

THE VIEW

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EUROPEAN ELECTIONS: WHAT A FRAGMENTED PARLIAMENT MEANS FOR THE EU'S PRIORITIES

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EXECUTIVE SUMMARY



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- In a few months, all the faces of Europe will change: the European Council President; the European Commission President and Commissioners and the European Central Bank President. These appointments will be impacted by the results of the May 2019 European elections, after which, for the first time in 40 years, a Grand coalition - spanning the European People's Party (EPP), the Progressive Alliance of Socialists and Democrats (S&D) and the Alliance of Liberals and Democrats for Europe and Renaissance (ALDE & R) is needed to govern. Eurosceptic parties fell short – by a small margin – of a minority blocking representation (33.33%). The strength of the Greens (almost 10% of seats) suggests they will be the swing force. They could look to partner with mainstream parties in order to have a bigger say in the EU reform agenda. Given that a higher share of Green voters are under 30, mainstream parties could also be inclined to accept them, which could bring the governing coalition to more than two-thirds.
- Looking at the manifestos, we expect the newly formed Commission to focus on purchasing power and social policy; security, defense and climate change over the next five years. The three-party agenda could also be supported by non-traditional parties. On the other hand, business-friendly reforms, and bolder, yet dividing, policy blocks for Europe do not appear to be on top of the list.
- When looking into the details, we identify three clusters of priorities for the next Commission:
 - ◆ First “easy breezy” topics, which should get wide-ranging support in the first half of the five-year mandate. This includes the reform of the European Stability Mechanism (ESM); higher infrastructure spending; strengthened migration controls; stronger European security and defence policy; increased climate change mitigation reforms and the ratification of a Brexit deal.
 - ◆ Second, “mixed feelings” topics, which are not yet on the agenda but the US-China rivalry and mounting populism could help prioritize and which get support in the second half of the five-year mandate. These are: a common industrial policy (CIP) including the Buy European Act, an unemployment reinsurance scheme, and the proceedings against EU countries which deviate from European democratic values.
 - ◆ Last, “hard-to-pass-without-a-miracle” topics during the five-year mandate, in the context of a fragmented European Parliament: the European Deposit Insurance Scheme (EDIS) allowing to finalize the Banking Union; the Capital Market Union (CMU) and less financial regulation; new Free Trade Agreements (FTA); a central budget for the Eurozone with a dedicated common Finance Minister and further EU enlargement.



Photo Arnaud Jaegers on Unsplash

32%

Share of seats won by hard populists in the EU Parliament

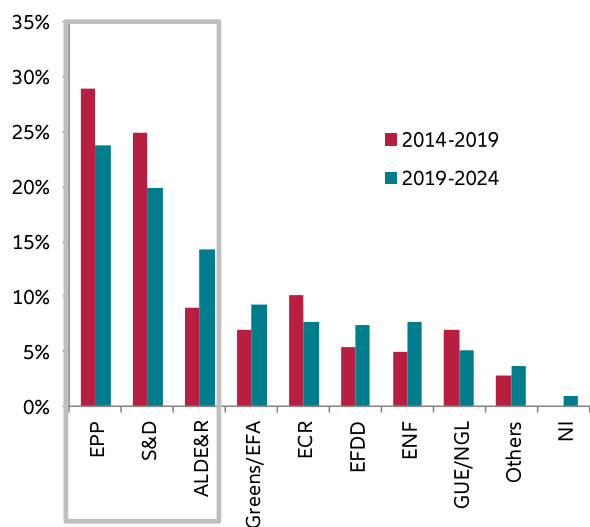
A NEW POLITICAL CYCLE

For the first time since 1994, over 50% of citizens voted in the European elections held in May 2019. But the results point to a fragmented EU Parliament, requiring a mainstream three-party Grand coalition to govern for the first time in 40 years, opening up a new political cycle. Hard populists¹ won around 32% of the EU Parliament in the May 2019 elections, falling short of the blocking minority of 33.33%. Overall, hard populists (affiliated to parties) won less than 10 additional seats in the EU Parliament compared to 2014. But far-right parties are in the driving seat. As the current coalition (EPP² + S&D³) fell short of its absolute majority (44% of seats vs 54% in 2014, see Figure 1), a Grand coalition among the three mainstream

parties which obtained most of the votes should be formed in the coming weeks (EPP + S&D + ALDE & R⁴). Pro-European parties will have to cooperate much more closely to avoid a policy standstill in the years to come. The strength of the Greens (almost 10% of seats) suggests they will be the swing force as they are viewed as pro-Europe and social measures, but against new Free Trade Agreements, for example. They could look to partner with mainstream parties in order to have a bigger say in the EU reform agenda. Given that a higher share of Green voters are under 30, mainstream parties could also be inclined to accept them, which could bring the governing coalition to more than two-thirds.

