their country should exit the EU, but in both countries only about a third of those respondents know that Switzerland is not in the EU, while about two thirds of working class respondents who think their country is better off inside the EU are aware of this fact.

Figure 3.10



[a)] Proportion of respondents who reply "False" to qa14_3 "Switzerland is a Member State of the EU" plotted against the response to d63 "Do you see yourself and your household belonging to…?" … class of society.
Source: Eurobarometer 84.3 (November 2015) and EEAG calculations.

3.7 EU responses: special deal versus damaging divorce

The Brexit referendum outcome and Eurobarometer opinions give grounds to reflect on how the EU might be improved, rather than destroyed by widespread scepticism or hostility. Ignorance may be at least partly excused because the EU's structure is complicated and can seem obscure. It mirrors the problems that the EU tries to solve, which are often complex and unclearly defined. As a result, EU regulations are widely perceived as an occasionally perverse set of bureaucratic constraints imposed from a distance.

Theoretical inconsistencies abound in the EU's policy framework. There is supposed to be no supranational competence on taxation or social policy, except when these distort a level playing field for trade (as is almost always the case, and has recently been recognised by the European Commission in the case of a multinational, company-specific tax ruling). Popular political sentiment typically favours the notion that policies are right (or better) when they are decided at the national (or lower) level. Such opinion is based on fears that more distant policymakers cannot be effectively monitored, and on the belief that politicians who live in an isolated bubble may only too easily ignore the day-to-day problems of ordinary citizens, and be swayed by the lobbying efforts of special interests. Improving transparency and accountability is hence a vital part of an EU reform agenda.

The widely-expressed preference for local decision-making and the belief that politics should always be local, rather than centralised, is problematic for two reasons. The first is that the effects of some policies transcend national borders. Just as it would be absurd to let each household decide how its own income should be taxed, so it is advisable to coordinate tax policies at the same supranational level at which markets operate. Uncoordinated choices in these respects generate spillovers across borders and justify moral hazard suspicions. For European public goods, from defense and border controls to long-range transportation and energy networks, the costs of common production are also obviously lower, and should be shared across all beneficiaries. It is not easy to transfer such decision-making and implementation powers to supranational bodies in the absence of an accepted political aggregation process like that of sovereign nations.

The second reason is that, even when policies have only local effects, they may not be chosen appropriately by local political processes: just as markets can fail, so can governments. Let us consider, for example, taxi regulations (a topical policy problem in the Uber era). Delegating the power to decide on the number of taxi licenses and the structure of taxi fares in cities they know little about to bureaucrats in Brussels would reduce the amount of useful information available to policymakers, but would also prevent capture of local regulators by powerful local lobbies.

These two principles give a rationale for many of the EU's competencies. From limitations of deficit spending to cucumber size and shape regulations aimed at standardising and easing trade, EU nations have more or less grudgingly accepted that EU bureaucrats should be in charge of setting many of their own policies. A large proportion of EU legislation now stems from community decision-making methods, characterised by a complicated hierarchy of unanimities and majorities and co-decision powers meant to endow the EU with its own political legitimacy and personality.

In many cases, however, and especially in crisis situations, national governments want to play a far more important role than that of the Council in a co-decision-making process, and would like European choices to be rubberstamping the outcome of intergovernmental processes. Brexit may again illustrate the more general issue. British Prime Minister Theresa May has been engaging other national leaders while ignoring Brussels, the Commission, and the newly appointed chief EU Brexit negotiator Michel Barnier. However, the conditions of eventual secession will have to be agreed upon by the Union, rather than by individual member states; and it would be disastrous for the negotiations to have to respect deals struck by the UK with specific countries.

How the rest of the EU reacts to Brexit is crucial to its future development. Accepting UK participation in the single market without personal mobility would dilute the project. A bitter divorce could consolidate the remainder of the EU as it rethinks its core purpose. But a push towards further political integration as a response to Brexit (as well as to Putin and Trump) may not be credible or politically feasible: public opinion currently favours national sovereignty, so an attempt to build a more coherent EU may well trigger a disastrous sequence of acrimonious exits. For many years the EU has been leapfrogging obstacles, turning every crisis into an occasion to strengthen its policy framework. The same process, however, can quickly shift into reverse, turning even minor nuisances into an occasion to dismantle some community powers.

Europe's position in the forthcoming negotiations over Brexit represents a deep strategic puzzle. Given that cutting the UK out of the single market would damage the remaining EU member countries, not least by depriving their economies of easy access to an efficient global financial center, it is tempting to think that the EU-27 should adopt a flexible attitude in a bid to preserve as much of the remaining countries' economic surplus as possible. Perhaps the EU-27 could let the UK stay in the single market, and exercise lenience over labour mobility and budget contributions in the upcoming negotiations. An advantage of this strategy would be that, in the current political environment, insisting on the four freedoms as a package may counterproductively fuel resentment at the EU's centralistic approach in other countries, and risk provoking a general backlash. In Angela Merkel's words, perhaps the EU should not be "garstig" (hateful or ugly) to the UK.

Unpacking some elements of EU membership to give the UK a special deal would, however, be complicated and dangerous. Labour market and financial market access have different importance for different countries. A deal that treats the UK kindly, by granting a single market "passport" to British financial services even as the UK is allowed to select incoming persons for instance, may well suit the richer and most industrialised areas of continental Europe. However, it would be unacceptable to Central and Eastern European member countries. As each country (or region) tries to defend its own interests, it would be hardly possible to refuse similarly special deals in other policy areas once such flexibility is displayed towards the UK. Stepping back from the degree of integration that has already been achieved would thus make it very difficult to develop the single market in areas where it is still very incomplete, such as personal and digital services The most worrying prospect of all is that a soft Brexit might provoke other imitators, especially in countries with similar social dynamics (Sweden would be an obvious candidate), in a falling domino pattern that turns the EU into a jumble of multilateral (or even bilateral) international deals.

It is therefore only a matter of self-preservation for the EU to adopt a clear stance at this pre-negotiation stage: the UK can participate in the single market only if, like Norway or Switzerland, it essentially embraces all of the other key EU policies. The only clear feature of the UK's position is that this would not be acceptable to its electorate and government. Other than that, the UK's negotiating strategy remains very unclear as this EEAG report goes to print. It is, in fact, difficult to envision what outcome would be both realistically possible and acceptable for the UK. The British public may very possibly interpret the European position as one of cruelty, meant to make Britain's path to economic and political stability rockier. British negotiators, responding to that clear European negotiating logic, may retaliate by attempting to make the process as painful as possible for the rest of the EU. The referendum campaign for Brexit was already driven by a firm belief that the UK would be better off on its own, and that the decision to leave would hurt Europeans far more than Britons.

As a fear of domino effects tilts EU negotiating strategies towards intransigent attitudes, and British popular sentiment similarly rejects sensible flexibility and demands fulfilment of that European disaster prophesy, the UK and Europe head towards a bitter and contested divorce: a Brexit that will be hard for Europe, too.

Faced with the likelihood of a damaging divorce, the UK may well try the equivalent of unilateral disarmament, giving the EU-27 open access to the British market for goods and services, in the belief that such openness might produce a rethinking of the continental European position. Such reconciliation might appear more attractive in the context of an increasingly politically insecure world and of the perception that the UK is a vital part of the overall European security structure. That benign outcome, however, depends in turn on an EU that has a more effective view of its own best interests and indeed of its fundamental coherence.

3.8 Crisis threats and EU development

Could Brexit offer the EU an opportunity to streamline itself and become more effective in dealing with numerous policy challenges, and more successful in attracting the support of its citizens? On the one hand, even in the absence of actual further exits, the political climate at present seems inclement to further integration. On the other hand, Brexit removes a powerful opponent to integration.

For example, plans to try and enhance cooperation among EU countries in defense and security (an obvious European-level public good) were kept on hold by the Commission until after the Brexit referendum, for fear of fostering negative sentiment in Britain. But given that UK opposition was the reason for the demise of earlier efforts in that direction (most recently by the Franco-German-Polish "Weimar triangle" in 2011), and in view of the need to reorganise European defense in the changed atmosphere created by Donald Trump's distancing of the US from NATO, Brexit means that proposals for permanent enhanced cooperation in defense are being made by the High Representative of the Union for Foreign Affairs and Security Policy at meetings of defense and foreign ministers.

Given that Brexit also removes obstacles to further fiscal integration in the EU, countries that wanted more fiscal integration and more transfers consequently see it as an opportunity to exert greater influence. Since Europe can't afford another "exit", other potential candidates are effectively deriving strong political leverage from the precedent set by Britain. Portugal and Spain have already escaped sanctions for violating the fiscal pact, largely due to uncertainties generated by Brexit. Perhaps the most obviously vulnerable country is Italy, one of the three largest EU countries, along with France and Germany, and one eager to play a greater role in European intergovernmental dealings (as the former Prime Minister Renzi made clear at the tripartite meeting to relaunch post-Brexit Europe on the symbolically important island of Ventotene, where Altiero Spinelli coauthored the European federalist manifesto as a prisoner of Fascism). The Italian government, however, is deeply frustrated (to the extent of threatening a veto in EU budget negotiations) by what it perceives as blatant disregard of its views on the revision of immigration and fiscal policies.

3.9 Common problems, common solutions?

There should be a better way forward to striking a balance between widespread scepticism over deeper integration on the one hand and the global challenges – both in economic and security terms – that make further integration almost inevitable on the other. The post-war European integration process was meant to result in a wider and more politically acceptable club of equals, within which France and Germany could work on their relationship in a more cumbersome, but also more constructive way than the wars which, not least due to British interference, had for centuries failed to yield a clear conqueror and a larger unified continental European state. Perhaps because of enlargement, and certainly as a result of the euro crisis, the EU's decision process and bureaucratic powers have taken a back seat to national policy priorities over the last decade.

Unfortunately, intergovernmental bargains cannot be as forward-looking and comprehensive as the EU is ideally envisaged to be. They can be more flexible, in the same way as speed dating is more flexible than a marriage with its cumbersome decision processes and complicated divorce procedures. Flexibility has short-run advantages, but a lack of commitment makes it difficult to coordinate the plans needed to achieve longer-term objectives. A promise to be together for better or for worse can be credible if divorce is difficult, fosters solidarity, and provides incentives to smooth out differences and invest in forward-looking projects.

Intergovernmental policy negotiations are useful when crises require immediate actions. However their appeal is generally stronger in a populist political environment that targets immediate self-interested benefits with no regard for their side effects and ultimate consequences. Moreover, deals struck between country leaders balance powers in conflictual ways and can engender resentment against the EU in smaller countries: if EU action is perceived to be the outcome of negotiations between French and German leaders, it cannot easily be accepted by the Italian or Dutch public.

In any integrated economy, it is necessary to find long-lasting and constructive compromises that bring together often contrasting views of how the economy should be managed. Can effective state interventions be sufficiently controlled and monitored so as to ensure that they are not simply a breeding ground for fresh corruption and inefficiency? In what ways can the private sector be involved? There are clearly important public goods that could be realized, and gains that could be reaped.

An obvious project is the integration of the flow of refugees, an area in which precedents are also to be found in moments of deep crisis such as Germany in the aftermath of 1945, or France in the wake of decolonisation, when millions of newcomers generated prosperity and dynamism. Another genuinely European project would lie in building infrastructure to connect local and national energy systems, which currently have incompatible pricing structures. In this field there are clear gains to be made from integration: the greater the diversity of supply and the more market alternatives exist (including different forms of energy), the more resilient the energy economy becomes against unanticipated events, including attempts to blackmail energy users.

