

# Popular Delusions

Fiscal pain, the politics of blame and growing stress on the euro

**Dylan Grice**  
(44) 20 7762 5872  
[dylan.grice@sgcib.com](mailto:dylan.grice@sgcib.com)

**We're told not to underestimate the commitment of member policymakers to the euro – but what happens as economic hardship within the eurozone changes the attitude of the electorate? And with public-sector balance sheets yet to feel the pressure of exploding age-related expenditure, much more economic pain lies ahead. Yet, as recent and upcoming elections in the single currency area show, the euro is already becoming a lightning rod for parties once seen as extreme, but now increasingly seen as mainstream.**

■ Europe's political landscape seems to be shifting markedly. Every time I open a paper at the European politics section the whiff of nationalism grows stronger. This is entirely consistent with the economic stress within the eurozone. The classic post war experiments by Henri Tajfel into why so many ordinary Germans willingly embraced extreme Nazi ideology shows us to have an inherent bias against 'outsiders', however spurious or random that definition is. This now well established trait has come to be known as "*in-group bias*."

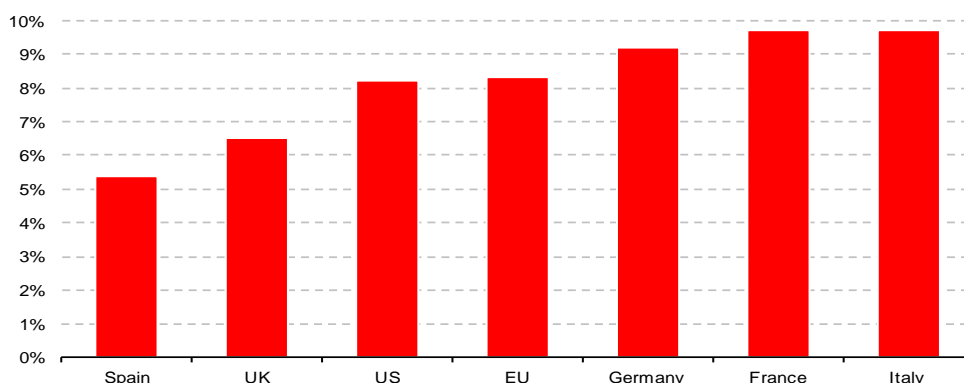
■ Most of the time education and social norms mitigate our tendency to discriminate against out-groups. But, in a fascinating recent review of the literature on the psychology of prejudice, academics at Kansas University show **that mental stress and emotional fatigue increase our susceptibility to turn on outsiders**. This is happening in Europe today.

■ For all the talk of austerity, the fiscal time bomb built into European governments' unfunded pension and health care systems has yet to be felt. The economic climate is therefore likely to become ever more fertile for a far right anti-foreigner ideology. But as we'll see inside, **while that ideology is anti-immigrant in the south of Europe, it is anti euro in the north**. Whether we like it or not, such views will shape the debate. During the run-up to the last UK election, then Prime Minister Gordon Brown didn't realise the mikes were still on when he dismissed a former Labour voter who'd expressed her immigration concerns to him as a "*bigot*." Most think it contributed to Labour's defeat. When the electorate voices concerns about such issues, it can be injurious to a politician's future to ridicule them.

**Global Strategy Team**  
**Albert Edwards**  
(44) 20 7762 5890  
[albert.edwards@sgcib.com](mailto:albert.edwards@sgcib.com)

**Dylan Grice**  
(44) 20 7762 5872  
[dylan.grice@sgcib.COM](mailto:dylan.grice@sgcib.COM)

**Perpetuity savings required to restore public sector solvency (% GDP)**



Source: Jagadeesh Gokhale

Many smaller eurozone countries have seen extreme political parties now either on the fringes of – or set to enter – coalition governments (e.g. the Netherlands, Austria and Finland). But the trend is growing. A recent [article](#) in 'The Economist' reported that a Catalanian politician, Xavier Garcia Albiol who is running for mayor in Badalona, just north of Barcelona, is gaining local support and national notoriety for his hard-line stance. He told the newspaper, *"When people stop me in the street, 80% of the time it is to do with immigration or crime."*

