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Politics and economics in 2017: an inseparable duo

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In the last few months we have seen how political events have become a key variable when analysing economic prospects. The science of economics has taken on board this new situation to such an extent that some economists now talk about political business cycles and study not only the classical technological and monetary shocks but also shocks of a political nature. This situation will intensify in 2017 and the duo of politics and economics will become inseparable. After being sworn in as US President, Donald Trump will start his mandate on 20 January while the EU will have to tackle negotiations with the UK and a political agenda packed with important elections, especially those of France, Netherlands and

Germany.

There are two factors related to the political sphere that are a particular cause for concern due to their possible repercussions on the economy at a global level. The first is the observed rise of political polarisation or, in other words, increased support for extreme economic or populist policies, either on the right or the left wing. The second is the intensification of political instability. As can be seen in the enclosed graphs, in the last few years there has been a substantial increase both of polarisation and political instability in Europe. This greater polarisation has also occurred in the US: according to the PEW Research Center, in 2014 92% of Republican voters had a more conservative stance than the average Democrat voter (64% in 1994) and 94% of Democrat voters held more left-leaning views than the average Republican voter (70% in 1994).

There is broad consensus in the economics literature regarding the negative consequences of both political polarisation and political instability for economic progress. Focusing on the first factor, political polarisation, according to the classic definition coined at the beginning of the 1990s by the renowned MIT economist Rudiger Dornbusch, populism is a set of policies that prioritise short-term economic growth without taking into account the potential risks, such as damaging public accounts in the medium term. According to Dornbusch, populism can have a positive impact in the short term although this is misleading since, in the medium term, economic imbalances result in very severe adjustments for the economy.

An increase in political polarisation can also damage economic growth through two other channels. On the one hand, polarisation makes it difficult for different agents in society to reach agreements and, in many cases, political leaders end up choosing to implement the economic policy that benefits their potential electorate even when this might not be the right one for society as a whole. This factor is especially important during economic booms as the larger volume of available resources means that political leaders can carry out their agenda more easily. Moreover, this gives rise to pro-cyclical fiscal policies when the ideal approach would be to implement counter-cyclical fiscal policies; in other words, saving during booms to be able to spend more during recessions and thereby revitalise the economy.

The second channel through which an increase in political polarisation can damage growth is the fact that, in general, this tends to be associated with the surge of political instability and therefore uncertainty.

In a recent article, an economist from the Federal Reserve of Philadelphia, Marina Azzimonti,[1] has attempted to quantify the impact on the economy of the rise of political polarisation in the US between 2007 and 2012. The results obtained highlight that this is not a minor phenomenon. According to the author, due to the increase in political polarisation, 1.75 million jobs were lost, investment fell by 8.6% and GDP contracted by 2%.

The second factor of concern is growing political instability, beyond that caused by the increase in polarisation. Greater instability has a negative effect on the economy because, as has already been mentioned, it fuels uncertainty, leading to the delay of investment decisions and of the hiring of new workers. One example of how the uncertainty caused by political instability affects economic decisions is that, in the developed countries, private investment tends to fall by 1 pp in the quarter prior to elections.[2] This figure is important to bear in mind given the large number of elections which will be held in Europe in 2017. Similarly, the IMF economists Ari Aisen and Francisco José Vega[3] have shown that political instability tends to be associated with lower growth and that this is particularly due to a reduction in productivity growth.

Looking now at Europe, and in addition to the increase in polarisation and political instability, the condensed electoral calendar for 2017 could also temporarily increase the pressure on public finances. The fact is that, as explained by the Harvard economists Alberto Alesina and Matteo Paradisi in a recent study,[4] governments tend to implement more expansionary fiscal policies in the run-up to elections in order to improve their chances of being re-elected; a phenomenon that increases especially when the outcome of the election is up in the air. And if there is one thing that characterises the elections to be held in Europe next year, it is precisely that the outcome seems quite uncertain, at least at present. In this respect, a recent study by Goldman Sachs suggests that this factor will lead to remarkable fiscal easing in France, Germany and Italy.

In short, 2017 will be a crucial year in political terms both in the US and in Europe, and this will have considerable repercussions at the economic level. In particular, there are legitimate concerns regarding how political polarisation and instability might result in greater economic uncertainty and an increase in macroeconomic imbalances. Should the political situation get worse, the common European project may falter, aggravating the loss of mechanisms for multilateral cooperation. Avoiding such a situation will require great political care and everyone concerned will have to show a great deal of high-mindedness.

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1. See Azzimonti, M. (2013), «The Political Polarization Index», Working Paper No. 13-41, Federal Reserve Bank of Philadelphia.

2. See Canes-Wrone, B. and Ponce de Leon, C. (2015), «Electoral Cycles and Democratic Development», Princeton Working Paper.

3. See Aisen, A. and Veiga, F. J. (2011), «How Does Political Instability Affect Economic Growth», IMF Working Paper.

4. See Alesina, A. and Paradisi, M. (2014), «Political Budget Cycles: Evidence from Italian Cities», NBER Working Paper.

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