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Mark Blyth

After the Brits Have Gone and the Trumpets Have Sounded: Turning a Drama into a Crisis That Will Not Go to Waste

Before Donald Trump was elected President of the United States, the British public’s decision to leave the European Union had already brought into reality a possibility that had been on the radar of European policymakers for some time but had always been marked with a heavy dis-
count – that the political foundations of the entire postwar order really might come apart. As a recent Delors Institute report put it, since 2008 Europe has managed to generate "a lost decade" for its citizens, and its member states were paying the price for that loss politically and electorally. The reasons are by now both well-known and multi-farious: the structural weaknesses of the euro banking ar-

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ea and pro-cyclical capital flows before the crisis; the lack of fiscal and other consumption-smoothing institutions to absorb shocks during the crisis; pro-cyclical austerity policies only belatedly counterbalanced by ultra-loose monetary policies after the crisis hit; and most recently, hostility towards intra-EU migration, refugees, and the EU itself.

Given this, it is no surprise that proposals to “fix the euro/Europe” have, to date, concentrated on the issues of institutional incompleteness, the appropriate fiscal stance, the need for greater investment, etc. And until the Brexit decision and the election of Trump, this was exactly where the focus needed to be. Unfortunately, this is no longer the case. What the EU faces now is something much more troubling than simply an over-leveraged banking system and the wrong policy mix. The EU, and the wider Western world, faces its first genuine political crisis.

This article argues that the ability of the EU to help resolve this situation, thereby bringing about the recovery that Europe so badly needs, rests upon how it chooses to diagnose this political crisis. Unlike what we economists (like to) believe, this diagnosis is not revealed by appeals to evidence alone. It is at its core political, and the politics are unavoidable.

In short, the EU institutions must diagnose the crisis that Brexit and Trump have brought to the fore as an economic crisis that is malleable to policy, and they must forcibly sell that diagnosis to the member states if they want to halt the further disintegration of the EU. Doing so would give member states room to experiment with locally appropriate policies rather than simply accept “one size fits none” policy rules. Such a diagnosis would be nothing less than an explicit political intervention by a supposedly technocratic set of institutions. But technocracies work best in good times, and these are not good times. Such a political intervention, specifically by the Commission and the Parliament, would allow centre left and centre right parties in member states to break the rules that they themselves have authored and that have, in part, generated this lost decade and ultimately the backlash from voters which they now feel. If the EU does not act in this way, then the only other diagnosis available, as I shall show, is one in which the free movement of labour and the equal rights of citizens are heavily curtailed. That is, we give in to the worst sides of Brexit and Trumpism. If that diagnosis is accepted, then Brexit really does mark the beginning of the end of the EU.

Europe’s Goldilocks Brexit problem

Focusing just on Brexit, the result of the referendum on 23 June in the UK was met with currency market volatility and an enormous amount of speculation about what it would mean in the British press. Two weeks later everyone figured out that no one in fact knew what it meant, and the volatility receded. That future is beginning to be clarified, and it increasingly looks like Prime Minister May favours a “hard Brexit” in which the UK will prioritise limits on the freedom of movement at the expense of access to the single market. This presents an interesting dilemma for EU governors, who must seek a kind of “Goldilocks solution” to the Brexit vote.

A path out that is “too hot” is one that harms the UK, which is an attractive option if you do not want others to follow, as recent remarks from French President Hollande signal. However, the UK is a very large part of the European economy, and its banking sector is too big to fail. Therefore, punishing the Brits for Brexit might harm Europe as much as it harms the UK. But an exit that is “too cold”, where the UK gets whatever it wants on the way out the door, risks making the EU a buffet of options without any raison d’être, which would make it a target for blackmail from other disaffected states. What then can be done to both strengthen the Union and solve the underlying crisis? Is it possible to find a Brexit strategy that is “just right”? To do so, we need to see Brexit in a much broader and comparative perspective.