3.10 How Brexit shifts the balance of EU voting power

In some European countries, notably Germany and some Central European states, the UK was seen as an important ally in a struggle to impose market principles, whereas in France and other countries it was largely seen as a blocker. National views of the consequences of Brexit largely reflect its possible effects on more or less desirable implications for EU. If Brexit moves the EU towards a more cohesive and dirigiste configuration, this is a positive development in the eyes of those who, as is often the case in France, think the state should play a strong economic role that is threatened by international competition. In countries where public opinion no longer favours ever closer integration (except perhaps with regard to a common army) and feels that taxpayers have been unfairly forced to pay for insolvent debts, as is typical in Germany, the fear is that without the UK, the EU will become "too Southern": not sufficiently market-oriented and, above all , not fiscally austere. Both Donald Trump and the new British government are making fiscal expansionism a key part of their agenda.

For those who worry about a return to fiscal profligacy, their main concern relates to the process of decision-making in the EU, and in particular the voting mechanism. On many issues the European Council decides on a system of Qualified Majority Voting, which requires a majority both of member states and of the EU population: 55 percent of members states representing at least 65 percent of the EU population need to approve a measure (or conversely a blocking minority in the European Council requires states representing 35 percent of the population). With the presence of the UK, and as long as the British government was firmly in the hands of market liberals, Germany could be sure that it could block efforts to introduce not only anti-market policies, but also and especially to endow the EU with a fiscal and banking framework that would allow public money to cross national boundaries. Without the UK's 65 million people, the EU balance shifts. Some formerly communist countries in Eastern Europe (Poland, and especially Latvia, Lithuania and Estonia) are strong supporters of market liberalism, but as net recipients of European structural funds, they may support the expansion and centralisation of supranational economic policies. Germany and its neighbours Austria, Belgium, Luxembourg and the Netherlands, plus Denmark, Finland and Sweden, have a population of 141 million, or 31.7 percent of the population of the remaining EU-27. This figure falls short of the 35 percent blocking vote.

No phrase causes greater political allergies than "transfer union" in Germany, where prevailing views involve resistance to higher debt levels and expansionary monetary policy. In France or Italy, the opposite is the case: popular opinion tends to hold public spending, preferably resulting in large deficits, for an economic policy panacea. Such simplistic viewpoints, rooted in narrow and self-interested perspectives, stand in the way of constructive compromises that, within both the EU and nations, should take a broader, longer-term approach to economic policy and taxation and recognise the broader and deeper economic and social advantages of sticking together.

Similarly, attempts to set up a suitable financial infrastructure, especially in the form of a proper banking union, are also being hampered by narrow-minded and shortsighted policy perspectives and political interactions. In an integrated monetary and financial market, banks are allowed to operate everywhere regardless of their nationality. Supervision and resolution should accordingly be carried out at the market-wide level. In the euro area, conversely, governments resist international bank takeovers and mergers, and are tasked with preserving the viability of their own countries' banking infrastructure. Insurance premia should be pooled across all deposits in the integrated money market, and deposit insurance funds should be a standby facility designed to preempt self-fulfilling crises, rather than to be tapped in order to shore up weak banks. Eurozone banks also lack a risk-free reserve asset like federal debt in the US, with the unfortunate consequence of vicious bank and government financial solvency spirals.

In the past EU crises have often been seized upon as an opportunity to leap forward and resolve such inconsistencies. More recently, by contrast, financial problems have tended to induce the repatriation of assets and liabilities and the renationalisation of banking systems. Progress towards resolving this problem is particularly hampered by Germany's resistance to supranational supervision of all of its banking sector and suspicion that any insurance scheme would imply resource transfers. This attitude is understandable in the light of other countries' symmetric tendency to try and tap common funds, but the resulting policymaking process is clearly not farsighted enough to keep the Union on the safe side of the brink.

3.11 The EU as an antidote to populism?

Only accurate and credible information on long-term policy trade-offs and disciplined politics can remedy short-termist populist tendencies to seek narrow, self-interested instant gratification, and rectify the resulting myopic behaviour that accelerates crises and makes it difficult to resolve them.

In principle, the EU's long-term, slow, cautious, wide-ranging policymaking process could help to offset such tendencies in national political processes. Indeed "Europe" was for a long time a useful excuse for politicians not to indulge in deficits and other popular policies. Just like bank runs can be prevented and controlled by wise regulators, so policymaking based on narrow and nearsighted self-interest can be kept in check by requirements to abide by European rules, justify policy decisions, and submit them to supranational audits. National policy makers (at least in large countries) also fear the public might not like such supranational accountability. This, however, is merely another instance of populist thinking. If European level policies are the only way to address many of Europe's long-term problems, then European-level issues do need to be discussed from a pan-European point of view, and not from a nation-state perspective.

The European co-decision policymaking process, involving the Commission, Parliament and Council, is cumbersome, but may take that point of view more naturally than summits of national leaders, which tend to produce lowest-common-denominator compromises of different, but equally narrow perspectives. The intergovernmental decision process and the particular importance of Franco-German negotiations is a child of Germany's reunification, just like the euro. Both may destroy the EU, but at least the euro makes it stronger if it does not destroy it.

Europe needs to deliver. It certainly needs a vision, and needs to communicate that vision effectively. But equally importantly it needs evidence that the vision produces results. It may be unfair, but is very natural for citizens to blame the EU for economic problems even when they originate elsewhere. Recognising that the most popular policies are now those with the most immediate and visible effects, the European Commission has prioritised capping mobile telephone roaming charges: certainly a minor issue, but an achievement nonetheless (as British tourists will notice when they are charged what is now paid by Swiss visitors on the Continent and Cyprus after Brexit).

Without substantial results and visible gains from co-operation, ordinary Europeans will lose sight of the European vision and their sense of a shared identity. The populist political equilibria arising from an "all is lost anyway" sentiment can be preempted if the EU monitors policy and can convincingly promise that sound policies will yield a brighter future that is well worth some short-term sacrifices. Unfortunately, that promise itself lost credibility during the crisis, in which the EU's incomplete institutional structure has appeared unable – not only in populist eyes, but also in the eyes of those who see an "ever-closer union" as the only robust solution to Europe's problems – to formulate and implement sensible and constructive compromise solutions. When unruly nations ignore supranational constraints, populist leanings are not only insufficiently controlled, but may even be reinforced by EU institutional failures. EU constraints, previously invoked as a reason to reform, are now often presented as something to be removed, possibly by exiting the EU. This new balance of bargaining power is well exemplified by the cases of Austria in the early 2000s and Hungary more recently. The former was sanctioned when its populist election results threatened democracy.[7] The latter escaped reprimands even as it meddled with the balance of judicial and monetary and political powers enshrined in the acquis communautaire and refused to participate in the European refugee relocation program. Similarly, a recent attempt by the Commission to reprimand the Polish government's grab for control of the constitutional court was met with scorn in Warsaw. A Europe that is being pushed conceptually back to a narrower core might find it hard to respond effectively to global problems.

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[7] Article 7 of the Nice Treaty states that the European Council can declare the existence of "a serious and persistent breach of fundamental rights". If this occurs, the Council may, by a qualified majority, suspend certain of the rights of the country concerned. This procedure is supplemented with a 'preventive instrument' that is very hard to activate. The text reads: "On a reasoned proposal by one third of the Member States, by the European Parliament or by the Commission, the Council, acting by a majority of four fifths of its members after obtaining the assent of the European Parliament, may determine that there is a clear risk of a serious breach by a Member State of principles mentioned in Article 6(1), and address appropriate recommendations to that State." The values and principles are spelled out as follows: "The Union is founded on the principles of liberty, democracy, respect for human rights and fundamental freedoms, and the rule of law, principles which are common to the Member States."

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

4.1 Introduction

Unrest in the Middle East and North Africa, including Syria, Iraq, Afghanistan and the Sahel region, is causing the massive displacement of people locally (within the affected countries), to neighbouring countries, as well as sending huge waves of refugees to Europe. By the end of 2015, 65.3 million individuals were displaced from their homes worldwide as a result of persecution, conflict, different forms of violence, or human rights violations (see UNHCR, 2016). Of this number, 41 million people were internally displaced; 21 million were refugees, and about 3 million were asylum seekers. In 2015, 1.3 million asylum applications were submitted to EU countries, with most applicants coming from Syria, Afghanistan and Iraq. Although various measures have somewhat reduced the refugee flows into the EU in 2016, the underlying migration pressure remains and the refugee crisis continues.

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 different parts of the world. In a European context, the conflict in Bosnia in 1990s also produced a large displacement of people and waves of refugees. But this refugee wave seems somewhat different. The Bosnian conflict followed the fall of the Iron Curtain and was generally considered a European problem. Current conflicts are arising outside of Europe in culturally more distant societies. Thus, it is hard to make the case that this should be primarily seen as a European problem. Moreover, the flow of refugees, while currently comparable with developments in the 1990s at the peak of the Balkan conflicts, involve much broader and more populated areas of the world, thus raising the issue of absorption capacity.

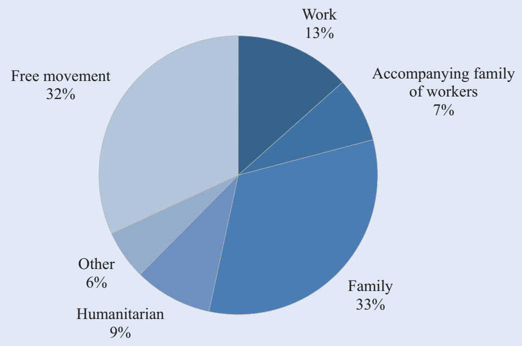
Across Europe, and not just in the far-right spectrum of the political discourse, the mass immigration of culturally (and, often, visually) very different people fuels fears primarily related to the preservation of the European national identities and ways of life. Importantly, the current refugee crisis follows close on the heels of the financial crisis from which many European countries have not fully recovered and which has challenged social cohesion within Europe. Critical voices are being raised not only about refugee immigration, but, also, over 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 significant opportunity for populists to start shaping the debate. Perhaps more than any other single issue, immigration has dominated the political landscape and an anti-immigration stance has become the battle cry of European populists.

The refugee wave is a humanitarian challenge calling for a cooperative solution across countries, and definitely among EU states. Yet developments seem to be moving 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 EU and thus further compounded the EU crisis.

In this chapter we try to paint the big picture with regard to migration before delving into specific issues related to the current crisis, and refugees in particular. To this end we begin by presenting some key facts on migration flows. We show that the number of asylum seekers in the leading EU countries has been cyclical in nature over the past 30 years. While current numbers of refugees are very large, they are still comparable with numbers experienced as a result of the conflict in Bosnia in the 1990s. We then present longer term population and migration forecasts and discuss the factors influencing migration flows. Next, we comment on some key aspects of humanitarian migration policies, and particularly their relevance to Europe. We then discuss the potential economic impact of the current refugee wave focusing, in particular, on its labour market effects and implications for public finances. Finally, we analyse important challenges and risks related to the current crisis and formulate some policy recommendations.

Figure 4.2

Migrants by category, OECD countries in 2014[a)]



[a)] Migrants categorised based on reason for granting permission for residence. "Free movement" refers to migration implied by general rules ensuring free mobility of workers as in e.g. the single market. "Accompanying family" of workers refers to close relatives to individuals having obtained status as worker migrant, while family includes family unification for asylum seekers.
Source: OECD (2016).

