Euro area: Brexit is not the only source of political uncertainty in 2019

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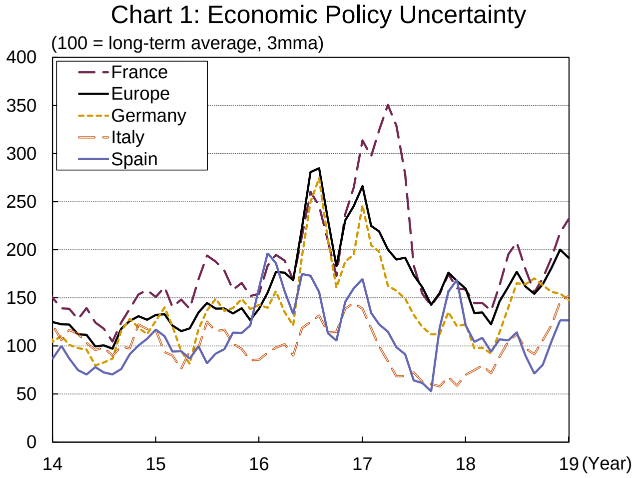
1. Introduction

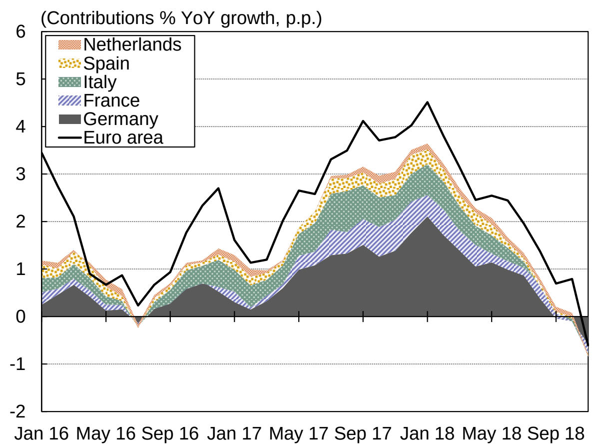
After a series of key elections in Germany (September 2017), France (May 2017) and Italy (March 2018), the European electoral calendar for 2019 looks fairly thin. There are plenty of sources of political uncertainty beyond Brexit which are worth dwelling on, however, and political uncertainty remains high (Chart 1). The European Parliament elections in May will be useful primarily as a stocktake of populist sentiment, but they will also have implications for policymaking and the wider European project. Nationally, a snap election has been announced in Spain where polling suggests another fragmented parliament and protracted process to form a government. There is a chance of a snap election in Italy too, as Salvini's League party may wish to consolidate its strong polling position, and there will also be the first post-bailout election in Greece. Against this background there is a clear risk of a leadership vacuum at a European level as the presidents of the European Commission, Council and ECB are all to be replaced this year. At the same time, Merkel has been weakened in Germany by a painful defeat in the Hesse state election, and Macron's authority at a European level has been damaged by the 'yellow vest' protests and his subsequent fiscal concessions in France. For the euro area, any increase in uncertainty is likely to be an additional challenge at a time when there are clear signs of fading growth momentum at the start of the year (Chart 2).

Chart 1: Economic Policy Uncertainty



Source: www.policyuncertainty.com, MUFG Bank Economic Research Office

Chart 2: Euro Area Industrial Production



Source: Eurostat, MUFG Bank Economic Research Office

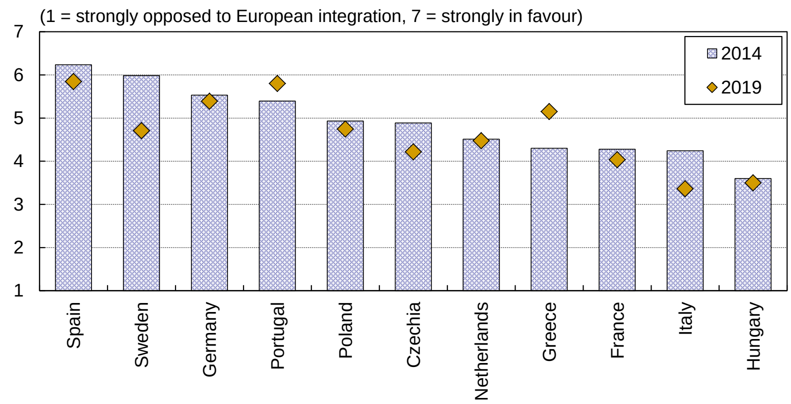
2. European Parliament elections

The European Parliament election on 23-26 May is the most important scheduled political event for the euro area in 2019. It could have important repercussions for European policymaking and reform over the following five-year term.