This time it really is different

Brexit, as many commentators have pointed out, has been a long time in the making, and it looks very similar to other “rebellions” in the rich countries of the OECD. One way of making sense of Brexit – as well as Trump and the decline of the centre-left and now the centre-right in Europe and the US – is to contrast the institutional order of the so-called “golden age” (1950-1980) with the order that we have today, which was in many ways built in reaction to that prior order. Where we were, i.e. the debtor’s

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2 For a good explanation as to why, see V. Schmidt: The Forgotten Problem of Democratic Legitimacy: “Governing by the Rules” and “Ruling by the Numbers”, in: M. Matthijs, M. Blyth (eds.): The Future of the Euro, New York 2015, pp. 90-117.

3 Watts: Theresa May indicates ‘hard Brexit’ and dismisses free movement deal to keep single market access, The Independent, 2 October 2016.


paradise of the 1970s, and where we are, i.e. the creditor’s paradise of today, are summarised in Table 1.

Driving this shift from one regime to the other was the mechanism outlined by Kalecki in the mid-1940s. In brief, Kalecki found “the bug” in what we might call Keynes’ software for running post-war capitalism. Over a 30-year period, he argued, running permanently full employment would produce inflation, destroy management control and eat profits. The neoliberal revolution was the predicted result, as the investor class sought to restore both margins and control. But the set of institutions that emerged over the next 30 years has its own endogenous fragilities – winner-take-all rewards, wage stagnation for many, and a global reshuffling of incomes (to use Branko Milanovic’s phrase) that benefitted Asia and the OECD super-rich but led to real income declines in the middle and lower end of the income distribution in the EU and the US – at least pre-tax. Tied to this regime was a new progressive politics, investment by the European Investment Bank (EIB) and anti-austerity coalitions. This we know already. And we also know that it is not happening. Despite all the excitement around the Juncker Plan and the European Fund for Strategic Investments, investment by the European Investment Bank (EIB) remains a fraction of what it should be, with many of the major disbursements to date going to countries that do not need them (France, Germany and the UK). Nonetheless, given this diagnosis, there is more than can be done. But what if one comes to another diagnosis of Brexit and related phenomena? What if this implicitly economic diagnosis of the crisis is in fact incorrect?

Table 1
Institutional equilibria in the OECD in the 1970s and 2010s

<table>
<thead>
<tr>
<th>Inflation: the debtor’s paradise of the 1970s</th>
<th>Deflation: the creditor’s paradise of today</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive inflation</td>
<td>Secular disinflation</td>
</tr>
<tr>
<td>Labour’s share of national income at all-time high</td>
<td>Capital’s share of national income at all-time high</td>
</tr>
<tr>
<td>Corporate profits at all-time low</td>
<td>Collapse in wage growth</td>
</tr>
<tr>
<td>Unions strong</td>
<td>Unions weak</td>
</tr>
<tr>
<td>Low inequality</td>
<td>High inequality</td>
</tr>
<tr>
<td>National markets</td>
<td>Globalised markets</td>
</tr>
<tr>
<td>Finance weak</td>
<td>Finance strong</td>
</tr>
<tr>
<td>Central banks weak</td>
<td>Central banks strong</td>
</tr>
<tr>
<td>Parliaments strong</td>
<td>Parliaments weak</td>
</tr>
</tbody>
</table>


Table 2
Democracy and deflation: winners and losers in a low-growth world

<table>
<thead>
<tr>
<th>Losers</th>
<th>Winners</th>
</tr>
</thead>
<tbody>
<tr>
<td>Creditors: Highly financialised economies where the real value of debt goes up but ability to collect goes down</td>
<td>Debtors: Can not and will not pay, but will vote – and not for the people who built the creditor’s paradise</td>
</tr>
<tr>
<td>Results: Collapse of vote share of neoliberal-friendly centre-left parties</td>
<td>Results: Rise of populist and right-nationalist parties and leaders (Trump, Le Pen, Brexit leaders, Orbán, etc.) with common narratives: taking back control</td>
</tr>
<tr>
<td>New left parties to be excluded at all costs (Syriza bashing by SPD, Corbynophobia within Labour, isolation of Die Linke, no deal with Podemos, etc.)</td>
<td>Renationalising markets</td>
</tr>
<tr>
<td>Anti-globalisation and trade and anti-austerity coalitions</td>
<td></td>
</tr>
</tbody>
</table>


8 See B. Milanovic: The greatest reshuffle of individual incomes since the Industrial Revolution, VoxEU, 1 July 2016.
What if it’s not the economy after all?

