Over the last 12 months or so, it has been very difficult to have a discussion about the global economic outlook without focusing on the global political backdrop. Whether it was Britain's decision to leave the European Union (EU), Donald Trump's election as US president or the rise of the National Front in France, populism has had a big influence on global asset price movements.

When we look across the developed-market economies, it is clear that the political centre has been eroding for some time. The share of votes going to traditional centre-left and centre-right political parties started to decline from the beginning of the 1980s, but accelerated after the financial crisis.

There are a handful of countries where populism does not seem to be an issue, or even where populism is arguably on the wane. However, there are many more where populism seems to be on the rise, or where populist parties are already in power.

But what is populism? Some may argue that it’s easy to recognize (“I know it when I see it!”), but, as our research suggests, populism is not so easy to define.

According to political scientists, populism has two defining characteristics. One is that leaders of populist movements typically frame their rhetoric around the idea of a conflict between the “true” people and an elite. This elite is often portrayed as corrupt and/or indifferent to what the people want. The second characteristic of populism is that populist leaders cast themselves as the only ones capable of understanding and representing those interests.

But populism is also a “thin ideology”: it has no real political substance of its own but must attach itself to an already developed ideology in order to attain power. In other words, populism is not a political movement but a means to gain power.

This explains why populist parties can come from either side of the traditional political divide: for example, the ruling Syriza party in Greece is a coalition of radical left-wing parties, and France’s National Front is firmly to the right.

If populism is so thin-centred, why has it gained ground in so many countries? The answer lies in its causes.
POPULISM’S ROOTS RUN DEEP
The drivers of populism fall into three broad and overlapping categories: economic insecurity, social insecurity and political ineffectiveness.

Economic insecurity is a result of rising income inequality and stagnation in average real incomes. Much of this can be traced back to the political sea change that occurred in the West in the 1980s, particularly in the UK under Prime Minister Margaret Thatcher and the US under President Ronald Reagan.

Income inequality had fallen steeply from the early part of the 20th century under the effects of two world wars, the Great Depression, postwar reconstruction and the rise of the welfare state. The changes were particularly notable in the US. Real income for the bottom 50% of income earners in the US between 1946 and 1980 increased by 102%. For the top 0.1% of income earners, the increase was 54%.

Between 1980 and 2014—a period that began with the free-market economic policies of the Thatcher and Reagan governments and included the global financial crisis—the picture changed dramatically. Real income growth for the bottom 50% of US income earners was just 1%; for the top 0.1%, real income grew by 321%.

But income inequality is only part of the answer. Display 1 shows that the increase in income inequality has been far less pronounced in France than it has been in the US. Despite this, roughly half of the electorate voted for non-mainstream candidates in the first round of the recent French presidential election.

**Display 1: The Link Between Income and Populism Is Nuanced**
Populism Strong in France, Despite Lower Income Inequality

As of December 31, 2014; latest available
Historical and current analysis for illustrative purposes only
As income inequality has risen in the developed world, global inequality has declined, as both emerging and developed economies have started to benefit from globalization. Display 2 shows how the distribution of real income changed between 1988 and 2008. Workers in the middle of the income distribution in many emerging markets, including China (point A), saw spectacular growth in income over that 20-year period. The same applies to workers at the upper end of the distribution (C), who tended to be in developed economies. But for workers in the low- to middle-income bracket of many developed-market economies (B), including the US, income largely stagnated.

Workers clustered around B, with stagnant income, see themselves as being overtaken not only by those further up the income distribution in their own economies, but also by those gaining on them in other economies.

Such shifts in income distribution can feed the sense of social insecurity. Communities are being disrupted by economic and cultural changes driven by factors that include immigration, trade, globalization and technology.