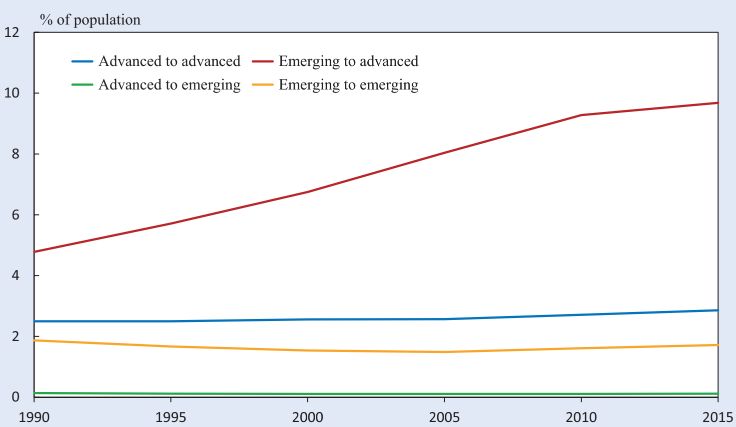
4.2 Migration patterns

Migration is one of the most important evolutionary mechanisms that have been shaping the development of humanity since its inception. Migrations are caused by a multitude of reasons. They can be largely voluntary, as in the case of worker migrants, or largely involuntary as in the case of people leaving conflict or persecution. One important trend is the movement of people from less developed to more developed economies. As a result, in many developed countries, the stock of foreign-born population is on the rise (see Figure 4.1). This can be seen as a natural consequence of globalisation i.e. an increase in the global exchange of capital, goods and labour.

Considering the various types of migration, work-induced migration constitutes a large part, also reflecting efforts to make worker migration easier. A prime example of such initiatives is the single labour market in the EU (see EEAG, 2015). Most countries have special immigration rules for workers, which make labour mobility easier for highly skilled and specialised types of labour. Migration due to humanitarian reasons constitutes a relatively small share of total migration (around 9 percent, see Figure 4.2). However, if family unification is also included the total share is around 42 percent. Another important category of migrants are students (included in the "Other" category).

Figure 4.1

Stock of migrants[a)]

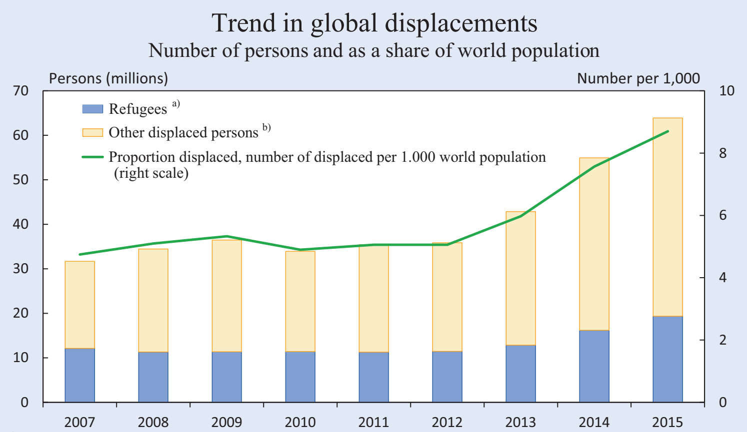


[a)] Data available in 5 year intervals.
Source: IMF (2016a).

At a global level the number of displaced persons in the past decade has been around 40 million per year, or about 6 percent of the world population, but recent conflicts have caused an increase (see Figure 4.3). Most of the displaced persons move within their own country (so-called internal displacement), while only a minority leaves the country and becomes refugees or asylum seekers.

Figure 4.4 presents the evolution in the number of asylum applications to developed European countries in the period 1985–2015. The left panel presents the total number of asylum applications for EU-15 countries in aggregate and, for the purpose of comparison, for Germany alone. The right panel shows the number of asylum applications in five other developed European countries that have received large numbers of asylum seekers in the past. It is worth noting that when looking at sufficiently long time horizons, the number of people requesting asylum in developed European countries shows a cyclical trend, with Germany closely approximating the general European trend. The peaks are reached dur-

Figure 4.3



a) Refugees include asylum seekers.
b) Other displaced persons include internationally displaced persons, persons under UNHCR's statelessness mandate etc.
Source: UNHCR, World Bank; and EEAG calculations.

ber of applicants (Figure 4.6, left panel). In terms of the number of asylum seekers as a percentage of the host population, however, it is Hungary and Sweden that have assumed the heaviest burden (Figure 4.6, right panel).

These are large numbers. However, for Germany, the number of refugees as a percentage of the host population, is comparable with the flows registered during the turbulent 1990s. Of course, only a fraction of these people will, eventually, be granted migrant status and some of those

ing large conflicts: the wars in Bosnia, Kosovo and now the war in the Middle East. After peace was re-established, the numbers fell substantially. Having said that, the number of asylum applications in Germany in 2015 surpassed the previous all-time-high corresponding to the war in Bosnia, prompting serious concerns.

In the first half of 2016, the total number of first time asylum seekers in the EU was around 593 thousand (Figure 4.5). In terms of origin, the majority of asylum seekers came from war-torn areas: Syria (close to one third), Afghanistan (over 14 percent) and Iraq (close to 12 percent). Most refugees came from the same countries-of-origin in 2015 (Eurostat figures).

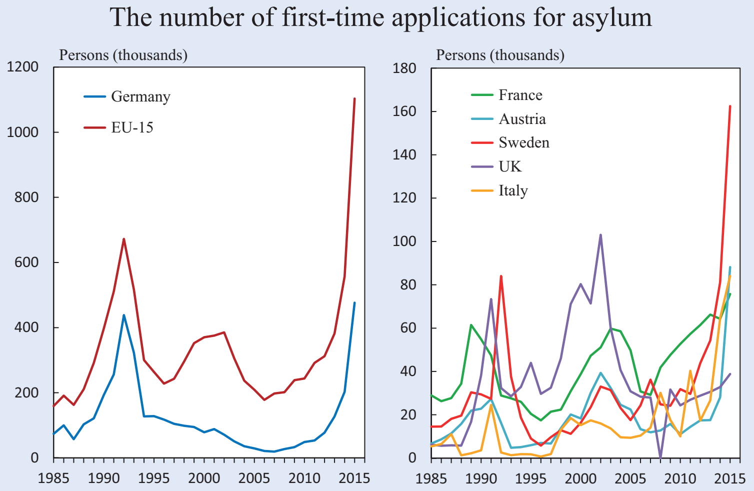
It is worth highlighting that, in terms of the number of applicants, Germany accepted the lion's share in 2015, with Hungary receiving the second largest num-

will inevitably either return home or move to another country.[1] Moreover, despite current developments in Europe, the fraction of the world population on the move from their own country of birth is fairly stable across time and is, on average, around 0.65 percent of the world population in any given five-year period (see, e.g. Abel, 2015). According to the same metric, from 1960 on, global migration reached its peak in the 1990s (and not, as one might think, in the 2000s). The next section discusses longer term population and migration trends using the best currently available estimates and forecasts.

4.3 Migration forecasts in the longer run

Forecasting future migration flows is both difficult and highly uncertain. The task would be particularly challenging if we were to try to forecast future movements of people for solely humanitarian reasons. This would involve predicting wars, civil conflicts, and natural catastrophes and somehow distinguishing between economic and other "non-humanitarian" causes of migration. In fact, migration flows are heavily affected by economic factors. Europe is a high income area and there are countries both to the

Figure 4.4

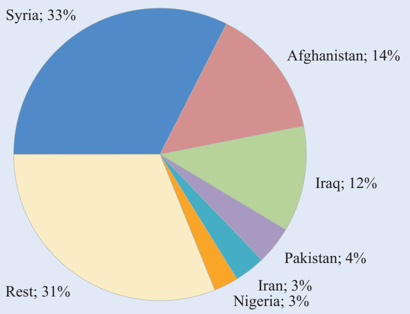


Source: Eurostat and EEAG calculations.

[1] There is a significant discrepancy across Europe in that regard. While Hungary has been speedily rejecting most of the asylum claims, this is not the case in Germany or Sweden (see Figure 4.14 below).

Figure 4.5

Distribution of first time asylum applicants in EU-28 countries by country of origin[a)]



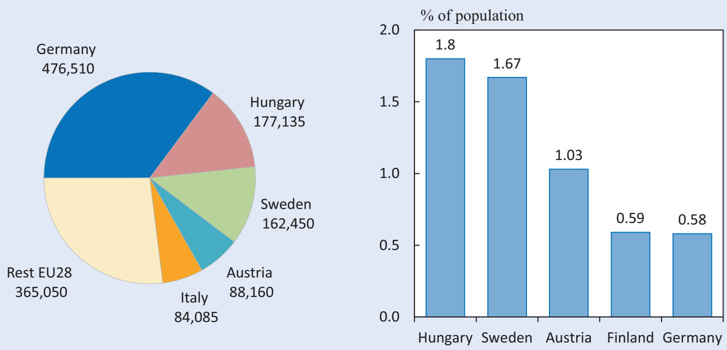
[a)] The graph illustrates the distribution of first-time asylum applicants (as a percentage of the total) in EU-28 countries for the first six months in 2016. We explicitly present data for the six countries with the highest number of applications. The rest are presented through the "Rest" slice of the pie.
Source: Eurostat and EEAG calculations.

south and to the east of Europe with lower income levels and correspondingly lower living standards. Moreover, population growth in the south is, on average, higher, and the population is generally younger than in Europe. This creates sustained migration pressure towards Europe. While in theory it is possible to draw a distinction between migration driven by economic and humanitarian reasons, in practice it is far more difficult to do so. One reason is that people displaced due to a conflict or a catastrophe may not be able to return to their country of origin within the foreseeable future, and therefore may need to consider where to settle. In this case economic factors play an important role, even if migration may have initially been triggered by humanitarian reasons. Moreover, recent experience shows that some economically motivated migrants may try to take advantage of refugee flows in an attempt to enter Europe. Therefore, it may in practice be difficult for administrators to distinguish between different migration types. Moreover, even if who falsely present themselves as refugees can be identified, it is not always possible to return them to their home countries (or, at least, not to do so swiftly). Although uncertainties are large, it is nevertheless important to consider possible future migration trends. As we shall see, while the precise type of migration may vary considerably across space and time, overall migration levels as fractions of the populations are relatively stable. This observation serves as a basis for the long-term forecasts that we use.

Since migrations invariably depend upon demographic factors, this is a natural starting point. Indeed, if we were not able to estimate, at least roughly, how many people will be on this planet and its continents at different points in time in the future, it would be all the more daunting to try to predict the future movement of people around the globe. Recently, significant progress has been made towards a better understanding of the key determinants of the global population dynamics (see Lutz et al., 2014). This study, a collaborative effort by leading international research institutions with the participation of over 550 population dynamics experts from all continents, documents a strong link between human capital development and long-term population dynamics. A number of socio-economic scenarios are constructed which take into account different future educational trends, their environmental impact etc. Our discussion primarily focuses on their base-case forecast.[2] This is a realistic, not overly optimistic nor overly pessimistic scenario. It incorporates, among others, the assumption that educational improvements prevalent around the globe in the past 20 to 30 years will continue more or less unchanged in the future.

Figure 4.6

The number of asylum applications in 2015 in EU-28 countries[a)]

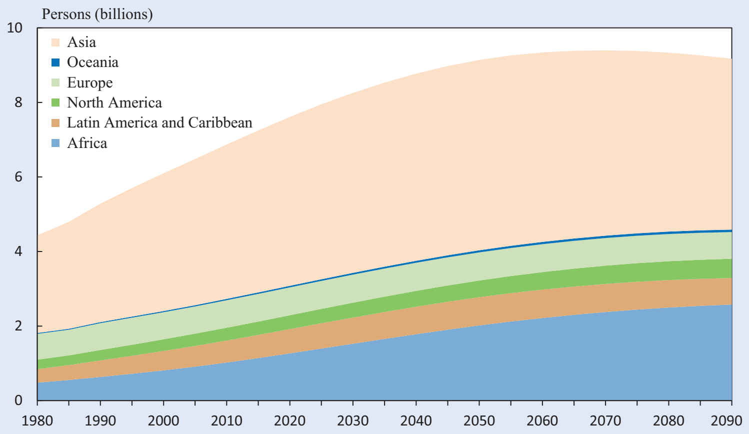


[a)] The left panel presents the distribution of asylum applications across the five countries with the highest numbers of received applications in 2015 (Germany, Hungary, Sweden, Austria, Italy and the rest of the EU-28 countries in aggregate). On the right, we present the top five EU countries in terms of the number of asylum applications relative to the population size (in percent).
Source: Eurostat and EEAG calculations.