Since the 2009 Lisbon Treaty, the authority and responsibilities of the directly-elected European Parliament have increased. Together with the Council of the EU, the European Parliament now has joint responsibility for passing EU laws which have been proposed by the European Commission. Members of the European Parliament (MEPs) are tasked with establishing and adopting the EU budget (together with the Council) and approving the EU's long-term budget (the "Multiannual Financial Framework"). The Parliament is also responsible for electing the European Commission President, and the parliamentary political groups have influence on the Commission's main priorities which are announced every five years.

More immediately, the election results will serve as a gauge of populist sentiment in the EU. Current polling suggests there could be a moderate increase in the number of populist MEPs, but also some gains for pro-integration liberal and green parties. We try to estimate the likely net impact. Chart 3 shows political experts' judgements on parties' positions towards European integration and immigration, weighted by actual (2014) or predicted (2019) vote shares in the European Parliament elections. The chart suggests that the Parliament could become slightly more Eurosceptic (the notable shift in Italy reflects the rise of Five Star and the League). A similar approach using the same data source suggests that Parliament may also become less receptive to immigration (this could be either due to a likely increase in votes for anti-immigration parties, or because established parties have hardened their positions since 2014). Taken together, recent polls do suggest a net increase in populism in the next European Parliament term. However, we note that typically low turnout for European Parliament elections can render polling less accurate than for national votes.

Chart 3: Average Position on European Integration



Note: Estimated party position weighted by European parliament vote (for 2014) or most recent polling for 2019).
Source: Chapel Hill Expert Survey, Politico, MUFG Bank Economic Research Office

The outlook varies across the four largest euro area countries:

- **Germany**: Merkel's CDU/CSU group looks set to comfortably win most seats. Current polling does not point to a populist surge – it is the pro-immigration Green party that seems likely to come second, building on the party's success in the Bavaria and Hesse regional elections last year. Meanwhile, the right-wing populist Alternative for Germany (AfD) party has faded slightly in the polls to around 12%.

- **France**: Representatives of the 'yellow vest' movement could run in the European Parliament elections. Initial polling suggests that any success could come at the expense of longstanding anti-establishment parties such as the National Rally rather than Macron's LREM.

- **Italy**: Salvini's League party seems likely to confirm its position as the country's most popular party after strong polling figures have followed last year's national election in which it came third. Five Star is also likely to receive a large share of the vote.

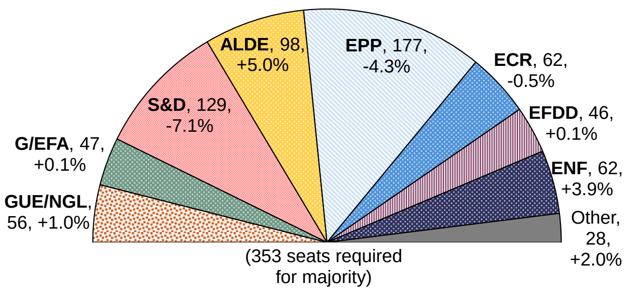
- **Spain**: Polling suggests that the right-wing populist Vox group, which performed strongly at the Andalusian regional election last autumn, is also on course to win several seats in the European Parliament.

At a wider level, the effect of any increase in populist parties in the European Parliament is unclear. The risk to policymaking is perhaps negated to some extent by the fact that populist parties are spread between various European Parliament groups (listed in Table 1) which is likely to limit cooperation. Austria's Freedom Party, France's National Rally and Italy's League are members of the Europe of Nations and Freedom group (ENF), while Germany's AfD and Italy's Five Star sit in the Europe of Freedom and Direct Democracy (EFDD) group. Smaller parties are similarly split between these two main groups, or are not affiliated to any of them.

At the same time, collaboration could become harder more broadly as the two largest groups historically – the centre-right European People's Party (EPP) and centre-left Socialist and Democrats (S&D) – are set to lose some of their share of seats (Chart 4).