More notable were the recent local election results in France where, although the far-right Front National (FN) won only two seats, their 12% share of the national vote was much higher than the 8% they usually get. Moreover, such averages don't tell the true story. In the 400 or so cantons in which it managed to reach the run-offs (out of around 2,000 in total), **the FN won a staggering 40% of the vote.** Polls show the new FN leader, Marine Le Pen's efforts to distance herself from the more extreme views of her father and former leader Jean-Marie Le Pen are working. She's currently more popular than Nicholas Sarkozy...

The far right has traditionally been *"anti outsider"*. When outsiders were immigrants, they were anti-immigrant. But in the eurozone today a new fault line is emerging. The growing suspicion of 'outsiders' poses unusual problems for the single currency because when it comes to monetary affairs, every single member country finds itself dominated by outsiders! Anti-immigration sentiment now holds hands with anti-euro sentiment. Thus in an [interview](#) with Kathimerini, the Greek newspaper, Ms. Le Pen said *"They promised us this currency would bring growth and welfare, and what happened? People were destroyed. We are talking about a real tragedy ... we must liberate our peoples and return to our own currencies."*

That view is gaining increasing traction by the day. In Finland, the True Finns have come from nowhere to begin looking like future government members. Though the party is keen to strut its anti-immigrant stuff whenever it gets the chance, hostility to the EU and the bail-outs of southern European member is its signature position. *"How come they can't see the euro doesn't work?"* [says](#) their leader, Timo Soini, adding that *"if a melon and an apple each wear the same size baseball cap, everyone can see that just doesn't work."* I'm not sure I would have used such bizarre imagery, but his sentiment is clear.

It's not just these former fringe groups that are growing wary of the euro though. *"Are we going to have to pay for the whole of Europe?"* asked the German daily, the Bild recently. The same paper polled its readers and 35% would today vote for a political party that promised to adopt the Deutsche Mark. *"Euro scepticism is a political force waiting to take off in Ireland"* [say](#) the Centre for European Reform. One might say the same for most countries in the eurozone.

The problem is that on a very basic level, the euro runs against the grain of a visceral behavioral heuristic known as *'in-group bias'* which causes people to favour anyone they perceive to be in their own group. The classic experiments on in-group bias were pioneered by Henri Tajfel, a Polish Jew who spent most of WW2 imprisoned in Nazi concentration camps and who, on returning home, discovered that none of his immediate family and few of his friends had survived the Holocaust.

He made it his life's work to understand the cognitive processes behind the horrors he had seen. Prevailing psychological theory at the time held that only those predisposed to prejudice would become bigots, but Tajfel struggled to reconcile this with his own experiences. He had seen how large numbers of Germans – and not only particular personality types – had

supported the Nazi's extreme prejudice against Jews and believed there was something generic in our thought processes rather than specific in some personality types.

His most famous experiment demonstrates how easy it is to create real divisions within groups where none previously existed and how those divisions can soon lead to discriminating behavior. Bristol schoolboys from the same year in the same school were given sheets of paper with dots on them and asked to guess how many dots were on each sheet. The boys were told the test was intended to assess their visual abilities and that they'd be split into groups according to performance. In fact, the schoolboys were split randomly.

Tajfel then asked each schoolboy to independently allocate rewards to other schoolboys. But the other schoolboys were to remain anonymous, and the allocator was told only which group the other schoolboy belonged to. Famously, Tajfel discovered that the vast majority of subjects allocated significantly more reward to their in-group, at the expense of the out-group. His theory that discrimination against outsiders was to do with hardwired systematic processing errors rather than a few rogue personality types was vindicated.