A weak European Council, composed by the 28 Heads of State, is not good news given its strong executive power. This fragmentation, in addition to that of the EU Parliament, could delay the next official appointments within the European Parliament and the European Commission. Around half of the 28 countries face minority governments; around 10 partnered with populists while around 10 will go through major elections in 2019. This suggests a longer and more difficult than expected process of naming and voting for the new EU Commission President and the College of Commissioners, which need to be in office starting on 1st November (see Figure 3).

Figure 1: Distribution of EU Parliament seats by political



Sources: European Parliament, Allianz Research

Figure 2: European Parliament regular powers

Legislative	The European Parliament adopts, jointly with the European Council (President + 28 Heads of State), laws proposed by the European Commission. It also votes on international treaties as well as the EU accession process, and gives a view on European Commission's works
Supervisory	The European Parliament elects the President of the European Commission and approves the whole group of Commissioners by Committee (through simple majority, i.e. 353 votes). The European Parliament can dissolve the European Commission through a motion of no-confidence (two-thirds majority).
Budgetary	In collaboration with the European Council, the European Parliament establishes and adopts the annual EU Budget, and approves the long-term budget.

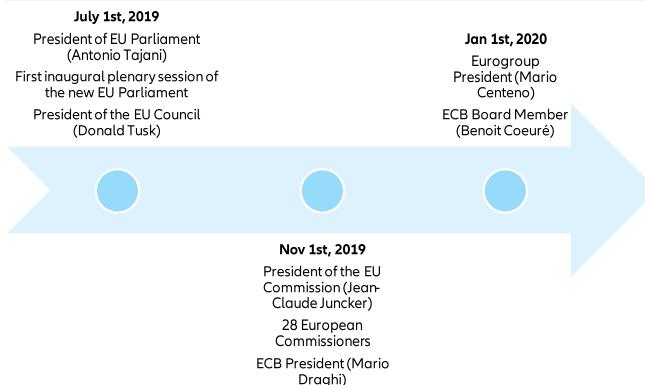
Sources: European Parliament, Allianz Research

1 Parties opposed to the rule of European law or advocating for exiting the EU.

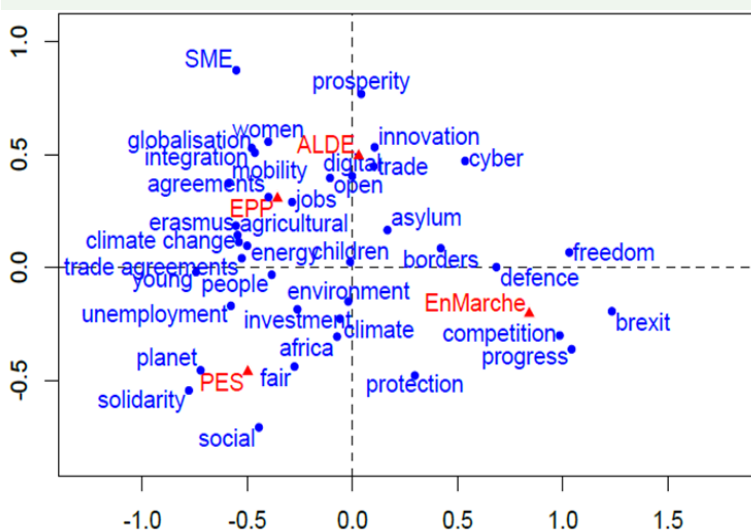
2 European People's Party (EPP)

3 Progressive Alliance of Socialists and Democrats (S&D)

4 Alliance of Liberals and Democrats (ALDE), Renaissance (Macron's République en Marche & USR Plus from Romania)

Figure 3: Calendar of future European institutional appoint-

Sources: European Council, European Parliament, ECB, Allianz Research

Figure 4: Common topics in the manifestos of the four mainstream parties by order of occurrence (EPP, S&D, ALDE&R)

Sources: Parties' websites, Euler Hermes

Current prospects for EU reform are not very encouraging. Reform momentum in Europe stalled with the German election in fall 2017 and the subsequent lengthy period of coalition building. Meanwhile French President Macron was busy with domestic politics, given the yellow vest movement. In addition, the Italian budget battle has weighed on reform appetite, particularly for more risk sharing. In 2018, when Brexit occupied a significant amount of time of the EU Councils, reform was further on hold. With Brexit taking more time than expected, and the Presidency renewals within the European institutions, the prospects for notable progress on reforms in 2019 seems very limited.