[2] See socio-economic scenario S2 in Lutz et al. (2014).

Figure 4.7

Actual and forecasted world population



Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

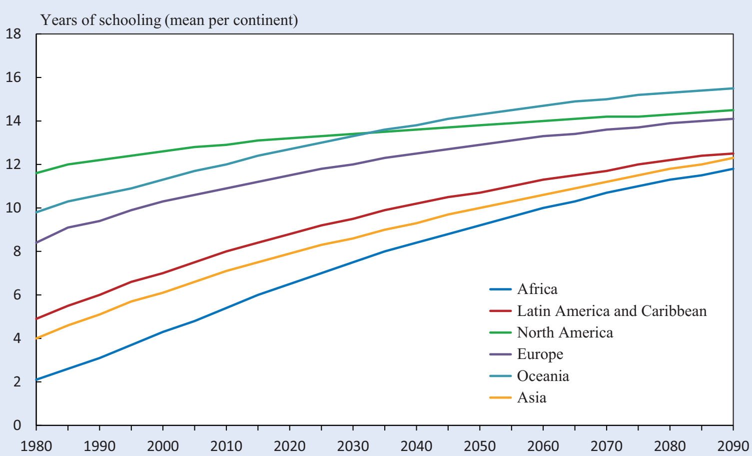
The base-line projection of the world population is shown in Figure 4.7. According to this scenario, the world population will continue to grow until about 2050 and then slowly start to decline. Population growth is initially driven by fertility rates above the reproductive level in less developed parts of the globe (most notably in parts of Africa and less developed parts of Asia). Over time, however, fertility rates are expected to continue falling across the world to a level close to or below the reproductive level. Across the globe there is also a mirroring trend of longer life expectancy and population ageing. All these processes are actually well under way not only in developed parts of the world, but also in a growing number of developing countries.

It is forecasted that the population of Africa will continue to grow both in absolute and in relative terms, accounting for around 28 percent of the world population by 2090. On the other hand, the populations of Asia, Europe and South and Central America are expected to start shrinking both in absolute and relative terms over the next two to three decades. By 2090, Asia will make up just under 50 percent of the world population, while Europe and Latin America will account for around 8 percent of the total respectively. The population of Oceania (including Australia) will continue to grow both in absolute numbers and as a share of the world population, but it will remain below 1 percent of the total. The population of North America, by contrast, will moderately increase in terms of the number of people, but drop slightly in relative terms. By 2090, 5.6 percent of the total world population will live in North America.

An important driver behind the changes in fertility rates in the above projection is the improvement in education along trajectories observed in the past 20 to 30 years. Particularly significant in this respect is continuing improvement in female education participation. It is worth noting that this scenario does not assume any spectacular additional educational push in the future with respect to current trends. As a result, Asia, Africa and South and Central America will continue to close the educational gap with respect to Europe, Oceania and North America (see Figure 4.8). By 2090, on average, the world population will have the equivalent of at least a high school education on all continents. Africa, in particular, will achieve today's European level of educational achievement by that time. More advanced countries will also make progress, albeit at a slower pace, reaching an average level of 15 years of education (roughly an equivalent of a college degree). An increase in education will, in turn, be associated with a significant drop in fertility rates across all continents, which will converge at levels below the reproduction level in most countries, including most of Africa.

Figure 4.8

Actual and forecast average years of schooling



Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

A very important, but challenging issue is making a plausible forecast of future migration flows between countries. The task is made even more difficult by the fact that some countries collect rather detailed data on migration flows while others do not. However, statistics on stocks of migration exist and are more reliable and comparable across countries (see, for example, Abel, 2015, 2016). They can be used to make informed assessments of migration flows.[3] In a recent and highly acclaimed article published in Science, Abel and Sander (2014) proposed a novel methodology for indirectly estimating migration flows. In their approach, immigration and emigration flows are estimated across all pairs of countries around the globe based on changes in migration stocks every five or ten years. These changes can be further corrected by estimating data on immigrant births and deaths. As a result, one obtains an estimation of flows that must have taken place between each pair of countries in a particular time period. Sander et al. (2013) describe how a similar method is applied to create forecasts of long term immigration flows presented in Lutz et al. (2014), see Box 4.1.

We primarily focus on the base-case scenario and demonstrate the extent of differences to other available scenarios in the case of a particular country, namely Germany. While the resulting projections are clearly quite uncertain, they are the best currently available source of medium to long-term base-case forecasts of global migration patterns. We focus on forecasts that have a direct bearing to Europe.[4]

[3] Two principal sources of migration stock data are provided by the United Nations (every 10 years) and the World Bank (every 5 years).

[4] The regions are defined as follows: (1) Developed Europe: Countries of the EU without former socialist countries, (2) Central and Eastern Europe (CEE): Poland, Slovakia, Hungary, Slovenia and Czech Republic, (3) South Eastern Europe (SEE): Moldovia, Bulgaria, Romania, and Turkey, (4) Western Balkans: Albania, BiH, Croatia, Montenegro, FYR Macedonia, and Serbia (including Kosovo), (5) Baltic Countries: Estonia, Lithuania, Latvia, (6) Ex-USSR10: Countries of the former USSR, without Russia, Baltics, and Moldovia, (7) North Africa: Algeria, Libya, Morocco, Tunisia, and Egypt, (8) Rest of Africa: All countries in Africa without countries of North Africa, (9) Select Asia: Afghanistan, Bangladesh, Iraq, Iran, Syria, Viet Nam, China, Lebanon, Pakistan, and India.

Box 4.1

Explanation of the migration forecasting method

This box summarises the method of forecasting migration flows developed in Sander et al. (2013). Essentially, the authors first develop estimates for immigration and emigration (by sex and age) for each country for the period 2005–10. Migration to and from each country is projected using bi-regional models, i.e. by dividing the world into the target country and the rest of the world. They make the assumption of the constant probability of emigration and immigration across cohorts (sex and age by country) and estimate these transition probabilities based on period 2005–10 rates estimates (with some adjustments). Directional migration flows are then projected as the product of migration probabilities and the population in the origin country (for emigration) and the rest of the world (for immigration). In order to make a more plausible forecast of future migration patterns, a large group of international experts from all continents provided their views in a structured online survey. These views were further polished and finalised at a two-day live gathering of a representative group of experts. The experts identified seven factors that are most likely to heavily impact migration patterns in the future (adapted from Sander et al., 2013, Table 3):

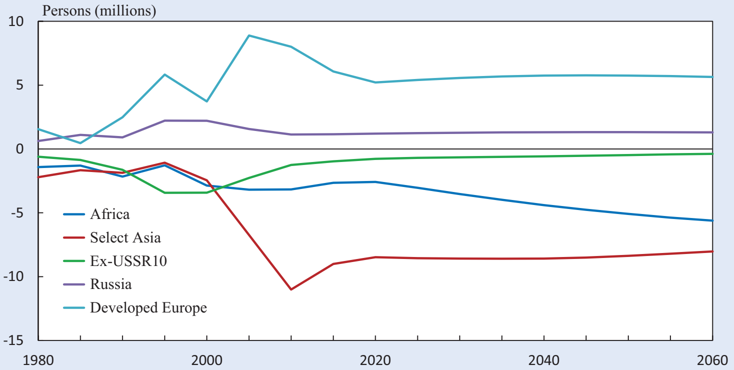
- Remittances will become more important for the economic development of migrant-sending countries.
- Temporary labour migration will increasingly compensate for skills shortages in developed countries and thus reduce permanent migration.
- Major shifts in the economic performance of industrialised countries will significantly influence demand for migrants.
- Shifts in cohort size, especially related to the baby boom and bust, will play an important role in shaping international migration levels.
- The propensity to move abroad among 15 to 29 year olds will be particularly high in countries with a large "youth bulge".
- International migration will mostly follow established paths and existing migrant networks.
- Political instability and oppression in African and Middle Eastern countries will result in more people seeking political asylum in democratic countries.

In their construction of the different scenarios the expert group decided that forecasting immigration and emigration for each individual country using a constant rate scenario (i.e. constant probabilities by country, age, and sex) estimated for the period 2005–10 coupled with the net impact of the above seven factors was preferable to using alternative methods (such as time series forecasts, turning point forecasting, etc.). After adjustments are made for 25 countries, which experienced rapid changes in migration rates over the past decade (like Spain, for example) that are unlikely to persist through 2060, these rates are assumed to stay constant until 2060. Based on these rates, they obtain a base-line forecast of the number of people immigrating and emigrating for each country for each five-year period. In addition, a number of alternative scenarios were elaborated based on the seven identified factors. In the Wittgenstein Center for Demography and Global Human Capital database, estimated and forecasted net migration data is available (immigration minus emigration) for each country and for different scenarios.[1]

[1] In the database of the Wittgenstein Center for Demography and Global Human Capital used here there are a total of seven different scenarios corresponding to each SSP scenario. The base case scenario is denoted as SSP2. Note that their data makes forecasts all the way to 2100. However, as explained in Sander et al. (2013), they have made explicit forecasts only until 2060. Thereafter they merely assume gradual convergence to zero net immigration by 2100. Thus, we do not present forecasts after 2060.

Figure 4.9

Actual and forecast net immigration in various regions of the world[a)]



a) Calculated as annualised net immigration per five year time periods (i.e. net immigration for a five year period divided by five). On the horizontal axis, five year periods are presented by the year when each period ends.
Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

Developed Europe and Russia are expected to continue to have positive net immigration. For developed Europe in particular, the trend is supposed to stabilise to just over a million people per year for the next 40 to 50 years (see Figure 4.9). This is not a small number. It is worth bearing in mind, however, that this figure includes net immigration from both within and outside of Europe (including developed Europe). These patterns are mirrored by net emigration patterns from select countries in Asia, Africa and the ex-USSR 10, which are expected to continue to be a source of emigration.

While net emigration from Africa will be driven both by the northern regions and the rest of Africa in the short run, it is sub-Saharan Africa that will be the largest net contributor to African emigration (around 1 million per year, on average) in the longer run.

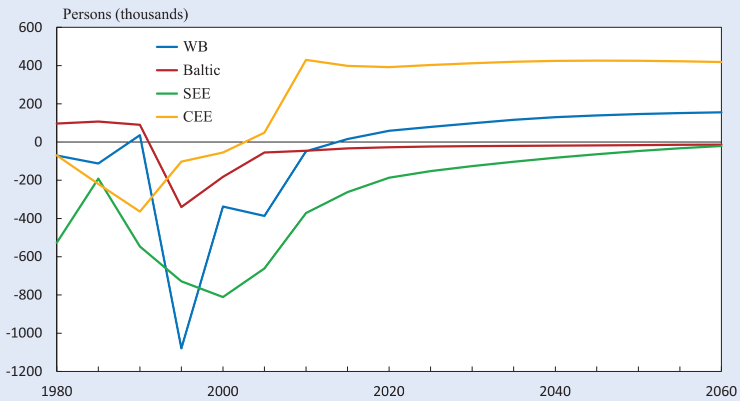
Over time these flows imply an increasing number of the foreign-born population living in developed Europe. Since the population of developed Europe is not forecast to change much under the base-case scenario, this further implies an increasing share of the foreign-born population. In the case of Germany, the total population is expected to fall moderately in the base-case scenario. Forecasts would have predicted more dramatic drops without net immigration. The same is qualitatively true for Russia where the inflow of immigrants, primarily from the former USSR, is forecast to continue.