Some caution is necessary here: perception can play a big part in the sense of insecurity. It’s hard to find a robust statistical relationship between immigration levels and the share of votes going to populist parties. But the perceived threat of immigration was clearly a factor in the Brexit vote and has become a dominant theme in French politics. As already noted, income inequality in France seems less of an issue than elsewhere, but populism continues to gain traction: as Display 3 shows, fear of immigration is a big factor.

Perceptions can be strong, which is why both mainstream and populist politicians use them routinely. For populists, political ineffectiveness is a particularly useful perception. The notion is that the system is “broken,” or that it only works for “global elites.” This storyline compounds the sense among ordinary people that they have been left behind and that the system doesn’t work for them.

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1 Migration Policy Uncertainty Index is constructed from the scaled quarterly counts of articles in major newspapers containing “uncertainty,” “economic” or “economy” and one or more terms relevant to policy and immigration. The Migration Fear Index also captures the use of fear terms such as “anxiety,” “panic” and “fear.”
Other factors give weight to these perceptions. They include institutions such as supranational entities (the EU and International Monetary Fund) and unelected technocrats (judges and central bankers). These players are seen as drawing authority away from democratically elected national governments and into their own domains. This was a key narrative of the Brexit campaign.

The fundamental causes of the rise in populism are deep-rooted, and there don’t seem to be easy fixes. Even if today’s populist politicians were to fade from the scene, the forces that brought them there in the first place would still bubble away under the surface. In other words, we should expect more—not less—of this political dynamic. Crossing our fingers, closing our eyes and hoping it goes away isn’t an effective strategy. Instead, we need to understand the lessons of past populist episodes.

**POLICY IMPLICATIONS**

When we look back at previous episodes of populism (particularly in Latin America), and current populist agendas, we can expect three broad groups of policy changes: raising the drawbridge, institutional erosion and redistribution policies (Display 4).

The sequencing of these policy changes is likely to vary from one country to another, and they may not (yet) be evident broadly. But if populism is a persistent theme, we should be prepared for these policy prescriptions to emerge.

Let’s take a closer look at them:

**Raising the Drawbridge:** These policies were prominent in President Trump’s campaign rhetoric. They include more trade protection and restrictions on immigration and cross-border labour flows, as well as withdrawal from supranational relationships (abandoning the Trans-Pacific Partnership Agreement negotiations and walking away from NATO). Immigration has been a key theme in recent European elections, and Brexit is perhaps the most dramatic example of a country electing to withdraw from a supranational relationship.

**Institutional Erosion:** Attacks on the media, which have escalated in the US since Trump came to power, are one example of the erosion of institutions globally. There have also been attacks on the institutions of state: the bureaucracy, the judiciary, parliamentary arrangements and others. Turkey’s referendum in April, for example, gave President Tayyip Erdogan powers widely regarded as autocratic. From a macroeconomic perspective, the relationship between monetary and fiscal policy is a critical issue: in particular, the potential undermining of central banks’ independence through actions such as the facilitation of money-financed fiscal stimulus.

**Redistribution Policies:** The third set of policies concerns redistribution—redirecting government largesse from the “rich” or “elites” towards the poor. Distributional policies could mean

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**DISPLAY 4: HOW POPULISM COULD RESHAPE POLICY**

<table>
<thead>
<tr>
<th>RAISING THE DRAWBRIDGE</th>
<th>INSTITUTIONAL EROSION</th>
<th>REDISTRIBUTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>+ Increasing trade protection</td>
<td>+ Erosion of monetary policy independence: fiscal dominance</td>
<td>+ Increased taxation on companies and high-income earners</td>
</tr>
<tr>
<td>+ Restrictions on capital flows, foreign direct investment</td>
<td>+ Greater use of fiscal policy; structural budget deficits; loose constraints</td>
<td>+ Minimum-wage increases/labour market regulation/universal basic income</td>
</tr>
<tr>
<td>+ Increased restrictions on immigration/cross-border flows of labour</td>
<td>+ Regulation and the rule of law?</td>
<td>+ Return of collective bargaining</td>
</tr>
<tr>
<td>+ Withdrawal from supranational relationships</td>
<td>+ Renationalization of key industries</td>
<td>+ Use of price controls</td>
</tr>
</tbody>
</table>

Source: AB
higher taxes on corporations and high-income earners, big wage increases, a huge expansion of state sector employment, use of price controls for “necessities” and so on. Of the three policy areas, redistribution is the least evident in developed countries right now. Indeed, the most notable redistribution initiative in the US so far under President Trump has been a proposed cut in corporate taxes.