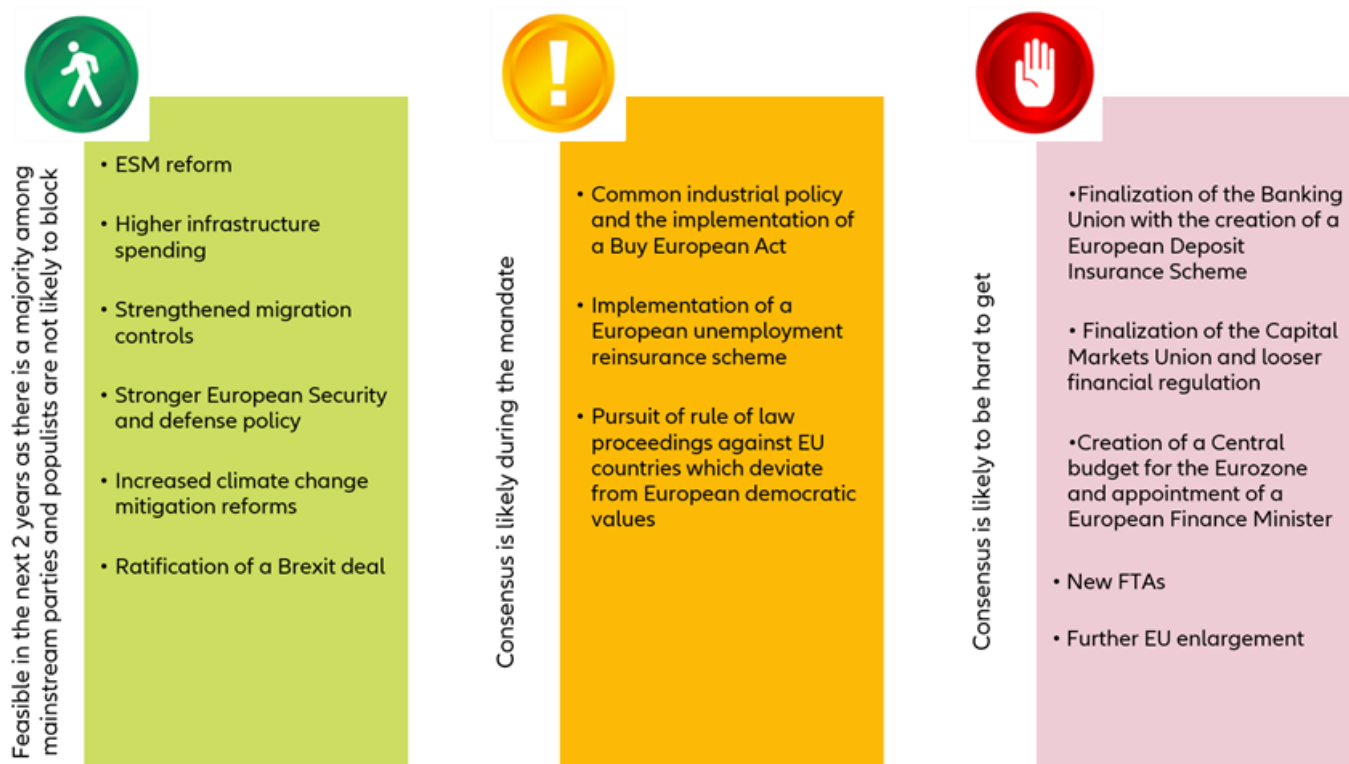
In this context, we take a close look at

