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Economics Group

Special Commentary

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Political Risks in the Eurozone in 2017

Executive Summary

Three large Eurozone economies, the Netherlands, France and Germany, hold important elections in coming months. There is potential, albeit seemingly at the margin, for populist and nationalistic parties coming to power in the Netherlands and France. Although the probability that either of these countries leaves the European Union (EU) in the foreseeable future is low, European financial assets, including the value of the euro, could be negatively affected by electoral success of these parties. This scenario would also represent a downside risk to our economic outlook for the Eurozone.

The probability that an EU-skeptic party comes to power in Germany following the Sept. 24 Bundestag elections is even lower than it is in either the Netherlands or France. The uncertainty in Germany involves the potential for Angela Merkel to lose her chancellorship. Another Social Democrats (SPD)/Christian Democrats (CDU) grand coalition would largely be seen as "more of the same," even if that coalition was led by the SPD rather than the CDU. A coalition between the SPD and the Greens could raise the prospects of fiscal stimulus, at least at the margin, and would represent a modest upside risk to our Eurozone economic outlook.

Important Elections in Three Large Eurozone Economies

In a recent report, we discussed the current state of the Eurozone economy and its outlook for the next two years.[1] As we noted in that report, the French presidential election, which will be held in late April and early May, represents a downside risk to our economic forecast for the euro area.[2] However, France is not the only country in the Eurozone that has elections scheduled this year. Specifically, voters in the Netherlands head to the polls on March 15, French voters return to the ballot box in mid-June for elections for the National Assembly, and elections for the German Bundestag (the lower house of the parliament) are scheduled on Sept. 24.

The Netherlands, France and Germany all hold elections in coming months.

Populist and nationalistic political forces appear to be ascendant in many countries, and the individual economies of the Eurozone are not immune to this global political phenomenon. We discuss the upcoming elections in the Netherlands, France and Germany in more detail in this report and highlight how these elections could affect our economic outlook for the Eurozone in 2017 and 2018.

The Netherlands: Will the PVV End up in Power?

An election to the 150-seat lower house of the Dutch parliament will be held on March 15. Because representatives are elected on the basis of proportional representation, the composition of parliament tends to be fragmented. There currently are 11 political parties, which are represented in the lower house. The center right People's Party for Freedom and Democracy and the center-

[1] See "Is ECB Policy Tightening Coming Into View?" (Jan. 31, 2017) which is available upon request.

[2] The first round of the presidential election will be held on April 23. If no candidate secures a majority of the votes in the first round, the top two vote getters will square off in the second round on May 7. Whoever wins that round will become the next president of France.

left Labour Party, which together hold 79 seats, form the current governing coalition. No single party has been able to form a government by itself solely in the post-World War II era.

The PVV would garner a plurality of seats if the election were held today.

Recent polls show that if the election were held today the populist Party for Freedom (known by its Dutch acronym PVV) would garner the most votes, which would give it a plurality of seats in the lower house. Prospects of the PVV leading the next government could raise some market concerns because the party is anti-immigrant and anti-EU. That said, the probability that the PVV leads the next government is seen by many analysts as low. Although the PVV may indeed win a plurality of votes, current opinion polls show that roughly 20 percent of voters expressly support the party. Therefore, it would need to form a coalition government with other parties and most centrist parties have ruled out cooperating with the PVV. Some analysts believe that another coalition of the center-left and center-right parties will likely form the next government.

However, a better-than-projected showing by the PVV could complicate matters. Although the PVV may not win a majority of seats, forming a stable coalition of non-PVV parties may be difficult if the PVV has a "critical mass" of seats. In that event, the PVV may be part of the next government, which could raise some market concerns regarding an exit from the European Union by the Netherlands. Even if the EU-skeptic PVV comes to power—Geert Wilders, the leader of the PVV has called for a referendum on Dutch membership in the EU—"Nexit" would not be likely, at least not anytime soon. The government could potentially call a referendum on EU membership, but it would be non-binding. A binding resolution would apparently require a constitutional amendment.

That said, a better-than-expected showing by the PVV in the March 15 election, should it occur, could induce a negative market reaction. Although Nexit may not occur anytime soon, a strong showing by the PVV could embolden populist/nationalistic forces in other European countries that are holding elections this year. In that event, prices of European financial assets could encounter some selling pressure, at least in the immediate aftermath of the Dutch election. Furthermore, a period of political uncertainty ahead of the French and German election, which we discuss in more detail subsequently, could weigh on investment spending, thereby posing a modest downside risk to our Eurozone economic outlook.[3]

France: Will Le Pen End Up in the Élysée Palace?

Marine Le Pen, who is the leader of the EU-skeptic National Front (FN), likely would be one of the top two vote-getters if the first round of the French presidential election were held today. Most polls show her leading the pack with roughly one-quarter of the vote. François Fillon, leader of the center-right Republicans and Emmanuel Macron, leader of the independent En Marche! party, are close seconds, with about 20 percent of the vote each. Most polls currently show that either Fillon or Macron would handedly beat Le Pen by 60 percent or more of the vote in a second round. However, if political events since last June have taught us anything it is that pre-referendum/pre-elections polls can be widely off the mark.

"Frexit" would require an amendment to the French constitution.

Fillon and Macron support French membership in the European Union. In contrast, Le Pen has proposed that France leaves the EU. Could a President Le Pen unilaterally take France out of the European Union? No. EU membership is enshrined in the French constitution, so "Frexit" would require an amendment to the French constitution.

There are two ways to amend the constitution. First, the amendment would need to be approved by a majority in the National Assembly, the lower house of parliament, as well as the Senate, the upper house. It would then need approval by a majority of voters in a public referendum. The second way to amend the constitution does not require a public referendum, but it would require 60 percent of the votes cast in both houses of parliament. Either way, parliamentary approval would be needed for France to exit the European Union.