In terms of macroeconomic impact, the sequencing and the extent of the shift towards these policies are very important. In the typical Latin American experience—of which there are very many, including many of the biggest disasters in the history of populism—the playbook generally runs like this:

+ Redistribution first. This is initially successful—in effect, a big fiscal stimulus. Everybody is happy. But, eventually, resource constraints begin to bite.

+ As a result, the central bank is co-opted into the redistribution exercise by, for example, printing money so that fiscal largesse can continue. Eventually this also runs into constraints: inflation starts to rise and external accounts go into deficit.

+ To deal with inflation and deficits, the government raises the drawbridge by putting restrictions on imports, the flow of foreign currency and other economic mechanisms.

+ Ultimately, this populist playbook results in economic and political crisis and eventual regime change.

So far, what we’re seeing today is the raising of the drawbridge, but our research is focusing increasingly on the factors that would trigger the other two policies.

The key point about all these policies, however, is that they tend to be inflationary (Display 5). Consequently, populism could add to other secular factors pointing towards higher inflation over the medium to long term—in particular, the need for inflation to assist in the deleveraging process across much of the developed world.

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**Display 5: Populist Policies Tend to be Inflationary**

*From Policy Change to Economic Outcomes*

- **Raising the Drawbridge**
  - Lower Growth
  - Higher Inflation

- **Institutional Erosion**
  - Greater Macroeconomic Volatility
  - Higher Inflation

- **Redistribution**
  - Lower Profit Share
  - Higher Inflation

Source: AB
IMPLICATIONS FOR INVESTMENT
We see the rise in populism as having five key investment implications:

- **Secular rise in inflation.** Greater recourse to fiscal stimulus already has the potential to lift inflation, particularly as central banks are likely to keep interest rates low to facilitate the process. Against this backdrop, populism could strengthen the political case for aggressively pursuing growth, thus adding to inflationary pressures.

- **Domestic factors will become more important.** Policies that “raise the drawbridge” will bring national factors to the fore. Not all countries will embrace populism—at least not to the same degree. So, the range of economic outcomes across countries should become more varied.

- **Bond yields and risk premiums should rise, and dispersion increase.** More varied economic outcomes will lead to greater dispersion of returns across bond markets. Higher inflation should cause bond yields to rise and lead investors to demand higher risk premiums for nongovernment bonds.

- **Less business-friendly policies.** Raising the drawbridge and shifting towards redistribution policies could redirect the income share away from business owners and towards wage earners. There are important countervailing forces—such as the rise of artificial intelligence, which may weaken workers’ bargaining power. However, these policies would be an important development that could lead to a reversal in the secular rise in the profit share, to the likely detriment of risk assets.

- **Imbalances and dislocations will be exposed.** The imbalance between the uniform single currency in the EU and the underlying economic disparities between member states is a potential flashpoint.

But over what time frame, and how strongly, should we expect these forces to play out? That answer is partly related to the broader health of the global economy. In the absence of a global recession, we would expect them to play out gradually, perhaps over a three-to-five-year time frame. If the global economy were to hit the rocks in the next year or so, however, these risks would crystallize much more quickly and probably much more forcefully. Clearly, populism and the world economy—and the interplay between them—are factors that global investors need to monitor very closely.
Past performance, historical and current analyses, and expectations do not guarantee future results. There can be no assurance that any investment objectives will be achieved.

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