the upcoming European policy topics and see how likely they are to be implemented in the next five years, given the current status of consensus among the biggest mainstream parties, and the minority blocking power of populist parties, should they manage to cooperate. Using a correspondence analysis (a specific factor analysis often used for text mining), we looked for themes with the highest occurrence in the manifestos of the main parties (Figure 4), which thus have a higher chance of consensus and implementation. Very strikingly, the first dimension (55% of the variance) is one that opposes value-rich words such as "freedom" and "progress", very characteristic of En Marche/Renaissance, to a traditional thesaurus. This axis also

shows that En Marche has a clearer stance on Brexit, and a European defense force. The second axis shows a traditional left-right cleavage, with for S&D words such as "social" and "solidarity" and measures tackling unemployment and underinvestment, versus key sectors "agriculture" and "energy" and a more business-friendly agenda by ALDE and EPP, that also include words such as "SME", "innovation", and "open trade". All parties share the fight against the climate, stronger borders, and more investment in their manifestos. Though not visible in this graph, financial integration measures (ESM e.g.) are also present in EPP, ALDE and En Marche's programs.

Figure 5: Upcoming European topics grouped by likelihood of getting a consensus in the next five years

PRIORITIES OF THE NEXT EUROPEAN COMMISSION



Source: Allianz Research

Hence, we classify the European policy topics that are likely to shape the next five years into three clusters:

1. “Easy breezy”:

These are likely to get the majority consensus in the first half of the 5-year mandate as there is support for them from the three mainstream parties and Greens and hard populist parties are not expected to block them. These are the European Stability Mechanism reform; higher infrastructure spending; strengthened migration controls; a stronger European security and defence policy, increased climate change mitigation reforms and the ratification of a Brexit deal.

2. “Mixed feelings”:

These topics are not yet on the agenda of all mainstream parties but external pressure (US, China), as well as populist trends, would push for them to be implemented in the second half of the 5-year mandate: a common industrial policy (CIP), including the Buy European Act; an unemployment reinsurance scheme and the pursuit of rule of law proceedings against EU countries which deviate from European democratic values.

3. “Hard-to-pass-without-a-miracle”:

The following are not likely to get the consensus during the next five years and/or will be blocked by the Greens and hard populist parties: the European Deposit Insurance Scheme (EDIS) allowing to finalize the Banking Union; the Capital Market Union (CMU) and less financial regulation; new Free Trade Agreements (FTA); a central budget for the Eurozone with a dedicated common Finance Minister and further EU enlargement.

“EASY BREEZY” POLICY TOPICS

1. A reshaped European Stability Mechanism (ESM)⁵ is expected to get through during the next EU mandate. Despite the rise in populism triggering less support for risk-sharing, all mainstream parties are in favor of finalizing the ESM reform.

On 14 December 2018, Eurozone leaders agreed on a series of incremental technical reforms in order to strengthen the euro architecture, aiming to make it better prepared to weather future crises.

The most important part of the ESM reform will be to provide the backstop in bank resolutions through the Single Resolution Fund (SRF)⁶ deemed to be fully operation by 2024 and fiscally neutral for the countries. The ESM backstop to the SRF further strengthens the European banking union. Banks have made notable progress in reducing non-performing loans (NPLs); however, the cooling economic environment means that risk reduction will be more gradual going forward. More risk-sharing could be compromised by the higher share of populist parties but we think it is a “must have” reform to re-build trust in the Eurozone banks and reduce financial fragmentation across the region without too much of fiscal integration.

The Eurozone finance ministers are cur-

rently working at the necessary amendments to the ESM Treaty, which will be submitted for ratification by all 19 ESM members by June 2019. This will require the involvement of national parliaments.

2. Higher infrastructure spending is likely to be pushed in the next Multi-Annual Financial Framework (MFF) for 2021-2027, which needs to be approved in fall 2019.

Populist parties push for more spending in the areas of infrastructure and support for social investment and small to medium-sized enterprises (SMEs). The reshaped Juncker plan, called InvestEU, still needs to be implemented but the new EU Parliament could call for more funds in the form of private-public partnerships. The EU Commission proposed EUR650bn by 2027 (compared to EUR500bn targeted funds by the Juncker plan since 2015) for four main areas: infrastructure; research; innovation and digital and SMEs and social investment and skills.