An interesting aspect of the Brexit and Trump votes was how they threw the “it’s the economy stupid” diagnosis into doubt. Support for the economic diagnosis of political disaffection had been brewing for some time. But the Brexit data and the rise of Trump suggested another possible diagnosis, that either the reaction we were witnessing, manifest in the rejection of centrist politics, “wasn’t (simply) economics”, or worse, that the disaffected are simply a bunch of racists and authoritarians. Perhaps the key finding in the Brexit referendum data was that no simple bivariate correlation between the level of income and propensity to vote for Brexit appeared.

For example, Torsten Bell at the Resolution Foundation produced a scatterplot in which the relationship between voting for Brexit and change in real hourly earnings showed zero correlation. Similarly, exit polls after the US presidential election confirmed once again that many of Trump’s supporters earned over $100,000 per year, which hardly sounds like the “left behind”. Another piece of research that received quite a bit of attention showed a similar graph comparing the Brexit vote and the “deprivation score” for an area, with the result being a similar scattering of noise. Polls taken prior to the vote showed “immigration” and “the economy” running neck and neck, while in-depth poll decomposition after the vote showed the Leave vote composed of older and less cosmopolitan voters, those with less than a college degree education, and/or those with lower employment status. Among those cohorts, a fear of immigration and multiculturalism emerged as the most salient issue. These findings encouraged a deeper exploration of what drives not just Brexit, but what we might call “working-class disaffection” from mainstream parties, and in particular, the rise of the new right.

For example, Sides and Citrin demonstrated, using European social survey data, that cultural disaffection was a more powerful predictor of one’s stance on immigration than one’s economic position. Coffe et al. showed how the Vlaam’s Blok vote in Belgium was positively correlated to higher incomes, less inequality and the presence of immigrants. Eatwell mapped the growth of the far right in Europe and found the same negative correlations – the far right did well when voters were richer and employed, rather than poor and unemployed. Halla et al. similarly found the presence of immigrants more important in explaining support for the far right than deprivation. Meanwhile, Ivarsflaten argued strongly that appeals that target immigration as a problem rather than the economy work best for new right parties:

Mobilization of grievances over economic changes and political elitism and corruption play a less consistent part in the electoral performance of populist right parties across countries than do grievances over immigration.

And in perhaps the only direct test of “what’s driving what” to date, Norris and Inglehart find “the most consistent evidence supporting [what they term] the cultural backlash thesis.” In summarising this research, Vox.com labelled this entire phenomenon conclusive proof that what is going on is not economic disaffection. Rather, it is a “White riot.”


15 As Coffman puts it, “Brexit was a rejection of British multiculturalism.” D. Coffman: Don’t blame Brexit on working-class anger – it’s more worrying than that, in: New Statesman, 28 June 2016.


19 M. Halla, A.F. Wagner, J. Zweimüller: Immigration and Voting for the Extreme Right, University of Zurich Working Paper No. 83, 2013. An important qualifier in this piece of research is how the skills bias of immigrants influences right-wing voting. Lower skills leads to more right-wing voting, which suggests an economic driver.


The racism diagnosis as a “convenient truth”?

Let us assume all the studies cited actually say what the proponents of the “culture trumps economics” camp say they do. What is the relevant counterfactual here? That the economy does not matter? That 30 years of rising inequality, job insecurity and income stagnation, further embedded in Europe in a near-decade-long economic crisis in which lower income groups bore the brunt of the adjustment via austerity simply do not matter? That would beg a few rather obvious questions.

