

# Andreas Dombret: Election time(s) in Europe - challenges on the way to economic recovery

Keynote speech by Dr Andreas Dombret, Member of the Executive Board of the Deutsche Bundesbank, at a Public Seminar at the University of Tokyo, Tokyo, 23 May 2017.

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## 1. Introduction

Prof. Shinohara

Ladies and gentlemen

Thank you for the kind introduction. I am honoured to be speaking at the University of Tokyo, one of the finest universities in the world.

Today, more than 13 million people live in the extraordinary city of Tokyo – it is one of the largest cities on the planet. Almost 600 years ago, in 1457, Tokyo was established as “Edo”, a small, virtually unknown fishing village. Growing from of a small community of fishers into such a tremendous city represents a major accomplishment, the outcome of human cooperation.

It is said that it takes a village to raise a child. What this proverb reflects is the common sense that it takes more than two parents to integrate a child fully into a community.

It is used widely in different contexts; for example, some researchers tend to begin their acknowledgements by saying that “it takes a village to write a book.”

The frequent use of this expression mirrors a simple truth about human society: our success as a species is rooted in our capacity to work together to achieve security and welfare; especially in our modern-day societies, in which we divide labour and where specialisation is becoming ever more prevalent, great achievements are always the product of a team – or a “village”.

Everybody’s individual contribution is highly important, and a certain degree of competition among individuals is healthy for innovation and for being productive; but success on a large scale – think of skyscrapers and building cities like Tokyo, monetary systems, or combating climate change – such achievements are possible only if we cooperate; this is a precondition for modern society.

This is true of the small village, it is true of the nation state, and it is also true of the “global village” to which all human beings belong. Achieving a prosperous post-war international order has been a remarkable success, in other words: we have created a global village out of many smaller villages.

Is this post-war order under threat from populism? Are populist election victories the result of conflicts within societies that could soon also become conflicts between societies?

Wherever I go these days on whatever continent, such questions seem to be on everybody’s mind. In my speech today, I will talk mostly about these fears as they present themselves in Europe, focusing on some of the economic factors behind the current surge in populism. My main message is that protectionism and confrontational politics pose a threat to our security and our welfare. They would divide our villages and weaken them. But our security and our welfare would be threatened just as much by sticking to the established regime of international trade and cooperation. That would mean overlooking the fact that economic change creates winners and losers in the village, thereby frustrating those who have lost the most. We need to find a middle way.

## **2. Election times: The euro area economy and rising populism**

So let's start with Europe's current economic condition. Since the financial crisis, the pace of recovery in the euro area has been slower than it has been in the United States, not to mention the emerging economies. Lately, however, there have been signs of a broad economic recovery.

For the euro area, recent figures held a positive surprise – with sound GDP growth of 0.5% for the first quarter of 2017. Unemployment stood at 9.5% in March, down from its peak of 12% in 2013. But a recent study has shown that the labour market in the euro area is in worse shape than the official job figures suggest, with workers unlikely to see real increases in pay because of the level of underemployment.<sup>1</sup> A measure of “slack” in the labour market indicates that about 15% to 18% of the euro area workforce are without jobs or would like to work more – which is nearly double the official unemployment rate. Underemployment is even growing in weaker labour markets, such as those in France and Italy.

The still weak labour market in many regions of the euro area is one of the gravest ongoing consequences of the recent financial crisis and an indication that the recovery is still weak. This is particularly true with respect to the high level of underemployment in peripheral regions and among young people.

Thus, while the recent growth figures make the euro area economy look increasingly healthy, it becomes clear on closer inspection that a lot still remains to be done in order to move onto a sustainable, integrative path of prosperity.

And that may already give you some indication as to why protectionism has been on the increase.

Ever since the UK vote for Brexit in June 2016, there has been much talk about the rise of populism in Europe. National elections in Austria, the Netherlands, France, Italy as well as regional elections in Germany and several other countries have seen populist parties on the rise, and public debate has been circling around the issue.

Even though extremist parties have not gained government control in Europe, they have had some impact on the public discourse. And even though the recent Austrian, Dutch and French elections confirmed pro-European politicians, it is clear that the tide of populism has not receded.

How can we make sense of this? The whole debate is spinning around a number of issues, some directly, some only loosely connected. But, at least from an economic point of view, there seems to be one topic that unifies these debates: a growing percentage of people seems to be voting against what has been a common denominator of politics for quite some time now: the belief that global economic liberalisation and cooperation, “globalisation” for short, is a good thing for everyone in our societies.

Should we ignore these votes? Should we simply be opposed to them? I believe that we cannot afford to do that. There are too many people involved to simply dismiss them. We must dig deeper to understand the underlying causes.

## **3. It's the economy, stupid! Reasons for the populist surge**

The discussion about the root causes of rising populism is typically divided into two streams: One is about national identity and citizenship, the other is about economic distribution. Both strings play an important role, but I will focus my remarks on the issue of economic distribution.