ALDE and EPP both agree on many fronts, such as investing in digital infrastructure, railways and the Western Balkans. They both nonetheless emphasize different angles in infrastructure investment. ALDE focuses on sustainability and meeting the Sustainable Development Goals (SDGs) through investment in sus-

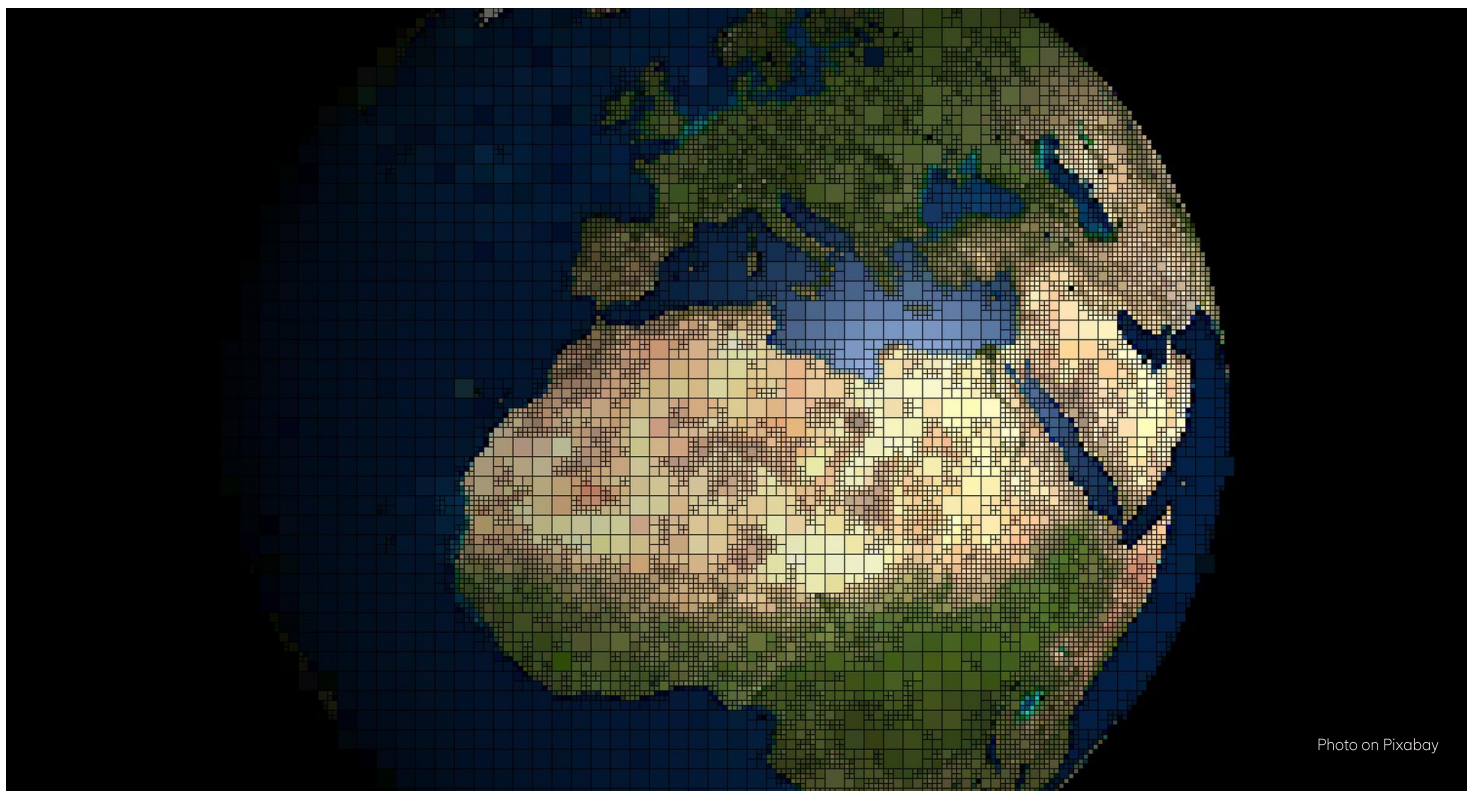
tainable infrastructure (like the Trans-European Network) and infrastructure that supports decarbonisation. EPP focuses on investments that align with the Cohesion Policy, connecting regions, cities and rural areas. Their aim is not just to connect the regions but to also reduce the disparities through infrastructure investment. The EPP has also set upgrading aging infrastructure as a priority in their Post 2020 MFF proposal. Specific projects are mentioned in both parties’ manifestos. The EPP mentions high speed internet and supercomputers in all regions, while ALDE mentions high-speed trains connecting major European cities. Three parties are in favor of increasing funding for the Connecting Europe Facility (CEF), with S&D putting emphasis on decarbonization and alternative fuel infrastructure like ALDE.

