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Beyond the Ballot: The Impact of Populism on Financial Market Dynamics in Europe

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Abstract

This paper analyses the impact of populism on financial markets in Europe. Examining an era marked by rising populism and spurred by widespread dissatisfaction with European Union policies and increasing economic uncertainties, we delve into the impact of this political trend on market dynamics. We highlight how populism introduces uncertainty and volatility into financial markets, underlining the need for further research into how different populist ideologies uniquely affect market responses. Such research is crucial for a comprehensive understanding of the impact of populism on Europe's economic stability and investors' strategic planning.

Keywords: Populism, Political Uncertainty, Elections, Financial Markets

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Introduction

As Europe enters a likely turbulent legislature for 2024-2029, the tension between populism and broader socio-economic challenges is emerging as a key concern. Populism, deeply rooted in Europe since the 1960s due to significant social and political changes, has gained momentum in what is described as "Europe's populist surge" (Mudde, 2016, p. 25). This resurgence, driven by security concerns, economic uncertainties, and dissatisfaction with the European Union's response to immigration and terrorism, is providing fertile ground for populist movements. This has a significant impact on the continent's economic and political environment (Mudde, 2016).

The rise of populist parties, exemplified by the Brexit referendum of 2016, underscores the profound impact of populism on both policymaking and financial markets. Our paper argues that the ongoing rise of populism will have a significant impact on European financial markets and examines its implications for investment decisions, market trends, and economic policy. Through this analysis, we aim to deconstruct the complex interaction between political uncertainty fueled by populism and financial market reactions, shedding light on the challenges this dynamic presents for Europe's future political and economic landscape.

Understanding populism

Given the resurgence of populism and its significant impact on Europe's political and economic environment, a fundamental understanding of the concept is crucial. The term "populism" encompasses a wide range of political movements and leaders, from the radical right to the far left, including figures such as Donald Trump in the United States of America and Hugo Chávez in Venezuela. The broadness of the spectrum highlights the complexity and multifaceted nature of populism, which defies a single, all-encompassing definition.

The ideational approach, advocated by scholars such as Hawkins and Rovira Kaltwasser (2017), provides a valuable framework. It defines populism as a thin-centered ideology that posits a moral struggle between the people and the elite. This essential perspective emphasizes the moral and ethical dimensions of populism in contrast to "thick" ideologies such as socialism or liberalism, which provide broader socio-political blueprints.

By emphasizing this moral dichotomy, the ideational approach provides a reliable empirical framework for analyzing populism. This focus not only delineates its ideological implications for politics and economics but also facilitates the systematic study of the far-reaching effects of populism. The relevance of the ideational approach in the social sciences as well as in the economic realm underscores its critical role when dissecting the complex influences of populism across political, economic, and financial landscapes.

Populism's widespread impact

Populism has a dual impact on the political domain. On the one hand, it promotes democratic engagement by reflecting public opinions and enhancing democratic participation. On the other hand, it poses potential threats to democratic systems by undermining essential checks and balances. This means that populism may simultaneously encourage progress while creating a risk of instability. The impact of populism on the economy is mixed; while it has the potential to disrupt macroeconomic stability and alter economic uncertainty, a minority of researchers argue that it can also drive reforms aimed at addressing systemic economic inequalities, potentially leading to a more inclusive economic framework.

Due to their inherent characteristics, financial markets are an ideal lens through which to analyze the impact of populism. They reflect political developments that affect market valuations, investment strategies, and the overall market equilibrium. The relationship between political events and financial markets marks the latter not only as a reflection of the political climate but also as a critical indicator of economic conditions and political sentiment. These roles underscore their profound implications for economic stability, investor confidence, and broader socio-economic trends, making financial markets a central arena for observing the impact of populism.

Populism can inject a substantial degree of uncertainty into financial markets; therefore, investors should consider the rise of populism more closely in their decision-making processes due to this potential to reshape market dynamics. The unpredictable and sometimes unsustainable policies of populist regimes represent significant long-term economic challenges. Moreover, their tendency to challenge or undermine established democratic frameworks adds complexity. The resulting uncertainty not only makes it difficult to assess the economic impact of changes in institutional structures but also weakens the foundations of these institutions, thereby eroding investor confidence. As a result, these dynamics lead to less market engagement and fewer investment opportunities.

Empirical research provides insights into the complex effects of populism on financial markets. For example, Hartwell's analysis of nine developed economies between 2008 and 2020 reveals a correlation between the emergence of populism and an increase in market volatility. This suggests a short-term, albeit varied, response from financial markets to populist developments. However, the effect of market reactions to populism seems to depend on each country's specific historical and populist context, suggesting that the long-term effects on markets are multifaceted and shaped by different factors (Hartwell, 2022).

Furthermore, Stöckl and Rode assess the short-term effects of populism on options markets, revealing significant market sensitivities to the electoral success of populist parties. They demonstrate how fluctuations in index option prices around elections can serve as indicators of the market's reaction to populism. These fluctuations are also influenced by the ideology of the populist party. The findings emphasize the complex nature of populism's impact on financial markets and the importance of thorough analysis that considers both the ideological spectrum of populism and the context in which it operates (Stöckl and Rode, 2021).

