A new political phase for Europe

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Introduction

Next year will mark the beginning of a new political phase in Europe. A new European Parliament will be elected in May 2019 and with it, a new president of the European Commission. Angela Merkel, Germany’s chancellor and the most prominent EU leader, will hold less authority both domestically and on the European political scene, as she will be constrained by there being a new leader of the Christian Democratic Party (CDU), which she has led since 2000. Meanwhile, the eurozone economy appears to have lost momentum, and in 2019 a change in personnel at the helm of the European Central Bank (ECB) could have implications for the future monetary policy stance in the region.

The Economist Intelligence Unit expects four key themes to emerge in 2019:

1) The European Parliament election will result in a fragmented political landscape, reflecting trends registered at the national level, such as the decline of the two-party system and the increase in support for far-right and centrist parties.

2) The growing presence of Eurosceptics in parliament does not pose a threat to the European project. Many parties have moved away from outright Euro-rejectionism; moreover, there are significant divisions among the far-right forces and the parliament will remain vastly pro-European.

3) It will not be necessary to use further fiscal integration, as advocated by France, to bolster the eurozone’s already resilient institutional framework. Progress on reform of the eurozone will remain limited, despite the rise of the Franco-German partnership.

4) Economic growth will slow from 2017-18 but will continue to be supported by the region’s fundamental strengths and market confidence in the ECB’s position as backstop to the euro.
Part 1: A fragmented European parliament

The outcome of the European Parliament election will reflect national trends

In May 2019 twenty-seven countries will go to the polls to elect a new European Parliament. This election will be historic in several ways. First, following Brexit in March, it will be the first election to be held after a member state has left the bloc. Second, this election will follow a series of national

Political groups in the European Parliament

<table>
<thead>
<tr>
<th>Political Group</th>
<th>8th Parliament</th>
<th>9th Parliament</th>
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</thead>
<tbody>
<tr>
<td>EPP</td>
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<tr>
<td>S&amp;D</td>
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<td>20</td>
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<tr>
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</tr>
<tr>
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<td>5</td>
</tr>
<tr>
<td>NI</td>
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<td>0</td>
</tr>
<tr>
<td>New parties</td>
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<td>0</td>
</tr>
<tr>
<td>La Republique En Marche</td>
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</tr>
<tr>
<td>Non-Attached</td>
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</tbody>
</table>

Note: Data on the 9th European Parliament are projections.
Sources: Pollofpolls, Politico, The Economist Intelligence Unit.

Decline of the two-party system

<table>
<thead>
<tr>
<th>Country</th>
<th>Previous</th>
<th>2017-18</th>
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<tr>
<td>Germany</td>
<td>67.2</td>
<td>53.4</td>
</tr>
<tr>
<td>Sweden</td>
<td>54.4</td>
<td>48.1</td>
</tr>
<tr>
<td>France</td>
<td>55.8</td>
<td>26.4</td>
</tr>
<tr>
<td>Netherlands</td>
<td>51.4</td>
<td>27.0</td>
</tr>
<tr>
<td>Italy</td>
<td>62.7</td>
<td>34.3</td>
</tr>
</tbody>
</table>

Note: General elections in France (presidential), the Netherlands and Germany took place in 2017, and in Sweden and Italy in 2018.
Sources: Statistical offices, The Economist Intelligence Unit.
election results across member states in which far-right, Eurosceptic parties have recorded their best performances on record. Third, the polls will take place after a year of intense debate over the future direction of the European project, which has highlighted splits within the bloc.

**Increased political fragmentation**
(number of parties in parliament)

<table>
<thead>
<tr>
<th>Country</th>
<th>Previous Term</th>
<th>Current Term</th>
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</thead>
<tbody>
<tr>
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<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Sweden</td>
<td>8</td>
<td>8</td>
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<tr>
<td>France</td>
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<td>11</td>
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<tr>
<td>Netherlands</td>
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<td>13</td>
</tr>
<tr>
<td>Italy</td>
<td>13</td>
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</tr>
</tbody>
</table>

Note: Data for France relate to the number of parties running in the presidential election. Sources: Statistical offices; The Economist Intelligence Unit.