Chart 4: European Parliament Seat Projection

(Labels show the projected number of seats and % change in number of seats since 2014 relative to the total)



Source: EuropeElects, MUFG Bank Economic Research Office

Table 1: European Parliament Groups

GUE/NGL	European United Left-Nordic Green Left
G/EFA	Greens/European Free Alliance
S&D	Socialists and Democrats
ALDE	Alliance of Liberals and Democrats for Europe
EPP	European People's Party
ECR	European Conservatives and Reformists
EFDD	Europe of Freedom and Direct Democracy (*Eurosceptic*)
ENF	Europe of Nations and Freedom (*Eurosceptic*)

Source: European Parliament, MUFG Bank Economic Research Office

It is not just the populist parties mentioned above that seem likely to gain at these groups' expense; pro-integration parties in the Alliance of Liberals and Democrats for Europe (ALDE) group are also poised to increase their number of MEPs. Note that the ALDE projection in

Chart 4 includes Macron's LREM party which has stated an intention to campaign with the group on a "common front", but stopped short of official membership. There are rumours that Macron may push for a new group to be formed after the election (this would require a minimum of 25 MEPs from at least seven different member states).

Whether or not that is the case, it does seem likely that Parliament will become more fragmented. Historically, the EPP and S&D have almost always cooperated under a 'grand coalition' agreement, but such a pact may not be possible after the upcoming election. Current polling suggests that the two groups combined will no longer control enough seats for a majority. Decision making would become more difficult if an agreement of three or more parliamentary groups is required.

The results are also likely to have political implications at a national level. There are several euro area countries with minority governments (Ireland, Portugal) or fragile coalitions (Italy, the Netherlands, Greece). The results of the European Parliament elections may widen any cracks in these governments and increase the risk of snap elections (we discuss key domestic policy risks in section 4 of this report).

On a more constructive note, national governments' policies might change if the pan-European election results send a clear message of voter discontent. That could put further pressure on governments to loosen fiscal policy, which could be a useful tonic for the euro area economy amid mounting signs of slower growth. There is certainly scope for it – the euro area's budget deficit is less than 1% of GDP (and Germany has a surplus of 1.7%).

On Brexit, it is worth noting that fewer MEPs will be elected this time owing to the UK's departure from the bloc, with the total set to decrease from 751 to 705. The number of MEPs allocated to each member state is roughly proportional to each country's population and the UK's withdrawal is an opportunity for some seats to be redistributed to underrepresented countries. France and Spain will be the main beneficiaries with each receiving five additional seats.

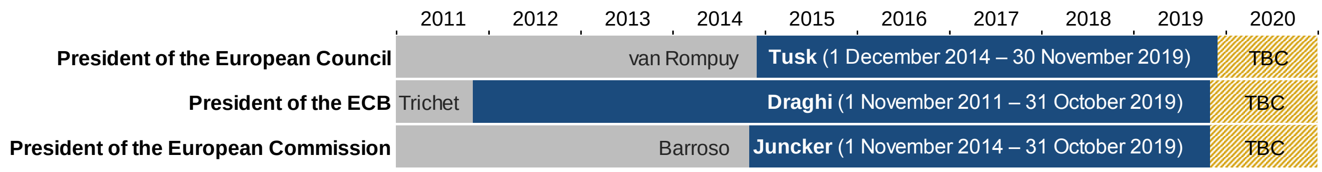
There is a chance that the UK's Article 50 notice period could be extended beyond the elections (the significant date is the first sitting of the new parliament on 2 July). This would be awkward for the European Parliament, but not insurmountable. For example, in the case of a short extension, the UK could be given 'observer status' similar to that of Bulgaria and Romania ahead of the countries' accession to the EU in 2007. Observers were selected by the national parliaments and had the right to "to attend plenary sittings, with access to the Chamber, but without the right to speak, vote or stand for election".

3. Risk of a leadership vacuum

A more fragmented European Parliament would coincide with a changing of the guard at the top of the most important European institutions. The presidents of the European Council, ECB and European Commission are all set to stand down this year (Diagram 1). At the same time, key national leaders have seen their European standing damaged. In Germany, Angela Merkel was forced to anoint her successor after her party struggled in state elections, and, in France, Emmanuel Macron has been weakened by his fiscal concessions in response to protests.

Weakened leaders in the euro area's top two economies combined with the impending job vacancies suggest a risk to leadership at a European level.