In the 1990s the countries of Eastern, South Eastern and Central Europe all experienced significant net emigration, with many people leaving for developed Europe, among other places (see Figure 4.10). From the 2000s onward, this trend fizzled out in Central and Eastern Europe. By the 2020s, the Western Balkans region, which had seen very significant net emigration in the 1990s due to the conflict in the former Yugoslavia and the relatively poor state of the economy, should start seeing small, but positive net aggregate immigration flow. Only the South Eastern European countries, which include Moldova, Bulgaria, Romania and Turkey, will continue to see a net outflow of people, but emigration from these countries is projected to diminish over time. In most of these countries birth rates are already at or below the reproduction rates.

Immigration patterns for Afghanistan illustrate the fact that large numbers of people that leave a war-torn country (as in Afghanistan in the 1980s) may eventually return when and if peace is re-established. In the case of Afghanistan, this happened after the end of the Soviet occupation. New conflicts, i.e. the Allied war against the Taliban, did not bring, on a net basis, as many refugees as in the 1980s, but these are still rather large numbers. Whereas Afghan refugees pri-

Figure 4.10

Actual and forecast net immigration from emerging Europe[a)]



a) Annualised net immigration based on estimated values for five year periods). On the horizontal axis, five year periods are presented by the year when the period ends.
Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

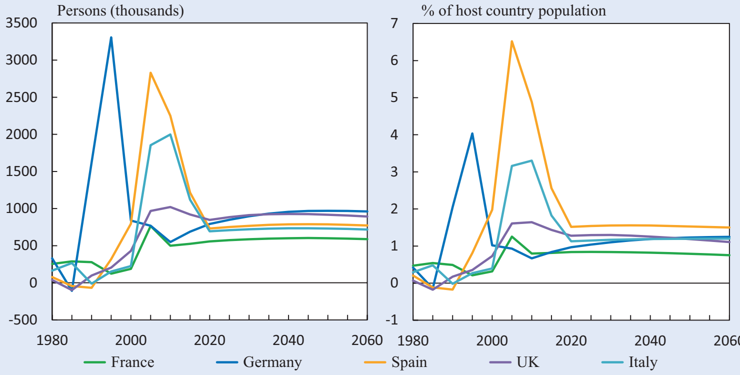
marily stayed in Pakistan in the 1980s, they are currently more likely to move to Europe as parts of Pakistan are destabilised too. Going forward, the forecast predicts that underdeveloped Asian countries such as Afghanistan, Bangladesh, and Pakistan will continue to have a significant outflow of people. Large emerging Asian economies will also produce a significant number of migrants (India much more than China), but these numbers will be small compared with the sizes of these countries.

We now take a closer look at both past and forecast immigration into developed Europe. Figures 4.11 and 4.12 present, respectively, net immigration into five large and five smaller European economies that have historically experienced significant immigration in the past. It is worth noting that, based on estimates made for five-year periods, immigration into Germany was at its highest level in the 1990s, while immigration into Spain peaked in the early 2000s. Somewhat similar insights can also be drawn from immigration patterns in five smaller European economies (Belgium, Greece, Netherlands, Sweden and Portugal). Interestingly, it is Greece, and not the Netherlands or Sweden, that has had the highest recorded net immigration among these five countries (posted in the 1990s), both in terms of the number of people and as a fraction of the population of the host country. In the case of Greece, this was primarily driven by a very large influx of immigrants from Albania (see Cholezas and Tsakloglou, 2008).

Thus far we have considered the base-case scenario. Let us now briefly comment on alternative scenarios. For this purpose we fo-

Figure 4.11

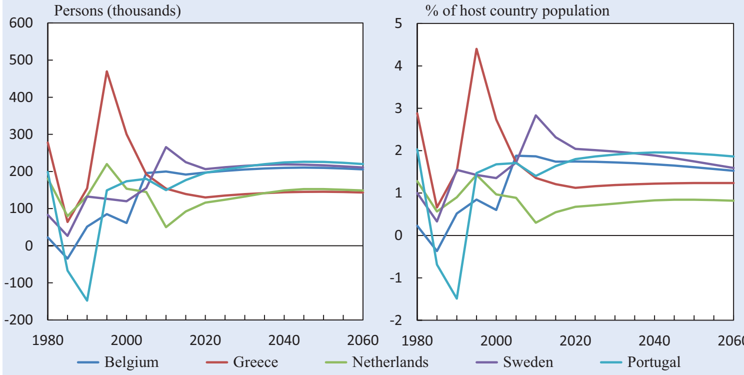
Actual and forecast net immigration into five large European countries[a)]



a) The data is for France, Germany, Spain, UK and Italy. Quantities are annualised based on five-year estimates. On the horizontal axis, five-year periods are presented by the year when the period ends.
Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

Figure 4.12

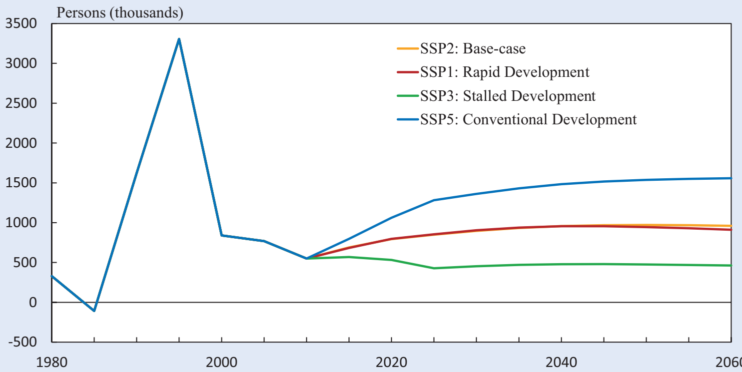
Actual and forecast net immigration to select smaller European countries[a)]



a) The data is for Belgium, Greece, Netherlands, Sweden, and Portugal. Quantities are annualised estimates based on five-year quantities. On the horizontal axis, five-year periods are presented by the year when the period ends.
Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

Figure 4.13

Actual and forecast net immigration into Germany under the base case and alternative scenarios[a)]



a) Quantities are annualised estimates based on five-year quantities. On the horizontal axis, five-year periods are presented by the year when the period ends.
Source: Wittgenstein Center for Demography and Global Human Capital database and EEAG calculations.

cus on the largest country in developed Europe, namely Germany (see Figure 4.13).

Let us note that, as expected, the different scenarios vary significantly. The base case scenario (red line) is bracketed between two more extreme cases.[5] The highest level of immigration into Germany is forecast under scenario SSP5 (blue line) which, in turn, also predicts strong population growth in that period. On the other hand, scenario SSP3 (green line) predicts both a decline in immigration, as well as a strong decline in the German population. SSP1, by contrast, leads to a very similar net immigration forecast for Germany as the base-case scenario. In both of these cases, an increase in immigration is coupled with a small drop in the population of the country, leading to higher shares of foreign-born residents.

In short, migration pressures on developed Europe are likely to persist, possibly at levels higher (in terms of the number of people) than observed, on average, over the past decade. These numbers include all forms of migration, and worker migration accounts for a significant share. The migration pressure driven by humanitarian pressure will persist, although it is very difficult to precisely predict the timing, the source, and the receiving countries.

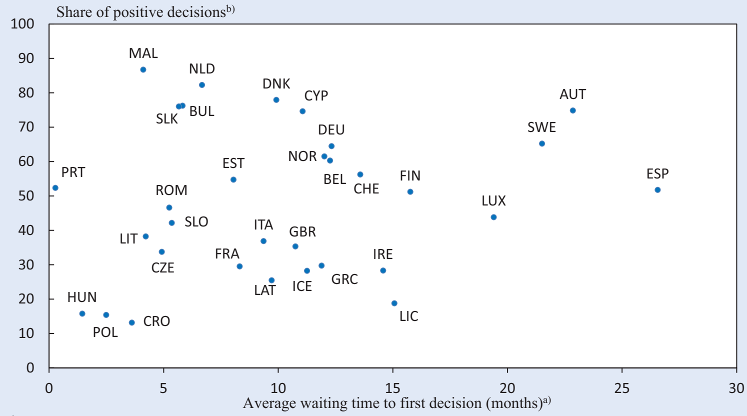
4.4 Humanitarian migration policies

The consequences of conflicts or natural catastrophes for the displacement of people depend on numerous factors including the type of event, its scale, and location. Displaced people may seek help in other parts of the country, or may ask for asylum in neighbouring or more distant countries. The specific routes taken depend on many factors including age, own resources, established networks and linguistic and political/cultural ties, as well as the humanitarian migration policies of potential host countries.

[5] There are three other net immigration scenarios which we do not present here since they lead to very similar results as the base-case scenario.

Figure 4.14

Average waiting time for decisions on asylum applications, and the share of positive decisions, EU countries 2015–16



a) Average waiting time is computed based on new applications for asylum and applications pending after one month, data 2016.1–2016.6, the average number is reported .
b) Share of positive decisions is computed based on total decisions on quarterly data 2015.4–2016.2, the average number is reported.
Source: Eurostat and EEAG calculations.

Rules for individuals wanting to enter a country for humanitarian reasons are very complex, see Box 4.2. Although the overarching principles are clear and shared by most countries, there is considerable scope for differences in interpretation and implementation of the rules. Conventions define a right to apply for asylum, but not a state's obligation to offer protection to anyone who claims it.

Countries interpret admission criteria for asylum seekers with varying degrees of stringency. This also applies across EU countries, despite efforts to define common asylum and migration policies. There are cross-country differences in criteria for granting both temporary protection and permanent asylum. Moreover, countries have different interpretations of "safe origin countries" and "third safe countries", and different waiting times, rules for family unification etc. (see e.g. European Union Agency for Fundamental Rights, 2016).

In particular, there are large differences in processing times and the share of approved asylum applications across EU countries (see Figure 4.14). Although various reasons may explain some of the observed cross-country differences, like the composition of the pool of asylum seekers, these differences are so large that they may also be seen as an indicator of the different policy stances across EU countries (Dustmann et al., 2016).

In setting migration rules there is a conflict between the ethical or humanitarian duty to help human beings in a difficult situation, and the right of citizens of recipient states to determine who enters their territory.

Box 4.2

Migration rules

Migration rules are complex. Some forms of migration are covered by international conventions while others are unilaterally decided upon at the country level. Under EU law, for example, there are 20 different categories of third-country nationals, each with different rights depending on their links to EU Member States or their need for protection. While the cases of students and migrant workers may be relatively simple (see EEAG, 2015 on the rules for worker migration within the EU), the rules applying to asylum seekers and family unification are detailed and complex.

There is a multilayer structure of migration rules and regulations including UN conventions, the European Social Charter (ESC) and the European Convention on Human Rights (ECHR) for the 47 member states of the Council of Europe (including all 28 EU countries), EU law for the EU member states, and finally national law. This is further complicated by the fact that not all countries have ratified or acceded to all of the ECHR Protocols; and not all EU member states are bound by all of the different pieces of EU legislation in the field of asylum, border management and immigration (for an overview see, for example, European Union Agency for Fundamental Rights, 2016). Moreover, international conventions leave room for different national interpretations and approaches. This further adds to the complexity of the problem.