Economic distribution is just an abstract term with a very concrete meaning: that any economic change will create winners and losers. Every innovation means that more use is made of some resources than of others – this can improve our welfare, our health, and our environment. One

basic idea of a market economy is that creative destruction brings progress; yet, such a market economy will at least temporarily leave people without a job, or force them to move to another sector or another location. Unless losers find opportunities to offset their losses, they have an incentive to oppose change.

So what changes might be responsible for rising political opposition? Well, there are several candidates, as can be seen from the debate about the repercussions of a market economy – but let me focus on globalisation and technological change.

First, there is international trade. Many attribute a considerable part of the rise in populism to a desire for greater protectionism of domestic industries – this seems to be true at least with a view to US presidential elections, the Brexit vote, and the recent French presidential election.

It is often argued that free trade puts workers of specific industries out of a job and that rising international competition leads to lower wages and inferior working conditions. How do such claims stand the empirical test?

We know that trade increases overall economic welfare owing to economies of scale and comparative advantages. But we have also known for quite some time that international trade is likely to create winners and losers within a society.<sup>2</sup> As such, there is considerable evidence that international trade pushes some people in import-competing industries out of jobs and reduces their wages.<sup>3</sup> There is even evidence that this leads to greater political polarisation.<sup>4</sup>

In sum, it is clear that trade boosts overall welfare, but that it also affects many people negatively. As much as some critics of globalisation seem to forget the substantial welfare gains from international trade, so do the cheerleaders of globalisation appear to forget that trade comes with substantial redistribution and negative effects on some parts of a country's population.

Let's leave this much debated subject and turn to the second topic, which is at least as important as a factor of economic change – I am referring to technological change, and its latest stage: "digitalisation".

In the context of rising populism, technological change has been identified with robots replacing manufacturing jobs and software replacing low-creativity middle class jobs. Several studies present educated guesses about how many jobs will become obsolete over the next few decades. They see 9% to 57% of all jobs in developed economies as being potentially at risk of being replaced by robots.<sup>5</sup>

How accurate is this picture? Well, some of these figures probably exaggerate what is going to happen. Yet, there is evidence that a number of low and medium-skilled jobs subject to automation have seen declining employment levels and wage stagnation or even wage loss.<sup>6</sup>

Similarly, recent research on US manufacturing sectors between 1993 and 2007 shows that each new robot introduced per thousand workers reduced the employment to population ratio by 0.34 percentage points and cut wages by about 0.5%.<sup>7</sup>

In sum, technological change and digitalisation have delivered massive welfare gains for our societies, and will most likely continue to do so. Yet, there is growing evidence that technological change also means job losses for some parts of the workforce and that these are jobs with lower education profiles.

If we take the perspective of the cooperative village: Villagers in the past specialised in a given job profile – such specialisation made possible a division of labour, thereby benefiting all the village's inhabitants. When the acquired skills are no longer needed, this has consequences, because people lose their jobs or their working conditions change. In simple terms, technology and trade disrupt the status quo, they create winners and losers. They change how a village cooperates.

It is clear that our societies face tremendous challenges from economic change: the creative destruction of the market economy – and globalisation and digitalisation, in particular – are restructuring our economies and having redistributive consequences. This cannot be ignored or healed with a few patches.

Therefore, all their benefits notwithstanding, globalisation and digitalisation have had negative effects for a significant number of people. Furthermore, foreign competition often serves as an emotionally satisfying scapegoat for many problems. Moreover, a lot of people who see these developments and hear such allegations fear that they might lose out in the future, too. Put these individuals all together, and you get a group that can be easily mobilised.

But, whatever we do, we should take care not to throw out the baby with the bathwater: Trade and technological change are both catalysts for tremendous welfare gains in our society. Resorting to protectionism and holding on to unproductive technologies would mean discarding something that is worth keeping: resorting to protectionism would severely weaken the welfare gains of large-scale cooperation. Clinging to old technologies merely to prevent redistribution would cause economic harm – just think how damaging it would be to stick with coal for our supply of energy rather than using renewable sources.

#### **4. What can be done? Improving, not ending global and European integration**

But what can we do instead? To answer that, we should first clarify the question. I think the question should really be: How can we harvest the fruits of trade, technological change and a market economy without dividing our societies to a point where social cohesion breaks down? In other words, how can the village become more prosperous without becoming splintered into much smaller communities that are in conflict with each other?

One important thing to remember is that, while trade and technology play a role in redistribution and restructuring, they are by no means the sole drivers of such developments – just think of the increase in inequality or low productivity growth in both Europe and the US.

The point is that building walls and limiting technological change will not solve the problems that our economies are facing; moreover, even when smart policies are chosen to balance the negative repercussions without undermining trade and technology (too much), this will not solve all the problems – globalisation is only partially responsible for the negative outcomes that some are witnessing.

So what then can we do? That's for politicians and their sovereigns to decide. But, based on the facts that I have discussed, there are a few lessons to be learned.

With respect to the degree of international cooperation, I suggest two things: First, resorting to protectionism will help no one. It will hurt all citizens. Rather, we should use the gains from trade, but also find mechanisms that help those who lose out from trade. Second, the same principle applies with respect to cooperation within the European Union – all EU citizens have benefited immensely from the EU, but the single market has also led to a restructuring of the economies, and this is especially true of the euro area. We should strive not only to maintain these achievements, but also to make them better, so that they work for everyone.