Populism and investors' return expectations

Our research on the relationship between populism and financial markets bridges the gaps identified in previous studies, which focused primarily on the immediate effects of populism and specific election outcomes, often limited to a specific geographic area (Schütz and Pape, 2024). Recognizing that stock markets are inherently sensitive and responsive to a range of factors, including regulatory changes, our goal is to broaden the scope of research to the long-term impact of populism on stock market performance and investor decision-making. More specifically, we focus on the impact of populism on the implied cost of equity, a key financial measure that reflects the risk-adjusted return required by equity investors. Using forward-looking implied-cost-of-equity models, we analyze how shifts in the political landscape driven by populism affect risk evaluations and market dynamics.

By incorporating Stöckl and Rode's populism measures, we treat populism as a continuous variable to analyze its manifestation within political entities from an ideational perspective (Stöckl and Rode, 2021). This approach draws on the comprehensive dataset of the Comparative Manifesto Project (Lehmann et al., 2023), which provides a robust empirical foundation spanning a wide range of political parties and countries over a significant period of time. Our sample included firm-year and country-year observations in 25 countries, mostly OECD members, from 1995 to 2021.

Our study consists of two phases: First, we examine whether populism affects long-term investor expectations to shed light on a novel aspect of political risk in financial markets. The analysis reveals a significant relationship between the rise of populism and an increase in the implied cost of equity. This outcome indicates that the political uncertainties associated with populism increase the cost of equity for firms. This phenomenon, which we call the populism risk premium, underscores the need for investors to demand higher returns as a buffer against the policy uncertainties created by populism (Schütz and Pape, 2024).

The second phase of our study focuses on how different ideological strands of populism influence this phenomenon. Left-wing populism challenges financial and capitalist elites that promote globalization and advocates for state intervention. In contrast, right-wing populism emphasizes cultural and national identity, often through nativism, and may adopt pragmatic, sometimes pro-business, economic policies. Our results indicate a complex relationship between investor expectations and populist ideology, with market perceptions varying depending on the overall level and ideological orientation of populism. Higher levels of populism combined with different ideological orientations can either increase or decrease investor concerns, reflecting the multifaceted nature of populism's influence on financial markets (Schütz and Pape, 2024).

Overall, the research on assessing populism and its ideological dimensions provides a refined understanding of how populism-induced political uncertainty affects investors' risk assessments and market dynamics, offering valuable insights for navigating the complexities of financial markets in the context of rising populism.

Future research directions

Our study focuses on a sample of OECD countries and reinforces the need for in-depth studies to unravel the unique characteristics and impact of populism in Europe, due to its complex and evolving nature. Thorough research is needed to understand how populist movements navigate the challenging political landscapes and consolidate their role as a formidable force. Key areas of interest include the alliances formed by populist parties and leaders, both domestically and internationally, and their influence on policies related to European integration and financial regulation. Additionally, it is important to further examine the interaction of populist parties with traditional political structures and the financial sector. Exploring these dimensions will not only deepen the existing understanding of populism's impact on financial markets but also shed light on the broader socio-political effects of these movements across Europe.

To facilitate a multidimensional exploration of populism's impact across Europe, several databases can serve as key resources, each with a specific focus. Firstly, Zulianello and

Larsen's work provides a supranational perspective by analyzing the electoral dynamics of populist parties in European Parliament elections from 1979 to 2019, covering 92 parties across the European Union. This analysis is essential for gaining insights into the broader electoral trends of populism (Zulianello and Larsen, 2021).

Secondly, the PopuList, which provides data from 1989 to 2022, distinguishes between populist parties and those identified as far-left or far-right across 31 European countries. The project closely examines Eurosceptic tendencies and the classification of borderline cases, offering a view of the political landscape and the positioning of populist entities within it (Rooduijn et al., 2023).

Thirdly, the Timbro Authoritarian Populism Index, spanning the period from 1980 to 2018, examines parties that challenge the principles of constitutional liberal democracy within and outside European Union member states, emphasizing authoritarian tendencies within European populism (Heinö, 2017).

These databases provide insight into the various ideological shades of populism and their implications. Examination of this data equips academics, analysts, and policymakers with the necessary tools to navigate the uncertainties introduced by populism, with a specific focus on its role in Europe's shifting political landscape.

Conclusion

As we navigate the challenges of this decade, we cannot deny the influence of populism on Europe's socio-economic landscape. Our study specifically examines the impact of populism on financial markets, which serve as important barometers of political and economic trends, to shed light on the broader implications of populism. Populism has been shown to inject volatility and uncertainty into these markets, influencing investor behavior and significantly altering market dynamics. This analysis underscores the need for investors and policymakers to adapt their strategies to the challenges posed by populism and provides a basis for further research and policy development to manage its impact on Europe's financial landscape.

Reflecting on the lead-up to the 2014 European Parliament elections, where a populist Eurosceptic wave was anticipated but did not fully materialize (Mudde, 2014), we face another electoral cycle with heightened anticipation. The central question is whether the upcoming elections will confirm established patterns or, conversely, usher in a new era of populist influence in Europe, marking a significant shift in the continent's political and economic trajectory.

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