The 1951 United Nations Convention ("Geneva Convention") relating to the Status of Refugees and the 1967 Protocol ("Refugee Convention") is the primary framework for international refugee protection. To date, 142 countries have signed the two. The Geneva Convention defines a refugee as a person who has a:[1]

"Well-founded fear of being persecuted for reasons of race, religion, nationality, membership of a particular social group or political opinion, is outside the country of his nationality and is unable or, owing to such fear, is unwilling to avail himself of the protection of that country; or who, not having a nationality and being outside the country of his former habitual residence as a result of such events, is unable or, owing to such fear, is unwilling to return to it."

The convention was originally limited to persons affected by events within Europe, but the 1967 protocol made coverage universal. Originally, the convention applied to individual persecution, but it is now interpreted to apply more widely to persons leaving their country due to wars and conflicts, and where the country of origin is unable to provide protection. Today this is also interpreted to include persons at risk of persecution for reasons of gender and sexual orientation or identification.

The two key parts of the convention are the right to seek asylum and be granted asylum if the conditions are satisfied, and the principle of non-refoulement. The latter prohibits states from returning a refugee or asylum seeker to territories where their life or freedom would be threatened, or where they may be subject to inhuman treatment or punishment.

The Geneva Convention does not stipulate the precise criteria that should be used to judge whether a person should be granted asylum, or the rights of refugees lawfully staying in a country, which leaves scope for differences in interpretation and implementation. This particularly applies to whether a temporary or permanent permit of residence is granted. For an overview, see European Union Agency for Fundamental Rights (2016).

The EU asylum acquis comprises intergovernmental agreements, regulations and directives related to asylum in the EU (although not all EU members are bound by all elements of the asylum acquis). The Common European Asylum System (CEAS) aims to establish common rules for asylum seekers across EU countries. Main pillars of the system are *(i)* The Dublin Regulation stipulating that the country of first arrival is usually responsible for the examination of an asylum request, *(ii)* Eurodac fingerprinting database, *(iii)* The Asylum Procedures Directive aiming at harmonising asylum procedures, *(iv)* the Qualification Directive aiming at defining common criteria for granting protection and stipulating the rights of asylum seekers, *(v)* The Reception Conditions Directive aimed at setting minimum standards for living conditions, and *(vi)* the European Asylum Support Office to support cooperation among member states on asylum policy.

Various policy initiatives have been implemented to strengthen EU cooperation on refugee policies. Interestingly, a directive on "Temporary protection in the event of a mass influx of displaced" was adopted in 2001, but was never implemented. The main idea was to set up a system that could offer temporary protection in case of mass refugee waves. In response to the recent refugee wave, the Commission has presented proposals to reform CEAS where the directive is replaced by a regulation (a regulation is binding for member countries, while a directive is not) to *(i)* simplify, clarify, and shorten asylum procedures, *(ii)* ensure common guarantees for asylum seekers, *(iii)* tighten rules to combat abuse and *(iv)* harmonise rules on safe countries (see European Commission, 2016).

[1] Article 1A(2).

The latter may become an important issue if large scale immigration significantly challenges a society economically and/or culturally. This is clearly a very difficult issue, since there is no counter-factual and the argument can be used to defend anti-immigration policies and stir up populism.

To deter asylum seekers, a country may adopt a slow and uncertain procedure for handling applications, granting family unification etc. At the same time, it is well-established that long and uncertain decision times are a deterrent to subsequent integration into society, which also applies to the labour market (OECD, 2016). There is therefore a trade-off between deterring entry and promoting the integration of those granted asylum.

As argued above, it is not always easy to draw a clear distinction between a refugee and an economic migrant, since there are multiple possible reasons for migration. Importantly, informational asymmetries exist between an applicant and asylum administrators. In designing migration polices one also faces the dilemma that those making it to the border (in case of long-distance conflicts) are selected among the displaced people and seldom include those that need protection the most, i.e. the weakest segment of the population. A further problem is that, even when asylum applications are declined, it may not always be straightforward to return migrants (see Box 4.2).

Refugee policies are a prime example of a policy area calling for international harmonisation and cooperation, not least within the EU. The root problem is a humanitarian one for which all countries share a responsibility. Moreover, in an EU context, the burden should not rest primarily on countries at the EU's external border and must be equitably shared. This does not necessarily imply that refugees should be distributed proportionally across countries, but that there should be a common admittance policy and clear principles for sharing the burden. Common admittance criteria make sense since, at least within the Schengen zone, once a refugee is admitted into one European country s/he effectively obtains the right to move to any other member state. Non-cooperative policies whereby single countries adopt their own policies in an attempt to lower refugee pressures lead to negative spill-overs to neighbouring countries, increase the total costs of managing refugee flows and may cause "rule speculation" or "regulatory arbitrage" among prospective refugees.

All of this weighs in favour of a common EU response to the refugee crisis. However, such a response has failed to materialise to date. Paradoxically, the EU adopted a Temporary Protection Directive back in 2001 with harmonised "minimum standards for giving temporary protection in the event of a mass influx of displaced persons and on measures promoting a balance of efforts between Member States in receiving such persons and bearing the consequences thereof".[6] This directive is specifically intended to deal with possible cases of mass arrivals into the EU of foreign nationals who cannot return to their countries, particularly due to a war, violence or human rights violations. However, the Directive has never been implemented. While the Directive was prompted by the refugee wave in the early 1990s following the conflicts in the Balkans, the consequences of failing to make progress in this area have become clearly apparent in recent years.

4.5 Economic impact of migration

The current influx of refugees into Europe has triggered lively discussions about the potential impact of immigration on the economic welfare, security, and culture of the host nations. Large-scale immigration has a dramatic impact on the source countries too.

[6] European Union, "The Directive on Temporary Protection in the Event of a Mass Influx of Displaced Persons," Council Directive 2001/55/EC, 20 July 2001, http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=URISERV%3Al33124.

This section focuses on the economic impact of immigration. It is worth noting that immigration has prominently featured in the European economy for some time now. According to a recent OECD study (OECD, 2014), migrants account for around 70 percent of the increase in the workforce in Europe in the past ten years (in the US the corresponding number is 47 percent). Overall, migrants work both in fast growing and in declining sectors of the economy, filling important niches. How much migrants contribute to the host economy depends, unsurprisingly, on the structure of the host economy itself, as well as on the migrants' educational level, the ways in which they immigrated into the country, their knowledge of the language of the host country and other factors.

In assessing the overall economic effects of migration it is crucial to distinguish between the different types of migration. Worker migration driven by differences in wages and thus productivity allows a potentially better allocation of resources and is, therefore, a possible source of welfare gains, although it is associated with distributional effects that create winners and losers. However, migration also involves entitlement to social arrangements, which in itself affect the economic implications, but may also impact migration patterns (see also EEAG, 2015). Admission of migrants on humanitarian grounds is clearly not motivated by economic concerns in the first place, but its economic consequences are, of course, important for the host countries.

We focus the discussion of the economic impact of migration primarily on aggregate measures such as production, the labour market and public finances. The effects in these three dimensions are closely interrelated; and a common denominator is the employment level of immigrants relative to the employment level of the population in the host country.

4.5.1 Production and income

When discussing the effects of immigration on production and income, it is important to distinguish between effects on levels and on per capita values. If, for example, the labour force increases due to immigration, then GDP is likely to increase; but this does not necessarily imply that GDP per capita will increase. GDP per capita can be decomposed as average value added per working hours times average working hours. The basic accounting principle therefore tells us that per capita GDP increases in response to immigration if immigrants either have higher productivity and/or work more than the population on average. Over time more complicated and subtle effects may arise if immigration affects the average productivity level in society, which clearly depends on the type of immigrants in question.

This reasoning immediately leads to a general point. It is difficult to make general statements on the effects of immigration, since it depends not only on the level but also on its composition (students, worker migrants, refugees, family unification etc.). Immigrants who can bring specialised knowledge and enter the labour market directly, clearly have different effects than immigrants with low qualifications who have difficulties finding a job. The heterogeneity implies that the composition of a given number of immigrants is crucial to their economic effects; and it is impossible to make general unconditional statements on the economic effects of immigration.

This is also clear from studies that find an ambiguous link between migration and economic growth. On one hand, migrants and, especially, high-skilled migrants, can positively impact human capital formation (less so in the case of refugees from countries with lower levels of education). On the other hand, with an increase in the number of people, capital per worker is mechanically reduced. On the whole, Boubtane and Dumont (2013) show that for a sample of 22 OECD countries between 1986 and 2006, the effect of immigration on economic growth was positive, but small. Namely, an increase of 50 percent in net migration of the foreign-born generated less than one tenth of a percentage-point of variation in productivity growth. As this result includes countries with highly selective skill-based immigration, the current influx of refugees is, at best, going to have very small positive impact on productivity. Münz et al. (2006) confirm that the impact of immigration on growth heavily depends on their labour market performance and is heterogeneous across countries. Furthermore, they find that immigration has a positive effect on demography and ageing, but will not alone resolve the financial challenges associated with ageing. They also find evidence that immigration has a small, but positive impact on the trade relations between migrants' countries of origin and host countries. This is demonstrated, in particular, in the case of the UK and Spain. The remittances represent a drain on the balance of payments for the host countries, but they may support the EU's export of goods in source countries too.

The above refers to the structural effects of immigration. In the short run, an influx of immigrants may induce a more expansionary fiscal policy. Many European countries have increased public spending in order to process asylum applications and secure conditions for the stay of refugees while their applications are decided upon. Both the EU and European national governments also provide some support to countries of origin, as well as to those countries through which refugees pass.

The OECD reports that Germany has projected an additional 0.5 percent of GDP per annum of public spending in 2016 and 2017 in order to meet the initial needs of the asylum seekers and to integrate them into the labour market (OECD, 2015). Austria allocated them 0.3 percent and Sweden 0.9 percent of their GDP in 2016. The Turkish government has provided aid to Syrian refugees in Turkey since 2011, which was worth the equivalent of 0.8 percent of GDP in 2014.

In the short run, additional public spending is likely to act as a demand stimulus, especially in countries like Germany, Sweden and Austria, which have the largest refugee populations. In 2016 and 2017, the additional spending could boost aggregate demand in the European economy by about 0.1 to 0.2 percent of GDP (this is an estimate that appears both in OECD and IMF reports).

4.5.2 Labour market

The labour market aspects of immigrants are essential. The ability to be self-supporting is in itself of importance, but it is also crucial for integration into the society at large, besides its obvious economic implications.

The likelihood of immigrants finding employment clearly depends on both labour market structures and institutions, as well as on the personal attributes of the immigrant including their education, skills, experience, language proficiency etc. Moreover, norms and gender roles may play a role when families from cultures where the man holds the breadwinner role enter countries with a different gender balance, and where the labour market participation rates of women are on par with those of men.

The fact that most countries have more flexible immigration rules for highly-skilled individuals clearly reflects their interest in attracting such types of labour. Highly-skilled people can integrate into the labour market more easily. Humanitarian immigrants, on the other hand, often come from low-income countries and therefore tend to be less educated than the population in the host country. In this way, large numbers of refugees tend to increase supply of low/less-skilled labour. Labour market institutions and structures influence how this affects employment and wages. In labour markets with relatively high minimum wages in particular, it may be difficult for immigrants to find jobs, while in others with a more flexible wage setting, job-finding is relatively easier, but at the risk of becoming the working-poor. In addition, there are issues in relation to recognition of skills and possible discrimination in the job application process.