Diagram 1: European Leaders' Terms



Source: ECB, European Commission, European Council, MUFG Bank Economic Research Office

The process to appoint successors to Tusk, Draghi and Juncker will be opaque and involve behind-the-scenes horse trading to ensure different interests are represented. On the ECB vacancy, we noted last February that the hawkish Jens Weidmann (the German Bundesbank president) could well be too parochial for many other euro area member states to accept.[1]

[1] See www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-Euro20180220.pdf

After being an early favourite, Weidmann is still in the running but his chances do seem to have faded. Now, two Frenchman – Benoît Coeuré (Executive Board member of the ECB) and François Villeroy de Galhau (governor of the Bank of France) are among the frontrunners. There are also two Finns in contention – Erkki Liikanen and Olli Rehn (former and current governors of the Bank of Finland respectively). Hawkish alternatives to Weidmann such as Dutchman Klaas Knot may be hampered if the recent weakness in the euro area economy endures.

The selection of all three presidencies will be closely related. If Weidmann is not selected as ECB president then it becomes more likely that a German is chosen as European Commission president. The "*Spitzenkandidat*" (lead candidate) system was used for the first time to select Jean-Claude Juncker in 2014. Under the system, each parliamentary group selects its *Spitzenkandidat* ahead of the European Parliament election. The group with the most seats sees its candidate appointed European Commission president. The EPP group, which is odds-on to win most seats, has selected German MEP Manfred Weber – who therefore becomes most likely to become the next Commission head. However, the *Spitzenkandidat* system is not a formal process, and there is opposition to it (not least from Macron's LREM party). If a different approach is taken (i.e. closed-door negotiations) then other contenders such as Margrethe Vestager, the European Commissioner for Competition, become more probable. Another option could be Michel Barnier, the EU's Brexit negotiator, who has impressed during talks with the UK. An orderly Brexit deal would further help his chances.

The president of the European Council will be appointed by EU leaders for a 30-month term, with the possibility of reappointment once. There is little speculation so far on possible candidates but we note that former Danish prime minister Helle Thorning Schmidt will leave her current role as a charity CEO this year. If she were appointed it would help to allay concerns about gender balance in the EU's top jobs. Mark Rutte, the current Dutch prime minister, could be another contender.

The selection of this new guard of presidents will be important. Draghi's replacement is set to continue the normalisation of monetary policy amid increased signs of a faltering economy. Against that background, time might be running out for useful euro area reform before the next crisis – a common euro area budget, banking union and capital market union all remain distant prospects. These will be some of several challenges for the new presidents of the Council and Commission, who will be tasked with pushing the European project forward while also managing the UK's departure from the EU.

4. National uncertainty

The list of national elections this year has been bolstered by the announcement of a snap vote in Spain (Table 2). On top of this there are several other potential flashpoints which could increase uncertainty and weigh on economic activity.

Table 2: Euro area elections in 2019

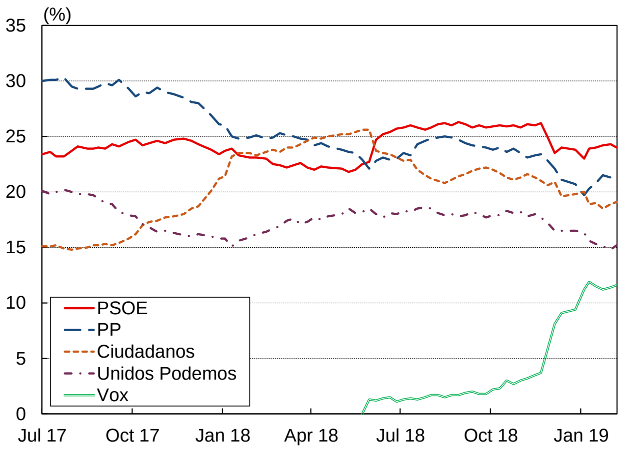
Date	Country	% euro area GDP	Type
3 March 2019	Estonia	0.2	Parliamentary election
14 April 2019	Finland	2.0	Parliamentary election
28 April 2019	Spain	10.4	Parliamentary election
23-26 May 2019	**EU27**	**116.4**	**European parliament election**
26 May 2019	Belgium	3.9	Federal election
6 October 2019	Portugal	1.7	Parliamentary election
By 20 October 2019	Greece	1.6	Parliamentary election

