

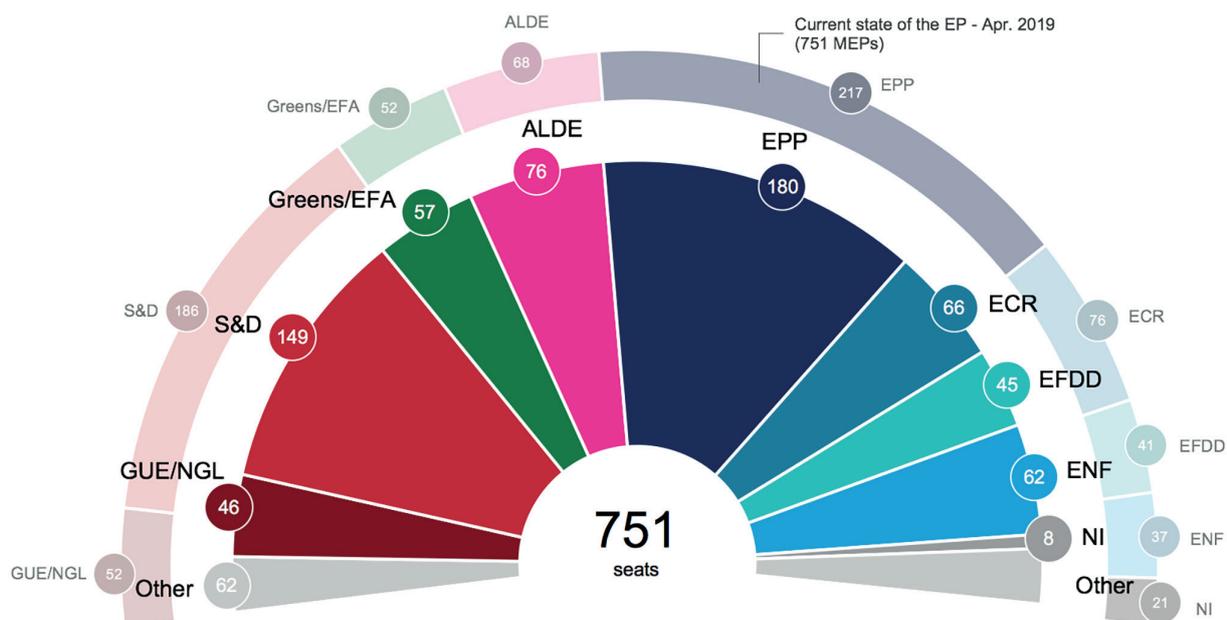
May 2019

# Do European elections matter?

The elections to the European parliament are due to take place on 23-26 May across EU member states. This note discusses the implications of these elections for European policy, key political appointments and market relevant political risk. While we expect populist parties will increase their seat share, disunity across the very different populist parties will mostly serve to add to policy stasis in Brussels given the relatively sturdy economic backdrop.

The more immediate impact on markets is likely to come from the emboldening of those populist parties back home in their national political scenes, particularly Italy. Overall, we expect the new parliament to be polarised and for policy progress to be further stymied. However, these elections also carry an unreported, albeit small, upside tail risk: that French President Emmanuel Macron's liberal pro-integration movement drives more efficient policymaking.

## What is expected to change as a result of the next European parliamentary elections?



Source: EU Parliament

Following on from the trend of the last European elections, consensus is for populist parties to make further gains in the European parliamentary elections at the end of May (see document attached for more detail on party grouping ideology and structure).

- A clear fragmentation and polarisation is evident in EU election projections, echoing the trend in European national parliaments, with smaller groupings gaining relative to the larger traditional alliances.

- European parliamentary projections suggest the largest party group, the centre-right European People's Party (Christian Democrats) (EPP), will fall to 180 seats from its current 217, while its ally the centre-left Progressive Alliance of Socialists and Democrats (S&D) will fall to 149 from its current 186. Even combined, these two groups will not get to a majority in the parliament, so other groups will be important for policy.

A potential kingmaker for policy and key appointments in the next parliament may well be the next version of Alliance of Liberals and Democrats for Europe (ALDE), the centrist liberal coalition that is dissolving to combine with Macron's Renaissance group (included in the "other" category of the chart above).

- While markets are focused on the populist risk, Macron's new group may provide a source of upside risk to European integration momentum – though a healthy dose of scepticism is always wise in Brussels.
- Key waymarks for this positive tail risk will be the leadership of the group and engagement with the traditional groups. The European parliament often suffers from stasis as groups are disparate; leadership will therefore be crucial.