But in a second experiment, Tajfel then gave the boys a choice of reward allocation *strategies*. Now the boys were asked to choose a strategy which would maximize joint profits, maximize in-group profit, or maximize the difference between in-group and the out-group profits. Perhaps unsurprisingly in light of the results of the first experiment, he found that the boys preferred to maximize in-group profits than total profit for the group. Startlingly though, when asked to choose between maximizing total joint profits and maximizing the difference between in-group and out-group profits, *the boys chose to maximize the differential*. As Gore Vidal said, to succeed in life is not enough. Others must fail!

So creating groups is very easy, and once created, groups tend to discriminate against each other. But this is where *"in-group bias"* becomes problematic, because once groups are formed, stereotypes soon follow, and these in turn influence judgments about anyone perceived to be in a particular group. In the early 1990s for example, a group of researchers at Yale<sup>1</sup> showed that those subconsciously exposed to gender stereotypes, subsequently evaluated the behavior of men and women respectively to be consistent with those stereotypes, *even though that behavior was ambiguous by construction.*"

And not only do stereotypes bias judgment, but they're very hard to dislodge once formed. Expectations based around prejudices tend to become self fulfilling. Nassim Taleb has written books about how we're biased against the unseen. Rather than connecting with our inner Karl Popper, we instead look for hypothesis confirmation at every turn. The fact is that positive statements are cognitively easier to process than negative ones. If you don't believe me, try evaluating the far right's rallying cry *"All our problems are caused by the foreigners"* against *"all our non- problems are not caused by foreigners."* In fact this last statement (cell D below) should be a part of any rational judgment.

	Caused by foreigners	Not caused by foreigners
Problems	A	B
Non-problems	C	D

To reach a more accurate conclusion we should compare each cell. But of the four cells possible, only one (cell A) is made up of a completely positive statement. The other three

<sup>1</sup> See "Implicit Stereotyping in Person Judgment" Banaji, Hardin and Rothman, Journal of Personality and Social Psychology 1993

contain negatives and so require more processing power. Hence most people will be swayed by observations falling into Cell A, and will overweight their importance accordingly. A few days ago I tried to explain to my son that the expected return of playing the lottery was highly negative because the probability of winning the lottery was close to zero. He reflected for a few seconds before replying “*yeah, but people do win it!*” We’re programmed to seek confirmation.

So “*in-group bias*” can cause wrong ideas to persist longer than they should. But persistence isn’t actually the problem. Any distribution has extremities at any point in time and there will always be some people with bizarre opinions about why one *out-group* or another is the cause of the world’s wrongs. The problem is when such thinking gains traction ...

And this is why I’m worried about where the euro is going. Most experimental evidence clearly shows that while *in-group bias* is common, we do a good job at suppressing the distorted perceptions and prejudices it creates. Social norms, empathy and the adoption of more rational value systems all help to mitigate our tendency to discriminate against out-groups. However, on a personal level that suppression requires an ongoing supply of what is essentially a highly scarce resource: mental energy. And in a fascinating literature review of recent work into the psychology of prejudice by two academics at the University of Kansas: a detailed picture emerges of how **mental stress and emotional fatigue increase our susceptibility to “*in-group bias*”**. Thus, the rise of aggressive nationalism throughout the world in the 1920s and 1930s and the consequent breakdown of global trade all occurred under conditions of extreme economic distress.

Worse, during such times, the release of a hitherto suppressed taboo makes people feel good. In one experiment, subjects were split into three groups: the first was encouraged to express prejudices that were previously taboo (e.g. against fat people); the second were encouraged to express prejudice that weren’t taboo (e.g. against child abusers), and the third control group were encouraged to discuss a negative topic that was unrelated to prejudice (e.g. pollution). The first group showed elevated mood and were found to have thoroughly enjoyed the discussion!

This finding explains a lot. It helps understand why some comics’ shock tactics do so well. It sheds light on the release football fans describe after a Saturday afternoon screaming abuse at opposing fans/players they’d never normally think about in the cold light of day. But does it also explain the comfort people feel embracing ideas they’d previously shunned, as now seems to be happening across Europe today?