Source: National sources, MUFG Bank Economic Research Office

(1) Spain – snap election called after minority government fails to pass 2019 budget plan

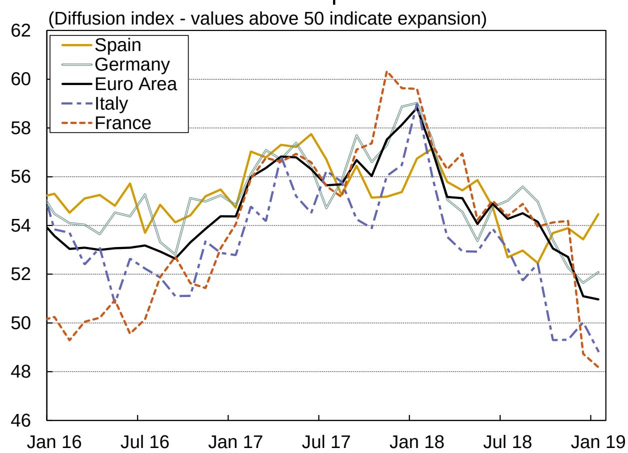
Spain's prime minister, Pedro Sanchez, announced a snap election will be held on 28 April after his government was defeated in parliament over its 2019 budget plan. It will be the country's third general election since December 2015 – and polls point to another fragmented parliament (Chart 5). The announcement of the election was received calmly by market participants, however, amid a solid economic recovery in Spain (2.5% YoY real GDP growth in 2018) and little sign of a slowdown yet in 2019 (Chart 6).

Chart 5: Polling for the Next Spanish General Election



Source: Electocracia, MUFG Bank Economic Research Office

Chart 6: Composite PMI



Source: IHS Markit, MUFG Bank Economic Research Office

However, with no clear winner likely, there could well be another protracted period of post-vote wrangling to form a new government. On top of this, there may be some concern about the rise of the far-right Vox party in the regional elections in Andalusia, and the risk of an increase in populism at a national level. Meanwhile, the Catalonian independence push is likely to continue to simmer in the background.

(2) Greece – first post-bailout election warrants close attention

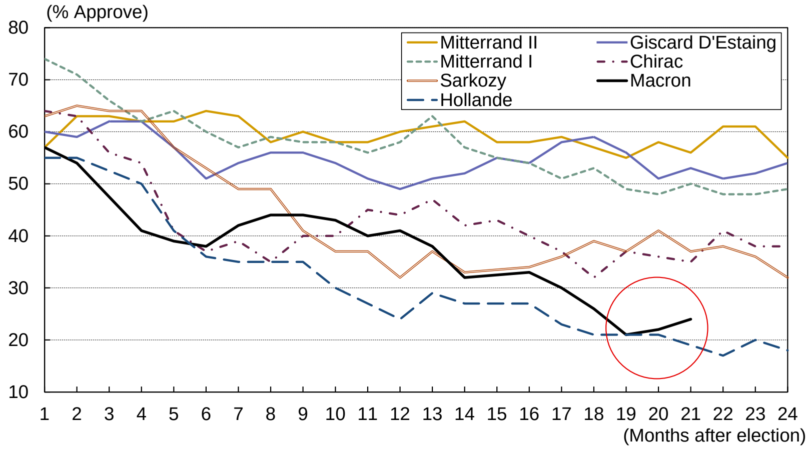
The vote in Greece, which must be held by 20 October 2019, also warrants close attention. The country's first post-bailout election will be held against a background of stabilising financial and economic conditions. The government is returning to bond markets, the IMF expects real GDP growth of 2.4% YoY this year and the country's primary surplus has improved markedly to above 4% of GDP in the latest figures. The election will provide some uncertainty, but current polls do suggest a market-friendly outcome with little possibility of a radical government. The established centre-right New Democracy group seem set to comfortably win the most seats (although it is likely to be short of an outright majority). Current Prime minister Tsipras' Syriza party is polling around 25%. We note that, while the election must be held by October, it could be called to coincide with the European Parliament in May. This would extinguish the risk that smaller populist groups could use the European election as a springboard to success in a later national election (as Syriza itself did in 2014/2015).