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[3] **We forecast that real GDP in the Eurozone will grow 1.8 percent in 2017 and 2.0 percent in 2018. See our *Monthly Economic Outlook*, which is posted on our website.**

After France elects a new president in May, voters will go to the polls for elections to the 577-seat National Assembly with the first round scheduled on June 11 and the second round on June 18. The FN is projected to increase its representation significantly in the National Assembly from its current two seats to as many as 70 seats. Nevertheless, it would still be well short of a majority in the National Assembly. The FN also has two seats at present in the Senate. One-half of the Senate seats will be up for grabs in indirect elections in September. Unless the FN wins all of these seats, which seems highly unlikely, it would remain well short of an absolute majority in the upper house. Consequently, the French constitution will not likely be amended anytime soon, making "Frexit" a low probability event.

That said, an unexpected victory by Marine Le Pen in the presidential election would send shock waves through financial markets. Although France probably would remain an EU member for the foreseeable future, a Le Pen administration would likely be hostile to EU institutions. France has been at the forefront of European economic and political integration ever since the Treaty of Rome was signed in 1957. An unexpected victory by Marine Le Pen, which would signal that France is starting to question the value of its EU membership, would raise significant questions about the long-run viability of European integration.

A Le Pen presidency poses a downside risk to our Eurozone economic outlook.

In our view, a Le Pen victory this spring, should it occur, would be negative for European financial assets. Prices of European stocks likely would decline, and spreads of European sovereign bonds over their German counterparts, which are the "safe-haven" assets in Europe, likely would widen. The euro likely would weaken vis-à-vis the U.S. dollar, as it has done during previous episodes of doubt about the sustainability of the Eurozone or the EU. Indeed, we believe that European financial assets would encounter more selling pressure under the scenario of a Le Pen victory in the French presidential election than they would under the scenario of the PVV coming to power in the Netherlands. In addition, we view prospects of a Le Pen presidency in France as posing more of a downside risk to our Eurozone economic outlook than PVV participation in the Dutch government.

Germany: Is This Merkel's Swan Song?

As noted above, EU-skeptic parties in the Netherlands (Wilder's PVV) and France (Le Pen's FN) are leading in the polls in their respective countries. Germany will hold elections for the Bundestag, the lower house of the German parliament, on Sept. 24. Current polls show that 10 to 15 percent of German voters currently say they intend for vote for the Alternative for Germany (AfD), the EU-skeptic party in Germany. As such, the AfD is polling well above the 5 percent of the vote it won in the 2013 Bundestag elections. However, support for the AfD is well below that of the center-right CDU and the center-left SPD, which each garner roughly 30 percent in current polls. Therefore, prospects for an EU-skeptic party coming to power in Germany are even more remote than they are in either the Netherlands or France.

Angela Merkel is in a neck-to-neck race to retain her chancellorship.

As the above polling results illustrate, Angela Merkel, who is the leader of the CDU and who has been the German chancellor since November 2005, is in a neck-to-neck race to retain her chancellorship. If the CDU does not win a plurality of votes, there is a good chance that Merkel would not return as chancellor. Merkel has been a bedrock of political stability, not only for Germany but for the entire euro area, over the past decade. Political uncertainty would rise if Merkel is no longer chancellor of Germany.

So what would happen if the CDU ends up in second place in Sept. 24 elections? It all depends on the actual election results on that day. The CDU and the SPD currently share power in a "grand" coalition and this coalition could remain in place after Sept. 24, assuming that the parties win enough seats together to form a governing coalition. Even if the CDU ends up in second place, Angela Merkel could still be chancellor, at least in theory.

However, if the SPD garners a plurality of Bundestag seats it is more likely that Martin Schulz, the SPD's candidate for chancellor, would end up with the top job. Schulz was a member of the European Parliament for more than 20 years and served as its president from 2012 until earlier this year, so he has impeccable EU credentials. European financial assets, including the value of the euro, could take a bit of a hit, at least initially, if Angela Merkel leaves the chancellorship. But another SPD/CDU grand coalition would largely be seen as "more of the same," even if that coalition was led by the SPD rather than the CDU. We likely would not be inclined to mark down our Eurozone economic forecast, at least not significantly, under this scenario.

German fiscal policy could presumably turn more expansionary under a coalition of center-left/left parties.

Things could get more interesting if the SPD and the Greens, which are further to the left on the political spectrum than the SPD, win enough seats together to form their own coalition. The CDU is a party of fiscal austerity, and talk of expansionary fiscal policy has essentially been verboten during the chancellorship of Angela Merkel. Although the fiscal taps would probably not fly wide open in a SPD/Greens government, fiscal policy could presumably turn more expansionary under a coalition of center-left/left parties.

American stocks rallied, U.S. bond yields rose and the greenback strengthened after Donald Trump was elected president and Republicans maintained their majorities in both houses of Congress. Market participants reckoned that the political outcome increased the odds of more expansionary U.S. fiscal policy over the next few years. European financial assets could conceivably respond similarly, albeit probably not quite to the same extent, if the odds of fiscal expansion in Germany, the Eurozone's single-largest economy, go up after the Sept. 24 election. In addition, prospects of more fiscal stimulus in Germany would represent an upside risk, at least at the margin, to our Eurozone economic forecast for 2018.

Conclusion

Three large Eurozone economies, the Netherlands, France and Germany, hold important elections in coming months. There is potential, albeit seemingly at the margin, for populist and nationalistic parties coming to power in the Netherlands and France. Although the probability that either of these countries leaves the European Union in the foreseeable future is low, European financial assets, including the value of the euro, could be negatively affected by electoral success of these parties. This scenario would also represent a downside risk to our economic outlook for the Eurozone.

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