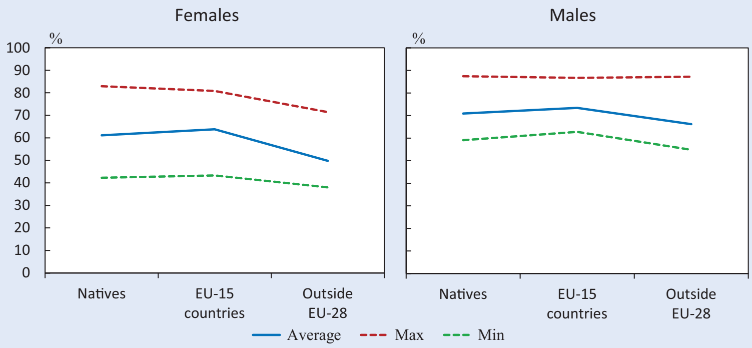
The difference in employment levels for migrants are illustrated in Figure 4.15, which shows employment rates for men and women for natives and migrants from EU-15 countries and outside the EU-28 countries. Firstly, the employment rate for migrants from EU-15 countries is on par with that of the native population in most countries, reflecting the fact that these migrants are predominantly worker migrants. Secondly, for migrants from outside EU-28 employment rates are generally lower, especially for women, than for natives; reflecting the fact that a significant share of those immigrants enter due to asylum and family unification. At the same time, the differences across countries are also large, reflecting both different labour market structures and differences in the composition of immigrants. The aggregate numbers reported in Figure 4.15 conceal differences depending on the reason for residence (work or refugee) and their country of origin. Employment rates among refugees are lower than those among natives in all EU countries, and the gap is particular large for women, although it tends to decrease with the duration of the residence period (see e.g. Dumont et al., 2016).

The labour market challenges and tensions created by immigration are intimately related to the increase in the supply of low-skilled labour. Globalisation and technological changes are known to create so-called skill-biased changes, implying that demand for low/less skilled labour is declining in high-income countries. In response to this, countries focus on improving the skill level of the work-force, to support high employment and an acceptable wage distribution – the race between technology and education. The tension from immigration thus arises from the fact that it tends to reinforce the skill-bias problem by increasing the supply of low/less skilled labour. This challenges labour market policies. It is also a source of social tension, since groups already under pressure find that they carry a disproportionally large share of the adjustment burden in terms of further pressure on job possibilities and wages, which in turn gives rise to the sentiment that: "they are taking away our jobs".

Considering in more detail the issue of labour market entry of immigrants, the speed and quality of integration of refugees into the labour market of the host country is important for both the short and the longer-term costs of the refugee influx. Significant factors are labour market options for asylum seekers while their applications are being processed, and should they receive a positive response to their asylum claim. Annex I on p. 41 of the recent IMF report on the refugee crisis in Europe (see IMF, 2016b) features a comparison of asylum rules for Italy, the UK, Germany, and Sweden. Differences across countries are quite substantial. While in Sweden asylum seekers are allowed, under certain conditions, to work right away without a working permit, in the other three countries a working permit is required. In Italy, it is received within two months after initially applying for asylum and is renewed every six months. Im-

Figure 4.15

Employment rates in EU-15 countries depending on country of birth, 2015[a)]



a) Gives the unweighted average employment rates for all EU-15 countries depending on the country of origin. Natives are persons born in the respective EU countries, EU-15 are persons born in one of the other EU-15 countries except the country of residence, and outside EU-28 are persons born outside the EU-28. The max and min are the maximum and minimum value in a given country, and need not be the same country across categories.
Source: Eurostat and EEAG calculations.

portantly, no restrictions are posed when searching for employment. In Germany, a work permit may be received three months after registering as a refugee. However, employers must prove that they were not able to find qualified German nationals, EU citizens or recognised refugees to fill the position in question. This is a serious barrier to early legal entry to the labour market in the application process. It has to be noted that this restriction does not apply to professions with labour shortages and it is waved after 15 months of residence. In the UK, the policy towards the labour rights of refugees is even more restrictive than in Germany. Namely, a work permit can only be obtained after one year and only in areas where labour bottlenecks exist.

Obviously, it is not enough to allow refugees to work. It is important that they in fact have those skills needed in the host economy and that businesses have incentives to hire them. One of the key problems is the lack of knowledge of the host country's language and/or the lack of appropriate training. Providing language and professional training for genuine refugees is clearly an important task of a host government. Let us compare the four countries cited above once again. Schooling of refugee children is compulsory up to the age of 15 in Germany and up to the age of 16 in Italy, Sweden, and the UK. In Sweden, children between 16 and 19 years of age often have to attend a preparatory course in Swedish and other core subjects before they can receive vocational training.

It is hard to estimate the skill structure of the current wave of refugees. One way to get a very approximate handle on it is to look at the percent of people that are enrolled into tertiary education in countries from which many of the current refugees originate.

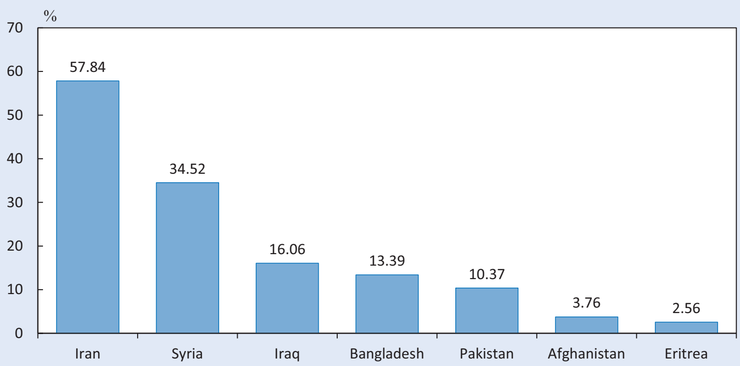
According to this criterion, Iranians and Syrians are the most educated among the sample countries, while the least educated, on average, are likely to be refugees from Afghanistan and Eritrea. Of course, a person's level of education is an individual characteristic. However, Figure 4.16 can, together with the national composition of the refugee population, provide at least a clue as to how well current refugees might integrate into a host economy.

Even if legal constraints for early employment are eliminated, important impediments for hiring low skilled refugees remain such as high entry wages and other entry barriers. Apart from lifting formal restrictions on working during the asylum process, it may, therefore, also be helpful to introduce some measures that provide incentives to hire refugees. Such measures could include wage subsidies to private employers or a temporary exemption of payment of the minimum or entry wages (see Sinn, 2015 and IMF, 2016b). It is important that welfare benefits for refugees are not such as to discourage them from actively searching for a job. Allowing those asylum seekers that found a job to switch their status to an economic migrant (as, for example, is the case in Sweden) may provide a good incentive for such individuals to look for work, instead of relying on welfare benefits.

One important worry is that the large influx of immigrants will invariably pool down the wages of the native workers. Several studies have addressed this issue in the past. Kerr and Kerr (2011) survey a large body of the empirical literature on the topic of the labour impact of immigration (see also EEAG, 2015). As expected, they find that immigrants in Europe, at entry, have lower employment rates and lower wages than natives. These differences diminish over the duration of an immigrant's stay in the host country, but do not entirely disappear. On the other hand, they also find that immigrants, on aggregate, have a small effect on labour market opportunities for natives, with the exception of less-educated natives and, especially, former im-

Figure 4.16

Total enrolment in tertiary education for selected host and source countries, 2013[a)]



[a)] The enrolment rate is computed relative to the total population of the five-year age group following on from secondary school. Tertiary education is defined as ISCED 5 to 8. Countries that feature prominently in the refugee population in Europe in 2015 are included. We use data for 2013 and, if unavailable, the latest available data point.
Source: UNESCO Institute for Statistics and EEAG calculations.

migrants. This is consistent with the findings of many other authors.

Sinn (2015) argues that the current flow of refugees into Germany is likely to have an adverse effect on people with lower education and on former immigrants. On the other hand, it could be beneficial to high-skilled workers who may benefit from a reduction in costs for many services that can be performed by the new immigrants. This is similar to the US experience: there, a large flow of workers from south of the border is keeping wage pressures down in farming and several other industries. It is worth noting that in the US, businesses often use undocumented immigrants in order to further lower their labour costs. The same situation was observed in Greece in the late 1990s and early 2000s, where illegal Albanian immigrants mostly filled cheap labour demand (see Cholezas and Tsakloglou, 2008). Previously outlined measures should help to prevent the widespread use of refugees in an informal economy in Europe.

Del Carpio and Wagner (2015) study the effects of Syrian refugees on the Turkish labour market. Currently there are around 2.5 million Syrian refugees in Turkey. The study combines newly available data on the distribution of Syrian refugees across Turkey and from the Turkish Labour Force Survey to assess the impact of refugees on the labour market. Just like Albanians in the early 2000s in Greece, today's Syrian refugees are predominantly working in the informal economy. The arrival of refugees has led to a large scale displacement of natives from the informal sector. On the whole, women and poorly-educated men have experienced net displacement from the market. At the same time, formal employment for natives has been growing (mostly for those that have not completed a high school education and mostly for men).

Manacorda et al. (2012) show that over the past 30 years in the UK a significant increase in immigration of more educated workers has significantly raised the supply of qualified labour. Instead of impacting the wages of educated natives, however, this increase in educated immigration has primarily negatively impacted the wages of former immigrants, and in particular those that have a university degree. The authors therefore argue that native and foreign skilled workers are not perfect substitutes in the UK.

Similarly, Münz et al. (2006) find that while the effect of immigration on wages across Europe is on average slightly negative, the effect is quite small. The authors note heterogeneity in Europe with respect to the effects of immigration on wages. In Greece, Italy, Spain, and the UK the effect was either non-existent or slightly positive. In these countries immigrants filled certain market niches that native workers previously would not or could not fill. On the other hand, in Germany prior to labour market deregulation, pressure from immigration had a more negative impact, especially on construction jobs. Overall, they find that labour market efficiency has improved as a result of immigration.

Thus, as we can see, a large new supply of immigrant workers may have different effects on different segments of the labour market. The overall impact, however, is not likely to be very large. Taking into the account current restrictions on market entry by asylum seekers, the OECD forecasts that by the end of 2016, the cumulative number of new entrants into the labour market for all countries of the European Economic Area and Switzerland should not be higher than 1 million people, or around 0.4 percent of the total labour force as a result of the refugee influx in 2014-2016 (OECD, 2015). The figure for Germany should be less than 400,000, or around 1 percent of the total labour force. Thus, the effects on host country labour markets should build up slowly over time, as refugees become better integrated and if and when they are allowed to reunite with their families.

4.5.3 Public finances

The public finance implications of immigration are intimately related to the employment performance of immigrants for the basic reason that individuals in employment contribute more taxes, while those who are not employed are often entitled to some form of public support. In all countries, public finances are therefore very sensitive to the employment level as a result, with larger sensitivities in countries with more extended welfare arrangements. In short, if employment levels among immigrants are above average, it tends to improve public finances and vice versa (see, for example, Liebig and Mo, 2013 and Hansen et al., 2016).

A commonly made argument is that since immigrants are more frequently excluded from the labour force or unemployed than natives, they spend more time on welfare and other forms of social assistance.[7] This assumption is not exactly confirmed by empirical studies. Kerr and Kerr (2011) show that welfare dependence is more likely upon arrival, but that, overall, the fiscal impact of immigration is very small. Large differences exist across migrant groups in the costs and benefits that they cause for a host country. The net impact depends heavily on the migrant's age, education, and duration of stay. On average, immigrants appear to make a minor positive net contribution to the host countries' public finance systems. Münz et al. (2006) find that countries that provide quicker access to work or otherwise have a higher share of economic migration (such as the UK, Italy, Greece, Portugal, and Spain) experience a positive fiscal contribution by immigrants. By contrast, when immigration flows are dominated by asylum seekers (who are permitted to work only under restrictive conditions) and families reuniting (as in the case of Denmark and Sweden), immigrants depend more on welfare payments than natives. The authors find that discrimination and inadequate access to schooling and training may make matters worse. One should be mindful of the potential problems with the current wave of refugees and do the utmost to integrate legitimate refugees into the labour market as quickly as possible. More recently, Liebig and Mo (2013) find that the impact on public finances of the cumulative waves of immigrants that arrived over the past 50 years in OECD countries is on average close to zero, and rarely exceeds 0.5 percent of GDP in either positive or negative direction. The highest positive impact is in Switzerland and Luxembourg, where immigrants provide an estimated net benefit of about 2 percent of GDP. These estimates are based on the historic levels and compositions of migration flows. The effects of changes in particular migration groups can be very different from the historic averages. Therefore, it is probably not too meaningful to make general unconditional statements on how public finances are affected by migration.