This will not be enough to solve the problems of restructuring and redistribution that arise from trade, technological change and further economic developments.

If we want to foster our economy with a complex division of labour – that is, our modern village – we have to deal with the redistributive and restructuring tendencies. If we want to foster a global, market-based economy and liberal democracy, policies need to help those on the losing side of redistributive and restructuring tendencies so that they still feel that they have a stake in society.

What could be on such a wish-list of policies for Europe's economy to recover?

Well, this could include giving those who lose out from globalisation and digitalisation a fair chance to reintegrate into the system and compensating them for losses.

It should include implementing more sustainable growth-enhancing policies; these should target investment in infrastructure and innovation – and that does not just mean road infrastructure and internet connections, but much more complex investments such as in child welfare and health care.

And it does include not depending on growth alone, since many policy problems cannot be solved by means of higher GDP growth – instead, what is required are demand policies of sustainable resource utilisation and intelligent countermeasures against rising inequality: for example, increased public expenditure on extending educational opportunities for everyone in society as a whole.

One final point is especially important in my eyes: we have to tackle these challenges rather sooner than later. Some may feel comforted by the fact that populist parties performed less successfully than expected in the Dutch and French elections; but this is no time for complacency. Populism is not a mere short-term electoral challenge. It has a strong base among economically frustrated individuals. This frustration must at least be taken seriously – otherwise it will come back with a vengeance in elections at a later date. We must identify the underlying problems and do our best to fix them.

## **5. Conclusion**

Ladies and gentlemen

We live in a global village; European citizens live in the village that is the EU – it will take these villages, together with our local communities, to raise future children; it takes these villages and their division of labour to continue our security and welfare.

Villages prosper through cooperation, not through conflict – 15th century Edo was no different from our global village and from the EU.

But why is populism on the rise? I have talked about the economic side of this issue. People vote for populists, because globalisation and technological change – together with further economic and non-economic forces – have been penalising significant segments of societies in developed economies. If we want to secure a global, market-based economy and liberal democracy, policies need to help the losers from redistributive and restructuring tendencies so that they have the chance to remain active citizens of their societies.

Think of the modern version of the division of labour in a global village: The baker or investment banker owes a debt of gratitude to their doctor, if she saves their children's lives. But the doctor also owes a debt of gratitude, as she would not be able to specialise in a particular area of medicine in the first place, without someone else baking her bread or investing her money. In a complex economy we all rely on each other, on the contribution made by everyone to the economy.

A cooperative society means progress and therefore change – as brought to us by international trade and technological advances. Protectionism and confrontational politics would threaten this progress; it would threaten our security and our welfare.

But simply sticking to the established regime of international trade and cooperation would likewise threaten our security and our welfare; because that would mean ignoring the fact that the current approach has also led to many people in our societies losing out. If we do not take the

needs of such people seriously, we will undermine the social fabric of our global village and our local villages – and that is how social cohesion is weakened and populism is fuelled.

Thank you very much for your attention.

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- <sup>1</sup> European Central Bank (2017), Assessing labour market slack. ECB Economic Bulletin, 2017(3): 31–35.
  - <sup>2</sup> WF Stolper & PA Samuelson (1941), Protection and Real Wages. *The Review of Economic Studies*, 9(1): 58–73.
  - <sup>3</sup> See, for example, for the US: DH Autor, D Dorn & GH Hanson (2013), The China Syndrome: Local Labor Market Effects of Import Competition in the United States. *The American Economic Review*, 103(6): 2121–2168; JR Pierce & PK Schott (2016), The Surprisingly Swift Decline of US Manufacturing Employment. *American Economic Review*, 106(7): 1632–62.
  - <sup>4</sup> See, for example, D Autor et al (2016), Importing Political Polarization? The Electoral Consequences of Rising Trade Exposure. NBER Working Paper No. 22637; for Germany: C Dippel, R Gold & S Heblich (2015), Globalization and its (dis-)content: Trade shocks and voting behaviour. NBER Working Paper No. 21812.
  - <sup>5</sup> M Arntz, T Gregory & U Zierahn (2016), The Risk of Automation for Jobs in OECD Countries. OECD Social, Employment and Migration Working Papers, No. 189, OECD; World Bank (2016), World Development Report 2016: Digital Dividends.
  - <sup>6</sup> G Michaels, ANatraj & J Van Reenen (2014), Has ICT Polarized Skill Demand? Evidence from Eleven Countries over Twenty-five Years. *Review of Economics and Statistics*, 96(1): 60–77; M Goos & A Manning (2007), Lousy and Lovely Jobs: The Rising Polarization of Work in Britain. *The Review of Economics and Statistics*, 89(1): 118–133; DH Autor, F Levy & RJ Murnane (2003), The Skill Content of Recent Technological Change: An Empirical Exploration. *The Quarterly Journal of Economics*, 118(4): 1279–1333.
  - <sup>7</sup> D Acemoglu & P Restrepo (2016), The Race Between Machine and Man: Implications of Technology for Growth, Factor Shares and Employment. NBER Working Paper No. 22252.