## Are we about to see populists take over Brussels?

For populist parties, an increased vote share is likely, but deep divisions between parties mean we don't expect a genuine populist union that generates meaningful change. However, they will add to the challenging policy environment and exacerbate existing inefficiencies.

- Populist parties have always struggled to unite in the European parliament, resulting in multiple smaller groupings (principally European Conservatives and Reformists Group (ECR), Europe of Nations and Freedom (ENF), Europe of Freedom and Direct Democracy Group (EFDD), independents) and lots of movement between groups. This reflects the fact that populism in itself is a thin ideology, often latching onto ideas of the extreme left and right. A far-left populist party is not necessarily an easy fit for coalition with a far-right populist party – as the Italian national case exemplifies.
- The far-right Lega party is attempting to build a new populist coalition with broader buy-in, but already divisions are emerging on which parties will join and how the group is organised. We broadly expect these divisions to continue to manifest between populist MEPs. Leadership of this group will be a crucial waymark for monitoring this tail risk.
- We think the market focus on the populist risk is overestimated given their likely inability to organise as a single grouping, though it is an important downside risk to monitor. The broader polarisation in the European parliament of anti- and pro-integration approaches is a problematic development politically as alliances will be more challenging. Leadership of new groupings on both sides of the debate will be crucial for tracking tails risks to the upside and downside in terms of relative political power.

More importantly for investors, a strong showing for populist parties like Lega in Italy, the Brexit party in the UK, Le Pen's party in France and AfD in Germany will be interpreted as a signal of popularity and domestic political direction.

- It is worth bearing in mind that European elections tend to have lower turnout than national elections, with supporters of populist or non-status quo parties more motivated to vote. This means that European elections have only a moderate read across to national elections, in contrast to the way the results are usually reported.
- However, in Italy, populist parties do have a majority of voter support. So, it remains for us the major source of Eurozone risk. The Lega party is using these elections as an acid test for its

popularity, against the backdrop of a challenging relationship at home with its coalition partner M5S. A strong showing in these elections combined with the challenge of a fresh fiscal bill in the autumn are a recipe for snap elections in Italy.

- In the UK, the stress of Brexit stasis is likely to be reflected in success for the pro-leave Brexit Party on the one hand and the pro-remain Greens, Liberal Democrats and Change UK parties on the other. However, this fragmentation is already embedded in our base case for the next steps in Brexit: a customs union-based deal to emerge (30%) or a general election (25%). A plurality of votes for the Brexit Party should not be interpreted as a sign that broader support for a hard Brexit has increased.

## What will this mean for policy at the EU level?

Given EU parliamentary policymaking powers (see document attached), we expect a larger populist share of European parliamentary seats, alongside a greater integration push from Macron's grouping, to heighten polarisation and reinforce policy stasis in Brussels.

- We think the vast differences in populist political viewpoints from the far-left to far-right and by country will be reflected in policy indecision. The risk of a coordinated, market-relevant populist policy agenda being enforced is low because there is no single fiscal or structural policy view that these parties coalesce around. However, if a broad populist grouping can reach 33% of the total seats, they have a number of powers that will make policymaking more difficult in Brussels (see table below).
- Macron's Renaissance movement in concert with ALDE may encounter similar issues collaborating with other moderate groups like the European People's Party (EPP) who are divided on issues of integration, though we think the issues in this space are less extreme than in the populist case.
- However, the crucial unknown is whether centrist EPP would embrace a more pro-integration agenda. This is a waymark for upside policy risk. That said, the EPP in particular is quite a diverse party grouping with stronger nationalist elements than the S&D parties, so a drift towards further integration is not inevitable. Indeed, following these elections some of the centre-right northern country members may feel compelled to take a less integrationist view to fend off the challenge at home from right wing populism.
- Underlying the debate about banking union completion and fiscal transfers to mitigate the sub-optimal currency area is the fundamental debate: does risk sharing or risk reduction come first? That question crosses party lines, as northern countries tend to advocate risk reduction as a pre-requisite for greater risk sharing, while peripheral countries tend to advocate risk sharing as a means to reduce risk. This argument remains unsolved and is the reason for our sceptical view of policy reform in the near term.
- Where populists may be most disruptive is in crisis management; in the event of a severe downturn, this Brussels stasis would be much more malign and have far more negative consequences than in the normal times we are in at present. With a messier parliament, the EU will continue to muddle through while the aggregate economy is growing. But constrained policy space and institutional vulnerabilities almost guarantee there will be significant stress when the current cycle does come to an end. At that point, muddle through may become harder to sustain and the more fragmented parliament will make it tougher to take the necessary steps to address the core problems.