First, if this economic backdrop does not matter, why not? It certainly seemed to matter the last time the right came to power in Europe in the 1930s. Migration was not the issue then, unemployment was. Policy-wise, does that mean states today can raise inequality and unemployment to the stratosphere and not worry? Second, when times were better for these income groups, such as during the golden ages of 1945-75 and again in the late 1990s, such sentiments seemed to be quite absent. What explains their emergence at this point? After all, in the case of Trump, the voters in five states that delivered the election to Trump had previously voted for Obama – twice. It cannot be the observation phenomenon itself, since that would confuse cause and effect. Third, why does this research only examine the right-wing reaction? This body of research seems to be rather blind to the fact that there is a left-wing version of this phenomenon that stretches from Bernie Sanders to Pablo Iglesias and back again. New Left parties and movements mobilise directly on the issues of economic insecurity and anti-elitism, yet they are decidedly anti-racist. They also appeared at much the same time as the New Right parties gained strength and have, in many cases, comparable vote shares.

Perhaps then it is worth considering what such a diagnosis allows politically. It allows the centre-left and the centre-right parties that abandoned their traditional lower income constituents for more affluent voters in the 1990s and who built the creditor’s paradise that squeezes them today to claim that they did nothing wrong. That building the creditor’s paradise was either good policy or irrelevant, since if “they’re all just racists” – or “deplorables” as Secretary Clinton recently called such voters in the US – then the policies that parties foisted on their traditional constituencies in the 1990s and 2000s, policies that were commodification, insecurity-making and income-skewing, need neither further examination nor reform. None of this denies that many European voters, and US voters for that matter, may be racist, but it does draw into question why such a diagnosis is gaining traction now. Nor does it need explanation that many Trump supporters were rich, for the simple fact that he was the Republican candidate. After all, rich Americans tend to vote Republican. What is more important for the argument here is that while such a diagnosis is convenient for the currents incumbents on the left who are responsible for a lost decade, it will prove absolutely fatal for the EU if this diagnosis is embraced.

It’s still the economy... and that is actually good news

Despite the excitement with which these findings have been accepted in some quarters, there is just as much research on the other side of the ledger that shows that it is still the economy that is driving events. Moreover, when we examine them closely, many of the key studies cited as proving the “culture” case do not in fact make the claims ascribed to them.

First of all, economics is not simply the scaled level of income nor the direct effect of the Gini coefficient on voting preferences. In fact, most research recognises this complexity and consequently “tests” of economic disaffection disaggregate the category and test for discrete effects. For example, Colantone and Stanig have shown, using data for almost all Western European countries, that “voters more exposed to Chinese competition tend to vote in a more protectionist and nationalist direction”. In the US, Autor et al. also found, using electoral data, that Republican districts more exposed to Chinese trade shocks tended to vote for more extreme Republicans in subsequent electoral rounds, driving politics to the right. Dippel et al. find the same holds for Germany. Getting underneath these shifts, again using American data, Ebenstein et al. have shown how offshoring and import competition have combined to lower the returns to labour.

across industries.\textsuperscript{28} As such, it is not the change in relative wages that matters; it is the change in wages over the whole distribution that matters over time. This finding goes some way to explaining the seeming “Brexit paradox” of no correlation with relative income shifts among areas, but rather with levels over time. Moreover, if one takes the immediate and publically identifiable causes of economic harm – for example, the austerity policies pursued by the Troika in the programme countries between 2011 and 2015, as detailed by Stuckler and Basu – then there seems to be a rather strong and obvious link between the rise of the New Right, and the New Left, and a sharp rise in health inequalities, job insecurity, negative income shocks and technological disruption, which have all arrived at the same time.\textsuperscript{29}

Second, some of the research cited to confirm the culture over economics diagnosis does not in fact say any such thing. For example, the widely circulated article “White riot” that summarised much of this research and made a strong case for dismissing economic motivations failed to mention the caveats embedded in much of this research or acknowledge contrary writing by the very authors cited in support of the anti-economics position.\textsuperscript{30} For example, Sides and Tesler, cited as protagonists of the anti-economics position, co-authored a piece that showcases pretty much the exact opposite set of claims.\textsuperscript{31} The Bell study that found no correlation between the Brexit vote and relative shifts in income had, in the same paper, a much stronger negative correlation between voting for Brexit and higher incomes that went unreported.\textsuperscript{32} Likewise, the “study” cited above on Brexit voting and local deprivation scores, which was really just a blog post, has two other slides that show much stronger correlations between the level of attained qualifications and the Leave vote, suggesting that if qualifications proxy for income, which they do, then the economic driver is very much still in the mix.\textsuperscript{33} Finally, the Norris and Inglehart paper that finds the strongest support for a “cultural backlash” thesis over an economic reading of populism takes pains to say:

