How economic populism works

By Andrés Velasco
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Now that populists are coming to power in the West, a conflict over the intellectual ownership of their approach is brewing. Writers like John Judis claim that nineteenth-century Americans invented *political* populism, with its anti-elitist stance and inflammatory rhetoric. Argentines, who gave the world *über*-populist Juan Domingo Perón, or Brazilians, who brought us Getúlio Vargas, might beg to differ.

Yet there can be no disagreement that Latin Americans have been the longest and best practitioners of *economic* populism. In the twentieth century, Perón and Vargas, plus Alan García in Perú (at least during his first term), Daniel Ortega in Nicaragua and Salvador Allende in Chile, and many others, engaged in trade protectionism, ran large budget deficits, overheated their economies, allowed inflation to rise, and eventually suffered currency crises. In recent years, Hugo Chávez and Nicolás Maduro of Venezuela took these policies to new lows.

What should the rich world, now undergoing its own bout of economic populism, learn from Latin America's experience?

Make no mistake: judging by the track record of its establishment pundits, the rich world needs some lessons. In Britain, Brexit opponents insisted that if voters decided to leave the European Union, a recession, if not a full-blown economic crisis, would be inevitable. After the referendum, the pound depreciated some, but nothing much else happened. Today, the British economy continues to grow.

In the United States, academic economists repeatedly warned that Trump's economic plans were little short of lunacy, and in the aftermath of his shocking election victory, some prophesied immediate economic catastrophe. Since then, the stock market has reached record heights, commodity prices have recovered, and forecasts of US economic growth keep rising.

Have the pundits been smoking something? Or have Trump and pro-Brexit leader Nigel Farage abrogated the principles of introductory macroeconomics?

Nothing of the sort. But to understand the effects of populist policies, one must first understand their logic. In a classic paper, Sebastian Edwards of UCLA and the late Rudiger Dornbusch of MIT define *economic* populism as "an approach to economics that emphasizes growth and income redistribution and deemphasizes the risks of inflation and deficit finance, external constraints, and the reaction of economic agents to aggressive nonmarket policies." They add that populist approaches "do ultimately fail," not because conservative economics is better, but as "the result of unsustainable policies."

"Ultimately" can be a very long time. Populist policies are called that because they are popular. And they are popular because they work – at least for a while.

A sizeable fiscal stimulus in a sluggish economy produces a pickup in growth and job creation. If financial markets turn bullish (as they often do), the exchange rate appreciates, quelling nascent inflationary pressures and making it cheaper to import. And, as Argentine economist and Columbia University professor Guillermo Calvo has long argued, precisely because they are unsustainable, populist policies cause people to shift spending from the uncertain future to the present, when the going is good. This reinforces the expansionary impact of the stimulus, which is particularly strong under fixed exchange rates. So, eurozone countries: beware!

With consumption, credit, and employment booming and asset prices sky-high, a warm and fuzzy feeling of prosperity permeates society. Populist leaders feel vindicated, and they are not shy about claiming credit. Their approval rating can only go up – and it does.

Soon, teetotalers begin to warn that debt is accumulating too quickly, credit quality is deteriorating, inflationary pressures are incubating, and an overvalued exchange rate is doing lasting harm to exporters. But the music is too loud and the dancing too lively, so no one listens to the warnings.

How long can the party go on? One thing we know from the Latin American episodes is that the answer depends, first of all, on initial conditions. Most industrial economies have grown little since the financial crisis. Deflation, not inflation, has been the problem.

Yes, the unemployment rate has dropped considerably in the US. But after so many shocks and so much technological change over the last decade, there is considerable uncertainty about how much unused capacity remains and where the non-accelerating inflation rate of unemployment (NAIRU) lies. It could well be that the likes of Trump find that they can stimulate the economy for quite a while before obvious imbalances emerge.

The other thing we have learned is that debt, both public and private, does become a constraint. But when and how depends crucially on what kind of debt it is. Today, advanced economies borrow in their own currencies at near-zero (and sometimes negative) interest rates. Even if the starting point is a high debt-to-GDP ratio, it can be a long time before growing debt triggers an emergency. Just ask the Japanese.

What happens when financial markets finally get cold feet and stop lending? Well, as the Nobel laureate economist Paul Krugman was at pains to demonstrate in a recent paper, an economy with flexible exchange rates and debt denominated in domestic currency will expand, not contract, in response to a foreign deleveraging shock. (Of course, Krugman was arguing for fiscal expansion under a Democratic president, but the point still stands.) Not even then do you get an immediate crisis.

In 1953, Perón sent a message to Chilean president Carlos Ibáñez, a fellow army general. "My dear friend: give the people, especially the workers, all that is possible," he wrote. "There is nothing more elastic than the economy, which everyone fears so much because no one understands it." Trump, should he come to think about it, might stumble to the same conclusion.

Anti-populists in the US, the UK, and elsewhere must come to terms with the reality that bad policies pay off, both economically and politically, long before they become toxic. Yes, the excessive private and public debt, the loss of export capacity, and the weakening of institutions harm the economy (and the polity) – but only in the long run. If critics do not understand that and act accordingly, populists will have as long (and destructive) a run in the rich countries as they once had in Latin America.

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