## What populists can achieve in the European Parliament with 33.3-49.9 percent of seats

<b>Constitution of the European Parliament</b>	If the mainstream is divided: hamper the election of a leading candidate for EP president (absolute majority needed)	Appoint 4-6 vice-president	Place their chairs on one-third of committees, albeit the least sensitive and prestigious ones
<b>Control of the European Commission</b>	If the mainstream is divided: hamper the election of a leading candidate for EP president (absolute majority needed)	<b>One-third of EP seats is sufficient to hamper the approval of a commissioner-designate by a committee</b>	If the mainstream is divided: hamper the appointment of the College of Commissioners or weaken its political mandate (simple majority required)  One-third of seats sufficient to hamper the censure of the Commission
<b>Legislative role</b>	If the mainstream is divided: derail or influence the shape of laws under the ordinary legislative procedure	If the mainstream is divided: have some impact on the text of the EPs proposals for treaty change once the Convention is convened by the Council	If the mainstream is divided: derail some of the EU's international agreements under the 'consent' procedure  If the mainstream is divided: influence the text of the EP's non-binding opinions or the pace of the process
<b>Budget and the rule of law</b>	If the mainstream is divided: influence the shape of the MFF and of its programmes	If the mainstream is divided: influence the shape of the EU's annual budget	<b>One-third of votes is enough to block the rule of law mechanism under Article 7 in the EP</b>
<b>Other pressure</b>	If the mainstream is divided or a wide coalition is preferred: influence the content of the EP's resolutions		

Source: EU Parliament

## What will it mean for key appointments?

One of the more important implications of the new EU parliament will be in approving the next European Commission president, though the system for selection by the EU Council followed by approval by the EU parliament is under question.

- First, the Commission president sets the tone for the policy agenda in Brussels because the Commission is responsible for proposing and drafting legislation. Given existing projections, the likely successful candidate will be some version of a moderate, so we do not see market risk as a base line in this appointment (though the table above highlights how populists can stymie this election).
- Currently, Michel Barnier is the favourite in Brussels circles given his extensive policy background and role in the Brexit negotiations. However, the ultimate method for selecting the Commission president is under question, which will affect the length of time it takes to select a candidate.
- Second, the political norms in Brussels mean that if a country has a Commission president, it will not hold another major leadership role in Brussels, e.g. European Central Bank (ECB) president. So the calculation about likely candidates for ECB president will be clearer once the Commission president has been chosen. This is one of the most market-relevant elements of these elections, given the varying predilections towards hawkishness/dovishness in different countries.

## What will it mean for political risk?

We expect the elections to show a rise in populist support (perhaps even to the 33% threshold) that may temporarily affect markets. Beyond the kneejerk reaction, political risk at the country level matters more for genuine risk pricing short-term. The most important immediate question is how Lega leader Salvini reacts at home if his party is successful in Brussels. A strong showing will underscore our expectation for an Italian election in early 2020.

Outside the populist threat, the centre-left SPD in Germany is reported to be likely to reconsider its coalition with the CDU-CSU if it does very poorly in the EU elections. However, there will be a

balance to be held: a weakened SPD would really struggle in the next elections, so extricating itself from coalition without triggering a damaging election would be very tricky and dependent on other potential partners for CDU-CSU signing up to a coalition without fresh elections.

Medium term, polarisation and fragmentation are likely to result in political realignment in parliament. This exacerbates the great uncertainty facing the Eurozone and the EU: how should the European project progress? This source of uncertainty will gradually need to be priced in – which is why Macron's movement is so crucial to watch for upside risk. Completing banking union, addressing fiscal transfers and the broader risk sharing debate has been challenging: these elections will exacerbate these challenges in the absence of charismatic moderate leadership and party group coordination.

The underlying issue of populism is much more challenging to solve. Unless policymakers can address the underlying social and economic issues driving populist support and eroding moderate support, the next EU election is likely to see this theme revisited. With each election that sees populist support in Europe grow, the risks rise; while we do not see the upcoming elections as the tipping point, the next ones will carry much greater risk.

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