3. Strengthened security & migration controls are the focus of all mainstream parties’ electoral programs.

In addition, stricter border controls will be back on the agenda as far-right parties are in the driving seat of the populist wave. Parties such as the PVV, Rassemblement National, Vlaams Belang, the Freedom Party of Austria, Sweden Democrats and Freedom and Direct Democracy are all in favor of reintroducing

⁵ This version of the ESM wouldn't require the creation of a Eurozone budget.

⁶ The Single Resolution Fund (SRF) is a fund established by the European Union in the context of the Banking Union for resolving failing banks financed by contributions from the banking sector, rather than the taxpayer. In the event that the SRF resources are not sufficient, the ESM can act as a backstop and lend the necessary funds to the SRF. The common backstop will be in place at the latest in 2024 or earlier provided that an assessment scheduled for 2020 shows that banks have made sufficient progress in reducing their exposure to risks, notably non-performing loans.



4. Increased climate change mitigation reforms.

In order to reach the goal of a 20% reduction in greenhouse gas emissions by 2020 and of 40% by 2030 (compared to 1990 levels), substantial efforts on the member countries' side are needed. In the recent legislative period, the EU has made progress on a reform of its emissions trading system, including a stricter approach to the market stabilization reserve that makes the supply of certificates more restricted, thus increasing pressure on CO₂ prices. Moreover, new regulations on cars have been put in place and a so-called "Clean energy for all Europeans" package has been adopted, waiting to be transposed into national legislation in the upcoming two

years. All parties are committed to the Paris Agreement and its specific targets in their manifestos. ALDE also goes one step further, mentioning a higher CO₂ reduction target than currently implemented (55% versus 40%). Moreover, it specifically calls for the extension of the EU ETS scheme to other sectors and industries, which at least EPP also might be in favor of, although the latter mentions this only indirectly in its program. Both ALDE and EPP are also clearly in favor of completing the energy union ambitions of an integrated European internal market for energy. Meanwhile, S&D calls for the implementation of a carbon tax.

5. A Brexit deal ratification

We think the ratification of the Brexit deal by the EU Parliament should be feasible in the next two years. The ratification by the UK Parliament is expected to take longer, possible until mid-2020, given the future political changes (new Conservative leader in the UK) and a possible referendum (which would take around three months to organize). Despite the rise in uncertainty, a no-deal Brexit remains unlikely to us (25% probability) while a soft Brexit continues to be a likely compromise, albeit challenging to get if a hard Brexiteer PM would be appointed. Hence, this is more likely to come after a referendum.

“MIXED FEELING”

POLICY TOPICS

Figure 6: MFF 2021-27 proposals (EURbn), agreement required by June 2020 to allow implementa-

	European Commission Proposal	European Parliament proposal	Difference European Commission vs European Parliament
Single Market, Innovation, Digital	166,3	215,1	-48,8
Cohesion and Values (including economic, social and territorial cohesion)	392,0	456,1	-64,1
Natural Resources and Environment	336,6	407,9	-71,3
Migration and Border Management	30,8	31,0	-0,2
Security and Defense	24,3	24,6	-0,3
Neighbourhood and the World	108,9	113,8	-4,9
European Public Administration	75,6	75,6	0,0
Total	1134,6	1324,1	-189,5
% of GDP	9,5%	11,1%	-1,6%

Sources: European Parliament, Allianz Research

1. Common industrial policy and the implementation of a Buy European Act

Back in September 2017, the European Commission outlined a renewed industrial policy strategy that would bring together all existing and new horizontal and sector-specific initiatives. Since then, Industry Days have been organized, gathering industry representatives, trade unions, national and regional authorities and civil society, and aiming at making progress on the European industrial policy, focusing on topics such as sustainability, digitalization, investment and globalization.

Digitalization, innovation and investment are part of the manifestos of at least two of the mainstream parties likely to form the coalition, though none of them talks explicitly about a Common Industrial Policy. However, amid growing protectionism, Europe will be forced to progress on industrial policy as it is the second largest export market - in terms of manufacturing goods - after China. Demographic changes and the specialization Europe has in medium to high value-added goods also require more coordinated action to maintain competitiveness. A Buy European Act – something Macron’s Renaissance En

Marche is in favor of, is also likely to be implemented in the second half of the mandate, especially as some of the populist parties are in favor of it as well.