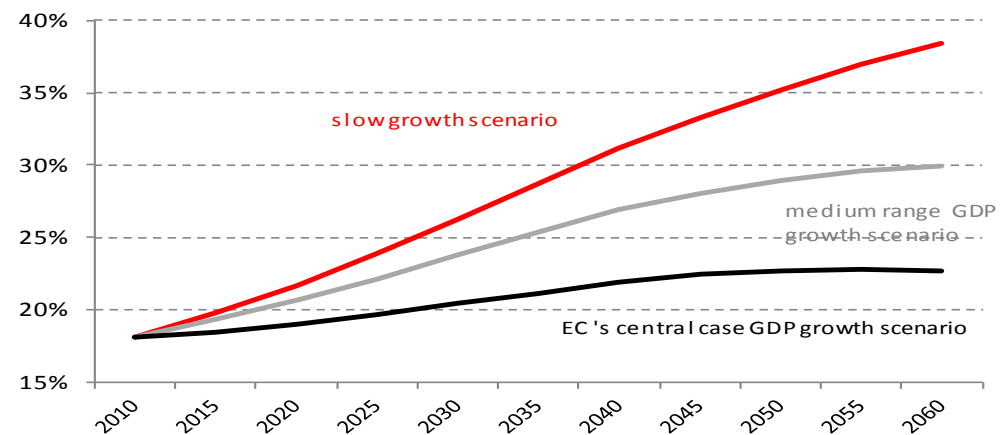
I believe what we are seeing is the beginning of the eurozone’s credit crisis, not the end. The historic and psychological evidence clearly links economic dislocation with the scapegoating of *out-groups* and, of course, the eurozone edifice stands increasingly lonely and tall as a lightning rod for the latter. I believe the likelihood is that over the course of the next decade or so, the trend will be towards greater fiscal problems and greater economic problems. I believe these problems will increase the temperature of debates about whose fault it all is, and that as the conclusion to these debates becomes more polarized they will play into the hands of nationalist, anti-immigrant and increasingly, *anti-euro* sentiment.

---

<sup>2</sup> See “A Justification-Suppression Model of the Expression and Experience of Prejudice”, by Christian Crandall and Amy Eshleman, Psychological Bulletin (2003)

The following chart shows some back-of-the-envelope calculations I did using the EC's fiscal dataset. The data have reasonable enough breakdowns of demographic cohorts to be able to back out just what percentage of GDP per worker will be needed to fund age-related expenditures (pensions and health). The black line shows the percentage of per worker GDP required under the EC's central case scenario of 1.9% trend eurozone growth. Under this scenario the burden of the aged on workers looks manageable.

**% of GDP p/worker required to pay for age-related expenditures in three growth scenarios**



Source: SG Cross Asset Research

However, eurozone growth hasn't averaged 1.9% per worker for quite some time and frankly, I find the assumption implausible. Over the last 20 years, it has averaged 1.3% while over the past ten years it's averaged only 0.8%. Let's call these medium growth and slow growth scenarios respectively. The grey and red lines show the trajectory of the age burden on workers in each scenario. In the plausible scenario whereby trend eurozone GDP growth is roughly similar to that seen over the last ten years, nearly 40% of per worker GDP will have to be diverted towards age-related expenditure merely to sustain *existing* debt burdens.

The current austerity drives are aimed at restoring pre-crisis budget balances. As the eurozone ages, each passing year without sufficient action will see a deficit between age-related expenditure and revenues that can be diverted to that expenditure. This deficit will grow because age-related expenditure will grow more quickly than available pool of wealth creators capable of funding those expenditures. Since each year that passes without those deficits being tackled will see them accumulate, one way to think of these growing burdens is as liabilities that are currently off the balance sheet but which over time will gradually come on-balance sheet.

How big are those liabilities? Take your pick. But my back-of-the-envelope calculations aren't too far from Jagadeesh Gokhale's, who reckons total unfunded health and pension obligations to be around 400% of GDP in the EU. That's a lot of pressure yet to come onto eurozone government balance sheets and with it, presumably, plenty of economic pain to fuel anti-immigration and anti-euro ideologies.