\begin{itemize}
\item It is not an either/or story, [economics or culture] for the two sets of changes may reinforce each other in part – but the evidence in this study suggests that it would be a mistake to attribute the rise of populism directly to economic inequality alone.\textsuperscript{34}
\end{itemize}

This of course makes perfect sense. After all, no one ever said that support for the right (while ignoring the same drivers on the left) is an increasing monotonic function of the Gini coefficient. The whole issue is both subtler, and yet in the case of Europe, more immediately political than that.

\textbf{What are the policy lessons of this Kulturkampf for the EU?}

The temptation to dismiss populist discontent as reactionary, especially after the Trump vote, and hope that it will all go away while focusing on the more comforting technocratic issues we are used to dealing with is alluring. But it would be fatal for the EU to do so now. First of all, it avoids the need for any of the parties involved in the construction of the broken down creditor’s paradise we now occupy to examine whether what they have done, and what they continue to argue for, is part of the problem. While such self-examination is painful, it is necessary if credibility with those currently in revolt is to be re-established by mainstream politicians and technocrats.

Second, if one accepts the “cultural backlash” diagnosis, then it is not clear what the policy solutions could possibly be. More Hungarian-style immigration restrictions with walls and quotas everywhere? An embrace of Trump by the EU? A reversal of the basic principles of European integration for short-term political advantage? The EU is, after all, an inescapably cosmopolitan project, and labour mobility is needed to make the single market work. It is incompatible with authoritarian conceptions of protection, identity and security. But accepting the diagnosis that the economic changes of the past 30 years, let alone the past ten, have disadvantaged, if not directly hurt, the life chances of millions of ordinary Europeans is a hard one to accept. Accepting that diagnosis will be painful, both psychologically and, in the short term, electorally, for those parties and those politicians most associated with such policies. Tony Blair’s inability to grasp what has happened to his Labour party – and the inability of his followers to slay Jeremy Corbyn over two iterations – and the trouncing of Clinton by Trump in the supposed heartland of the Democrats both suggest that this will not be an easy process. Similarly, the almost complete collapse of support for the German SPD – who seem to care more about stopping Syriza in Greece,


\textsuperscript{30} Z. Beauchamp, op. cit.


\textsuperscript{32} T. Bell, op. cit.

\textsuperscript{33} A. Rae, op. cit.

\textsuperscript{34} P. Norris, R. Inglehart, op. cit., p. 30.
while passing free trade agreements with Canada or preventing a red-red-green coalition in Germany than they do about increasing the wages of German workers – grinds along similar lines to an electorally desolate future. But let us consider what accepting the economic diagnosis of disaffection does for the EU in a positive sense.

Conclusion: a time for the EU to help member states break the rules?

What has been keeping the EU going, like much of the global economy this decade, is massive central bank intervention. If banks were to remove that liquidity support and those asset purchases, yields would spike. At that moment, the banking systems of Europe, which never quite de-leveraged after the crisis as the US banks did, would be in even bigger trouble than they are today. The combination of tighter regulation, capital raises, over-leveraged borrowers who do not want more credit despite the cheapness of money (at least in the core countries), too-slow economic growth, and too-fast non-performing loan growth has hollowed out the Italian and Spanish banking systems and seems even to have impaired the German banking system. Ostensibly, there should be no reason to fear another banking crisis. After all, we just had one, the regulatory culture has completely changed, there is no inflation anywhere where there has not been a sharp devaluation, and the price of money is whatever the central bank says it is far out along the curve.