(3) France

When we discussed Macron's bold reform agenda last March we noted that many of his policies could be politically painful.[2] One in particular, a planned increase in fuel taxes, caused significant ire and instigated the so-called 'yellow vest' protests in mid-November. The movement has since spread across France and represents more general discontent at the government's policies. In response, Macron announced concessions such as a fuel tax freeze, elimination of tax on overtime, and a government-funded rise in the minimum wage. Taken together, these fiscal measures should provide a temporary boost to the economy which could offset some loss of output caused by the disruption. And, while the protests continue, the recent data suggest that manufacturing and consumer sentiment recovered somewhat in January. Macron's personal approval rating as president has also shown signs of recovery (Chart 7) but remains relatively low at this stage of his tenure when compared to previous presidents.

[2] See www.bk.mufg.jp/report/ecoeu2018e/BTMU-Economic-Brief-France20180316.pdf

Chart 7: French Presidents' Approval Ratings



Source: Kantar Sofres, MUFG Bank Economic Research Office

We also note that there seems to be widespread discontent towards all of the main parties and no clear support for an alternative group to put pressure on the government. Macron's LREM party is still roughly level with the National Rally party in polling for the European Parliament elections at around 20-25%. At any rate, the French constitution makes it very unlikely that Macron will be forced from office, and he is set to remain as president at least until April 2022. By this time it is possible that some of his structural reforms will have started to bear fruit and boost the economy. There are already encouraging signs. The unemployment rate reached a near-ten year low in Q4 2018 (falling to 8.8% from 9.1% in the previous quarter).

(4) Italy – Budget sanctions are unlikely, but there could be an election in 2019

Macron's fiscal concessions in France are significant for Italy, as we noted last month.[3] It has now become much harder, politically, for Brussels to impose fiscal discipline on Italy while France's budget deficit is likely to slip past the 3% of GDP Maastricht limit again. The Italian government has also backtracked somewhat by agreeing to reduce its budget deficit target to 2.04% of GDP this year (from 2.4% previously). The result is that Italy is set to escape any sanctions by the European Commission under an excessive deficit procedure (EDP). However, structural issues persist and Italy will be more vulnerable to the next crisis in the absence of meaningful debt reduction.[4] The spread between Italian and German 10Y government bond yields remains above 250 basis points.

[3] See www.bk.mufg.jp/report/ecoeu2018e/monthly_we20181226e.pdf
[4] See www.bk.mufg.jp/report/ecoeu2018e/specialreport_20181109.pdf

Against this background, political uncertainty remains high. Since forming a government together in May 2018 the League party has surged ahead of its partners, Five Star, in the polls. The coalition is fragile and we suspect that Salvini, leader of the League party, may be eager to translate his higher popularity into votes. There is a clear risk that snap elections may be called this year. Current polling would point to another fragmented parliament – and the prospect of another long process to form a government.

5. Conclusion

Brexit is not the only source of political uncertainty for Europe this year (note we have published separate reports on the economic risks for the UK and the euro area).[5]

[5] For Brexit risks to the UK please see www.bk.mufg.jp/report/ecoeu2018e/specialreport_20180913.pdf and for risks to the euro area please see www.bk.mufg.jp/report/ecoeu2018e/specialreport_20181211.pdf

The European Parliament election in May is the most prominent event. Current polls suggest a more divided chamber and a possible end to the traditional 'grand coalition' agreement between the two main centre-left and centre-right political groups. Fragmentation could make European policymaking more difficult. Meanwhile, any increase in populist parties' vote share would be mitigated by the fact that the parties are split between parliamentary groups (which limits cooperation), but may serve a guide for upcoming domestic elections.

The most important *scheduled* national election this year will be in Spain, where a snap election is likely to result in another close result with the risk of protracted period of political instability. The election in Greece this year will also warrant close attention as the post-crisis recovery continues, but current polling suggests that the formation of a radical government is unlikely. However, market participants would be more concerned if early elections are called in Italy (which is certainly possible) – not least because the European Parliament election is likely to show consolidated support for Italian populist parties.

These risks of electoral uncertainty combine with a changing of the guard at the top as the presidents of the ECB, European Council and European Commission are all due to step down this year. The threat of a leadership vacuum at a European level is heightened as both Angela Merkel and Emmanuel Macron have been weakened by events at home. Taken together, progress on useful euro area reform is unlikely to become any easier, and, as the outcome of the Brexit negotiations remains very uncertain, it seems that risks to the European project as a whole may increase.