2. Implementation of an European unemployment reinsurance scheme

The EU Parliament plays a key role in the allocation of expenses in the bloc’s annual budget as the Lisbon Treaty puts it on an equal footing with the European Council (EC). Back in December, the EC exchanged views on the proposed 2021-2027 Multi-Annual Financial Framework (MFF) (see Figure 6) and said it aims to reach an agreement in fall 2019. An agreement on the seven-year budget plan needs to be made before June 2020, ahead of its implementation in January 2021.

The rise of populist support and increasing social tensions, would push the direction of the new Budget towards more measures in favor of purchasing power and social protection. As a result, we expect the idea of an unemployment reinsurance scheme to regain momentum in the EU Parliament as anti-establishment parties are likely to support it, though not all mainstream par-

ties see it as necessary.

3. Pursuit of rule of law proceedings against EU countries which deviate from European democratic values

Over the past few years, the rule of law in the EU has been increasingly under pressure in several member countries, sparking concerns over how it can be better protected and enforced. A “reflection process” on the rule of law in the EU, and a process of setting out possible avenues for future action, were announced in April this year by the Commission. But strengthening the rule of law is unlikely to be an easy endeavor in the next five years for political reasons. The way the rule of law should be further enforced in the EU remains a highly controversial topic, even within parliamentary groups. Though ALDE calls for “new effective mechanisms outside the framework of Article 7 of the TEU”, as well as “sanctions in cases of violations”, neither S&D nor EPP directly refer to a reform of the current framework in their manifestos. They do state that they are committed to the rule of law but we have mixed feelings they will be able to keep the same strict tone during the 5-year mandate given the populist pressure.

“HARD-TO-PASS-WITHOUT-A-MIRACLE” POLICY TOPICS

1. Finalizing of the Banking Union with the creation of a European Deposit Insurance Scheme

All mainstream parties have a rather cautious view on the finalization of the Banking Union, given their lower willingness to share risks on the back of rising populist parties. EPP calls for the completion of the Banking Union with a Deposit scheme but only when the banking environment is more stable. ALDE prioritizes the “rapid” implementation of the Banking Union, but with a harsher approach on bank owners and creditors to protect taxpayers, which suggests the completion of the Single Resolution Mechanism. Lastly, S&D does not specifically mention a Banking Union but rather only calls for stricter rules guiding the financial and banking sector.

2. Finalization of the Capital Market Union and less financial regulation

None of the three major coalition parties mention the Capital Market Union as a priority nor do they explicitly talk about less financial regulation. However, SMEs appear in ALDE and EPP’s manifestos: the former talks more about R&D investments for SMEs, while EPP is in favor of a prolonged Investment Plan for Europe to improve SME access to finance. EPP is the only party to mention less regulation for SMEs: “Reducing red tape for businesses by 30%, especially for SMEs, and repealing unnecessary regulations will facilitate greater and more sustainable growth”.