Yet on the other hand it could happen all too easily. The Italian crisis is emblematic in this regard. Deep banking crises are fixed by states, not by bail-ins of private creditors. Period. Everyone knows this. Indeed, as countries as different as the UK in 1866 and the US in 2008 have repeatedly demonstrated, if it is done quickly and seriously, then the bad banks can be shut down and the good ones can be triaged and recover. But Europe has decided against any and all state aid, as it is against the rules – which is equivalent to telling anyone holding bank equities that they are going to zero.

The same mistake was made with the totemic adherence to the “no-bailout clause” in 2010, when simply buying and burying any and all Greek debt subject to rollover risk on the ECB’s balance sheet would have cost a fraction of what has been spent to date and would have been far more effective. Such rules make for good politics, but they are bad governance instruments. Since 2010 Europe has tied itself in knots with more and more of them, to the point that even if they want to do differently, ruling parties cannot act decisively. Renzi needs to bail out his banks.

Merkel (probably) needs to bail out her banks. Spain can barely form a government to do much of anything. The rules prevent domestic actors from acting, and yet they were the authors of the rules that act as constraints.

In the banking sector example, constraining state action in this way is simply asking for a banking crisis to erupt once equities slide beyond a point that equity holders subjectively deem excessive. And in the absence of state action to shore up balance sheets, such a slide is only a question of time. In a world that obsesses about the medium-term fiscal stance, goals such as hitting the inflation target, formalizing the exit date for QE or completing the banking union are comforting but useless, for one main reason: financial crises really do bring the extreme right to power.

As Funke et al. have recently shown through an exhaustive statistical analysis of the political reactions to financial crises from 1870 to 2014 across 20 countries:

Political parties on the far right appear to be the biggest political beneficiaries of a financial crash. On average, far-right parties…increase…their vote shares [by about] 30%…[and] these gains are not limited to the interwar period…After financial crises voters seem to be systematically lured by the political rhetoric of the far right. Moreover…on average, the far left did not profit from periods of financial instability.

This is what is at stake in how we diagnose this moment. If we take the easy option and diagnose the reaction to the “creditor’s paradise gone awry” that we have built as “a cultural backlash”, we mistake the symptoms for the cause and risk proving Funke et al.’s point further. But if we recognise this “creditor’s paradise gone awry” for what it is, one that we need to own and try to fix, then we will be able to open up a political space for action that goes beyond the rules and the technocracy. While this is not a comfortable space for the EU, it is a space that the EU already occupies, as everything from the micro-management of bailout conditionality in the periphery, to the protection of core creditors at the expense of periphery borrowers, to the deliberate run on the Greek banking system in 2015 all telegraph. So if we are already in this political space, let us embrace it.

By embracing the economic diagnosis of the crisis openly, the EU can create the political space for member states to begin to address the problems that are undermining their party systems, their banking systems and their eco-


economic futures. Paradoxically, they are the only ones who can do this, since domestic parties need the EU to help them break the rules. If the EU declares the current moment and the current policy mix insufficient, domestic actors would be empowered to act, and to do so in a way that strengthens rather than weakens the union. The European Commission has already gone part of the way. By admitting that there is more to growth than cost competitiveness and by expanding the notion of structural reform to encompass the budgetary stance, private sector rent-seeking and the need for better tax policy, the EU can help states help themselves. But unless the EU embraces this diagnosis as the key problem that Europe faces and creates that space, the political systems of the member states will be crushed under the weight of opposition that they have generated and the rules against action that they themselves have authored.

We may get lucky. The banking crisis detailed above may never happen. But the revolt is real, nonetheless, and it is everywhere. As Bruno Cautrès put it recently regarding the French National Front’s continuing surge among working class voters, “The party (FN) offers a double explanation for their malaise: Europe has failed to protect their jobs from globalisation and failed to protect their way of life from Muslim immigrants.” 37 If Europe wants to win back those voters and protect the European project, it needs an alternative diagnosis. To stop Brexit from being the first of many such exits and to stop the blowing of trumpets everywhere, we need to identify this crisis in a way that compels our action. To do otherwise, while comforting, only accelerates our own demise.

37 As quoted in A.-S. Chassany: How France’s National Front is winning working-class voters, Financial Times, 21 October 2016.