The German government estimates that each refugee will cost the state around 12,000 euros per year. However, the total costs facing Germany and other EU countries will depend substantially upon factors that are largely under the control of the state. Namely, a speedy resolution of asylum claims and early integration of refugees into the labour market would both reduce costs and help diffuse the building-up of social pressure.

The speedy resolution of claims would involve, in part, rejection of unfounded asylum claims from all countries that are currently not in war zones and can, therefore, be deemed safe. In order to protect people who are under genuine threat, it is important that the state conserves limited human and material resources. The best way to do this is to strongly discourage would-be economic migrants who disguise themselves as refugees. Such asylum applications should be quickly rejected. Furthermore, people making such claims should be speedily repatriated. This would go a long way towards discouraging an uncontrollable increase in asylum claims. In 2014 and early 2015, a large number of would-be economic migrants from the Western Balkans (mostly Roma and Albanians) applied for asylum protection in Germany, Sweden and some other EU countries. Designating countries of the Western Balkans as "safe countries of origin" quickly and dramatically reduced incentives for "asylum tourism" from these countries in 2016. Given the common border between the Schengen countries, it is critical that these measures (and some others, as we shall discuss in the next section) are coordinated among countries to rule out "regulatory arbitrage", or the exploitation of weaknesses in some countries' regulations. Having said this, EU countries should provide an outlet for people who are looking for jobs to apply for economic migration visas through managed migration programmes. Such programmes would match the skills that immigrants possess with unmet needs in host countries.

4.6 Key challenges and potential policy responses

Immigration pressure on Europe is likely to persist in the foreseeable future. While the level of future immigration is highly uncertain, the underlying drivers are going to be present, which in turn raises a number of questions concerning migration policies. Migration takes many forms. The following primarily discusses the policy options related to refugees and family unification.

In the past year, the refugee crisis has taken centre stage in the public debate in Europe, putting politi-

[7] It has been debated whether generous welfare arrangements are a magnet attracting immigrants that would benefit from the welfare system. The evidence in support of this hypothesis is not strong (see Pedersen et al., 2008 and Giulietti et al., 2013). There is some indication of "welfare magnet" effects between the "old" and "new" EU member states (see De Giorgi and Pellizzari, 2013), but not much influencing EU migration flows (Skupnik, 2014). However, irrespective of the driver underlying migration, the public finance consequences depend on whether the immigrants find employment.

cians under mounting pressure to take action. In the wake of a dramatic raise in populism this is understandable. However, it is important to act wisely and to take into account the long-term consequences of potential policy responses. First of all, it is critical to avoid moves that would worsen the crises in already destabilised countries, or create new "hot spots". In addition, one should act preventively and help, as far as possible, afflicted and potentially afflicted countries to develop their economies, thus reducing the incentives for people to emigrate. The key is to enable trade and investments with these countries. Another complementary measure would be to focus more of the development aid efforts on improving training and education.

Such general considerations are important, but do not make more specific refugee policies redundant. On the contrary, while migration pressures have recently somewhat diminished (among other reasons, due to the EU's arrangement with Turkey), this may not be a permanent situation. There is therefore an urgent need to develop a coherent policy response.

Refugee policy is a clear case for European policy cooperation. The ultimate objective is humanitarian, namely to help people displaced by wars, conflicts or natural catastrophes. For a European response to be viable in the long run, the burden should be apportioned equitably among countries. This can only be achieved if states cooperate. At present, however, European policy is characterised by a shift towards a non-cooperative approach whereby countries take different routes in an attempt to reduce the inflow of migrants.

The break-down of the European humanitarian migration system is no surprise, since it has never been fully developed (see Box 4.2). A core element is the Dublin regulation whereby the responsibility of examining asylum applications rests on the member country of an immigrant's first entry into the EU. Without any sharing mechanism, this system is bound to break down in the case of mass migration, since it places an excessive burden on the border countries. The opposite situation with elaborate sharing mechanisms involving all EU countries, and having individual countries determining who is admitted in, reduces the incentives of border countries to control entry. Furthermore, once a person is admitted into one Schengen country, s/he can move, eventually, to other European countries. Thus, individual country decisions to admit refugees may create a negative externality for others. For this reason, there needs to be developed a system with a common set of admission rules and criteria determining when asylum is granted (including safe-third countries), as well as a time-consistent sharing rule determining how the burden related to hosting the asylum seekers is allocated across countries.

In trying to come up with a workable system two key factors have to be recognised, although they may initially seem unacceptable to some on humanitarian grounds. Firstly, the current system has a tendency to foster illegal immigration. Secondly, migrants are driven by different motivations, and there is an important, but difficult issue of distinguishing between those who have a legitimate reason to apply for an asylum from those who use this option as a way to immigrate into Europe, but are not facing pressing humanitarian need.

According to the Geneva Convention, a refugee has to enter the territory of a country in order to apply for an asylum. As a result, most refugees rely on irregular migration channels in order to reach the country where they want to apply for asylum. This makes a strong argument for developing designated asylum application centres in countries outside of the EU and close to (but outside of) the conflict zones. This would reduce the incentives for refugees to resort to hazardous migration channels in order to reach destination countries, thus lowering both human and financial costs for refugees. The approach is also attractive because it would significantly rein in the uncontrollable influx of people into the EU. However, it is demanding in terms of the required resources, and presupposes broad cooperation both within the EU, as well as with those countries that host such centres.

Furthermore, the EU countries would also need to coordinate their actions regarding the refugee problem with those countries surrounding the EU. A close coordination with the Western Balkan countries is already established and should be further deepened. Some of these countries have done a lot to cooperate with the EU in handling the refugee crisis. The region should also be encouraged to cooperate internally and, eventually, as it progresses economically and politically, it should be integrated into the EU. This would establish a contiguous, well-defined border of the European Union that would be easier to protect than is currently the case.

An especially sensitive problem is how to deal with Turkey. Currently, Turkey is home to over 60 percent of all Syrian refugees. The agreement with the EU implies that Turkish citizens should obtain the right of visa-free travel into the EU. In principle, this is a good idea given that Turkey is a fast growing economy with a large number of highly qualified individuals. Thus, engaging Turkey and cooperating with it has no reasonable alternative. On the other hand, it is not wise to fully lift visa requirements for Turkish citizens without a marked improvement in the respect of human rights in that country. Otherwise, a visa-free travel agreement with Turkey is likely to create fresh waves of refugees into the EU, this time out of Turkey.

While it may, at first, seem to conflict with humanitarian aims, an effective sorting of individuals seeking a refugee status is crucial to the long-term functioning of the system. It is necessary to recognise that refugee waves triggered by conflicts and wars often bring other migrants along, who are not fulfilling the criteria for asylum, but are escaping severe poverty, for example. Such sorting requires clearly defined rules applied equally by all European countries. The present situation with unclear and disparate rules and procedures across EU countries create "regulatory arbitrage" opportunities, which do not improve the situation, to say the least.

One important risk is "The Bubble Effect". Recall the late 1990s and the so-called dotcom bubble. Driven by the desire for fast profits, media frenzy, and the Clinton administration's talk of a "New Economy" not based on economic fundamentals, people started to believe that the prices of dot.com companies would increase forever. As a result, a large share of the population thought that one should either create an internet start-up or, at the very least, buy shares in such companies in order not to be left behind. In a self-fulfilling prophecy, the share prices of internet companies skyrocketed. For the bubble to inflate, people had to stop making rational decisions and start taking huge, unwarranted, financial risks just because everyone else around them was doing it. Allen Greenspan, former Chairman of FED, warned about "Irrational Exuberance" in 1998, but failed to burst the bubble. One serious danger is that something similar could happen with the refugee situation in Europe if expectations are not properly managed.

When a fraction of people from war-torn countries in or close to Europe apply for asylum in Europe, the continent can handle the situation. It has shown this on numerous occasions, including the wars in the former Yugoslavia. Offering shelter is both a humane and a rational act. It is equally as rational for the affected people to look for help. More recently, however, especially after Angela Merkel's "Wir schaffen das" (English: we can do this) statement, expectations started to form that there would be virtually no limits to Germany's (and, by extension, to Europe's) absorption capacity for refugees. This, in turn, attracted a large number of people who were not directly impacted by the conflicts to apply for an asylum. A bubble of sorts started to form. To an increasing number of people, it seemed that they needed to emigrate now in order not to miss out on the opportunity. By doing so, they have been willing to take enormous, often completely unwarranted, risks. It is important that European leaders clearly manage such expectations and burst the bubble. This requires clear and transparent rules for when asylum is granted, and common criteria for safe countries where people are not under imminent threat. Such policies may sound insensitive to some, but they would actually save many lives that may be seriously jeopardised otherwise. The example of the Western Balkans shows that this approach can work.

It can only be successful, however, if those who are not genuine asylum seekers are effectively excluded from the asylum system. In addition to the previously described bursting of the "refugee bubble", the rules across Europe on illegal border crossings or travelling without a passport and, especially on human trafficking should be seriously tightened. This is paramount in order to fight organised crime and the possible infiltration of terrorists alongside genuine victims of wars. National European police forces should closely cooperate with each other. Simply put, Europe should protect its borders.

Developing a workable sharing system among EU countries raises difficult questions. More specifically, refugees may wish to go to a particular country, but that country may not wish to host them. If the number of asylum seekers is below national absorption capacity, this does not create a major problem. However, this may no longer hold true in periods of a massive refugee influx. Thus, it is reasonable for countries to have some upper limit on the intake of refugees. In fact, countries may have an incentive to set that limit at such a low level so as to shift the burden to other countries.

One possible solution to this is that all EU countries contribute to a joint "refugee fund" (computed based on, say, relative GDP). The size of the fund would depend on the total number of refugees admitted into the EU under jointly established criteria. In this system, refugees would propose, say, three countries to which they would consider relocating (in the order of preference). Countries accepting them would then be compensated from that fund. The idea is to come up, as far as possible, with an incentive-compatible allocation rule. Such a scheme would maintain the right of member countries to determine inflows of asylum seekers, while ensuring that they do not free ride on the common policy. It is worth highlighting that the EU settlement agreement in 2015 was deficient in that respect. Namely, not only did some countries not want to accept refugees, but refugees also did not want to go to these countries in some cases. Furthermore, one should bear in mind that, as long as Schengen agreement stays in place, allocating refugees to a particular country does not mean that they will stay there if they do not want to.

We focus on a possible set of solutions to the refugee crisis that can be termed as a "More Europe" approach. If no coordination proves possible, one arrives at another solution that could be termed the "Less Europe" approach. In the latter case, European countries may attempt to defend their own borders, often disregarding the welfare of others (this is partially already happening). This is an inferior solution as it is costly, and it will probably lead to the eventual break-up of the Schengen Treaty, one of the EU's key achievements to date. In addition, it may result in various types of misunderstandings and conflicts between European countries. The main obstacles to establishing a cooperative solution are political in nature. Namely, many countries are taking an opportunistic approach by pursuing narrowly defined short term national interests, although that may make things tougher for everyone in the long run.

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