3. More Free Trade Agreements

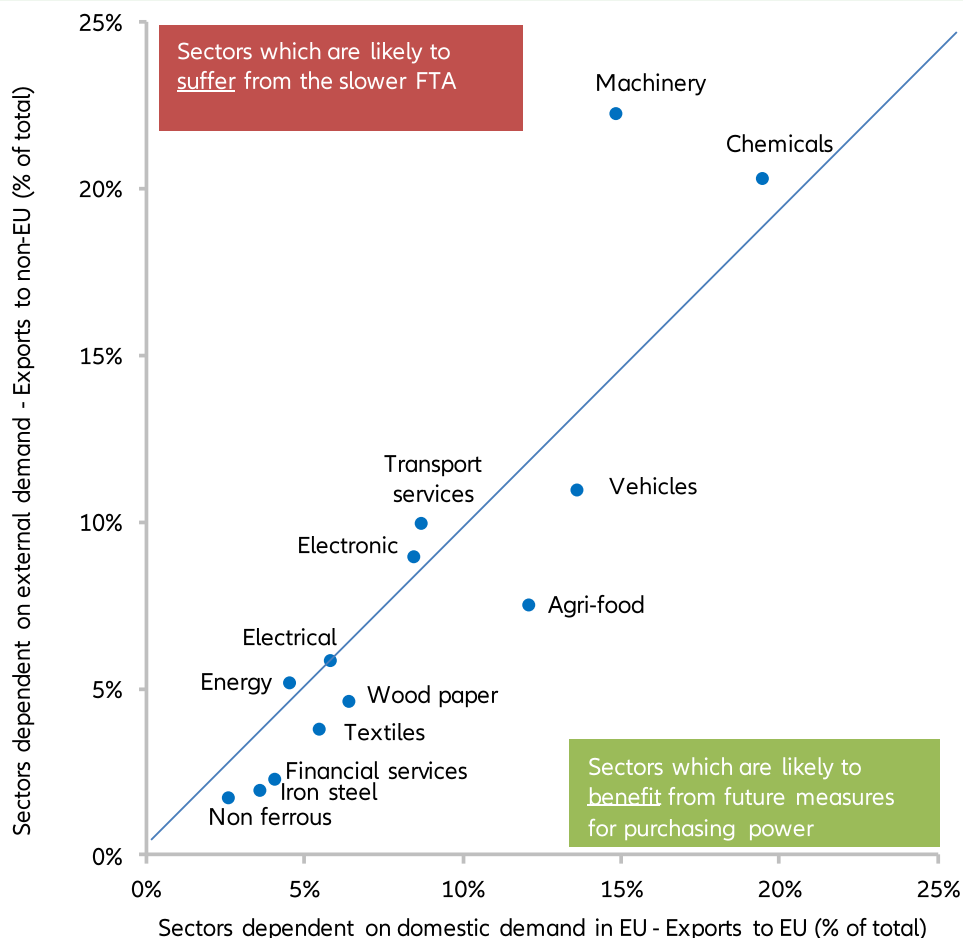
Mainstream parties continue to list free trade among their priorities. However, longer negotiations or the obstruction of ratification of new trade agreements⁷ constitute a rising risk due to the high number of populist parties (M5S, Rassemblement National, la France In-

soumise, the Danish People’s Party, Belgium’s Vlaams Belang, Greece’s Golden Dawn, Jobbik, the PVV, the FVD, the Freedom Party of Austria, Sweden Democrats, and Freedom and Direct Democracy). Indeed, the Lisbon Treaty gives the EP veto power over almost all trade and other international agreements due to the consent procedure, which requires an absolute majority. Delaying the implementation of the FTAs currently under negotiation (15+) by the EU would represent a missed export opportunity of EUR40bn per year, hence depriving real GDP growth from an annual boost of almost half a pp of GDP growth. The sectors which are likely to suffer from the slower FTA implementation are Machinery and Equipment; Chemicals and Electronic and Electrical products, which are known to account for a higher share of total exports outside the EU rather than within the EU.

⁷ Excluding the one with the UK.



Figure 7: Sectors which are likely to be impacted by slower trade agreement implementation but higher purchasing power



Sources: Chelem, Euler Hermes

4. More fiscal flexibility and/or a Central Budget for the Eurozone and appointment of a European Finance Minister

More fiscal flexibility is not expected to gain traction in the next years. The deviation from the targets in Italy and France in 2019 can be seen as temporary exceptions accepted by the EU Commission as they will ask for corrective measures in the next Budgets. More fiscal integration under the form of a Central European Budget or European Finance Minister (or even debt mutualisation) doesn't seem to be among the priorities of the three mainstream parties, given the rise in populism support and the need to focus on

more people-oriented measures. The EPP and ALDE point out the need to respect the fiscal rules. Renaissance En Marche pointed out this idea, but they would probably de-prioritize it during the next mandate in favour of other topics where consensus is more likely.

5. Further EU enlargement

EU enlargement plans are currently not on the political agenda of any of the main parliamentary groups in the European parliament. While both EPP and ALDE state the strategic importance of the West Balkan, they do not express plans to pursue an enlargement of the EU in the upcoming years, emphasising only closer cooperation instead. The

EPP even explicitly focuses on ending the ongoing accession negotiations with Turkey.

Therefore, we expect the enlargement process to slow down during the upcoming legislative period. Depending on the election results and the strength of populist groups, the election of a new enlargement commissioner could even be hampered or populist groups could push for the designated Directorate-General to be merged with another department, signalling the lower priority it will have going forward.

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