**IMPORTANT DISCLAIMER:** The information herein is not intended to be an offer to buy or sell, or a solicitation of an offer to buy or sell, any securities and including any expression of opinion, has been obtained from or is based upon sources believed to be reliable but is not guaranteed as to accuracy or completeness although Société Générale ("SG") believe it to be clear, fair and not misleading. SG, and their affiliated companies in the SG Group, may from time to time deal in, profit from the trading of, hold or act as market-makers or act as advisers, brokers or bankers in relation to the securities, or derivatives thereof, of persons, firms or entities mentioned in this document or be represented on the board of such persons, firms or entities. SG is acting as a principal trader in debt securities that may be referred to in this report and may hold debt securities positions. Employees of SG, and their affiliated companies in the SG Group, or individuals connected to then, other than the authors of this report, may from time to time have a position in or be holding any of the investments or related investments mentioned in this document. Each author of this report is not permitted to trade in or hold any of the investments or related investments which are the subject of this document. SG and their affiliated companies in the SG Group are under no obligation to disclose or take account of this document when advising or dealing with or for their customers. The views of SG reflected in this document may change without notice. To the maximum extent possible at law, SG does not accept any liability whatsoever arising from the use of the material or information contained herein. This research document is not intended for use by or targeted at retail customers. Should a retail customer obtain a copy of this report they should not base their investment decisions solely on the basis of this document but must seek independent financial advice.

**Important notice:** The circumstances in which materials provided by SG Fixed & Forex Research, SG Commodity Research, SG Convertible Research and SG Equity Derivatives Research have been produced are such (for example because of reporting or remuneration structures or the physical location of the author of the material) that it is not appropriate to characterise it as independent investment research as referred to in European MIF directive and that it should be treated as a marketing material even if it contains a research recommendation (« recommandation d'investissement à caractère promotionnel »). However, it must be made clear that all publications issued by SG will be clear, fair, and not misleading.

**Analyst Certification:** Each author of this research report hereby certifies that (i) the views expressed in the research report accurately reflect his or her personal views about any and all of the subject securities or issuers and (ii) no part of his or her compensation was, is, or will be related, directly or indirectly, to the specific recommendations or views expressed in this report.

**Notice to French Investors:** This publication is issued in France by or through Société Générale ("SG") which is authorised by the CECEI and regulated by the AMF (Autorité des Marchés Financiers).

**Notice to UK investors:** This publication is issued in the United Kingdom by or through Société Générale ("SG") London Branch which is regulated by the Financial Services Authority ("FSA") for the conduct of its UK business.

**Notice To US Investors:** This report is intended only for major US institutional investors pursuant to SEC Rule 15a-6. Any US person wishing to discuss this report or effect transactions in any security discussed herein should do so with or through SG Americas Securities, LLC ("SGAS") 1221 Avenue of the Americas, New York, NY 10020. (212)-278-6000. THIS RESEARCH REPORT IS PRODUCED BY SOCIÉTÉ GÉNÉRALE AND NOT SGAS.

**Notice to Japanese Investors:** This report is distributed in Japan by Société Générale Securities (North Pacific) Ltd., Tokyo Branch, which is regulated by the Financial Services Agency of Japan. The products mentioned in this report may not be eligible for sale in Japan and they may not be suitable for all types of investors.

**Notice to Australian Investors:** Société Générale Australia Branch (ABN 71 092 516 286) (SG) takes responsibility for publishing this document. SG holds an AFSL no. 236651 issued under the Corporations Act 2001 (Cth) ("Act"). The information contained in this newsletter is only directed to recipients who are wholesale clients as defined under the Act.

**IMPORTANT DISCLOSURES:** Please refer to our websites:

<http://www.sgresearch.socgen.com/compliance.rha>

<http://www.sgcib.com>. Copyright: The Société Générale Group 2011. All rights reserved.