We believe that the outcome of the election will be greater political fragmentation, confirming the trend recorded across the region in recent years. From France’s presidential race in April 2017, to Sweden’s ballot in September 2018, election outcomes have symbolised the decline of the two-party system, and the rise in support for parties at both ends of the political spectrum, and at the centre.

**Social-cultural issues gain ground**
(% of respondents that identified these issues as the top-two most important the EU is facing)

Sources: European Commission; The Economist Intelligence Unit.
Several factors have fuelled this trend: the decline in class voting; the increasing dominance of socio-cultural issues over socio-economic issues; the shift of traditional parties towards the centre (leaving a vacuum of power on the extremes); and a growing sense of anxiety, brought about by economic and social changes associated with technological disruption and globalisation. Far-right parties have experienced a boost in support in France, the Netherlands, Germany, Italy and Sweden. Some have long existed in the political scene of their respective countries, while others have only recently made their first break into parliament. All of these parties have put pressure on the mainstream political class to address issues of national identity, migration and integration.

EUrosceptic threat will be contained

The rise in support for Eurosceptic parties has meant that the election could represent a test for the survival of the European project. However, the increased presence of such parties in the European Parliament will not pose such a threat. In fact, the combative tone of the Eurosceptic forces has decreased significantly over the past four years, with parties moving away from outright Euro-rejectionism. In addition, the room for designing a more hawkish migration agenda will be limited, especially as the political consensus across the bloc has been gradually shifting towards a more conservative stance since the 2015 refugee crisis.

Furthermore, despite calls from far-right parties to create a common front against the ruling European class, divisions among them—on migration, foreign and economic policies—will likely render these ineffective. In the past, similar attempts to build a unified opposition have failed. Finally, the balance of power in the European Parliament will remain tilted towards pro-EU groups, who are set to secure more than 50% of the available seats, despite the declining trend in their vote share in recent years.
Centrist parties team up to challenge political order

The voting share of centrist parties will be boosted by gains secured by socially liberal movements in recent national elections. Led by La République en marche (LRM), the party of the French president, Emmanuel Macron, which has joined forces with the Alliance of Liberals and Democrats for Europe (ALDE) group, these movements are set to challenge the two traditionally largest groups in parliament, the European People’s Party (EPP) and the Progressive Alliance of Socialists and Democrats (S&D). This shift could complicate the nomination of the new president of the Commission and lead to new dynamics in the parliament.

Decline in the European Parliament’s legislative activity
(number of ordinary legislative procedures)

All in all, a more fragmented political landscape will complicate coalition formation and policymaking, which will be reflected in weaker legislative activity and could prove crucial in respect of timely approval of the EU’s 2021-27 budget.
Part 2: Europe without Merkel

* The Franco-German partnership is back—but is it enough? 
Throughout November 2018 member states met to finalise proposals for reform of the euro zone, in an attempt to capitalise on the existing momentum for reaching consensus. We have long argued that the reforms proposed by Mr Macron are not necessary to maintain the euro zone’s institutional resilience, and that the other member states are unlikely to agree to such an ambitious reform package. The first steps towards reform of the euro zone came with the Meseberg Declaration between France and Germany issued in June 2018, although more concrete measures are likely to surface in the coming weeks.

We maintain our view that there will be progress on euro zone reform, but that this will be slow. The German-French agreement on a euro zone budget is a key example. Mr Macron had long called for an independent budget that would amount to several percentage points of total euro zone GDP. On November 18th a far smaller budget was agreed (potentially amounting to just 0.2% of euro zone GDP), which will also be integrated within the EU budget for structural funds. The modest agreement reached between the two countries is symptomatic of the return of the Franco-German partnership at the heart of the bloc.

Such an axis might not be sufficient to steer further reforms. A group of northern European and Baltic countries, together with Belgium and led by the Netherlands, joined forces in February in creating the New Hanseatic League, a fiscally hawkish alliance. The emergence of this new alliance is in part a response to calls for deeper fiscal integration within the euro zone, and in part an attempt by these countries to retain their influence at the EU negotiating table following the UK’s departure from the bloc.

* Ms Merkel will not sit out her full term, but Germany’s EU stance will remain unchanged 
Ms Merkel’s decision not to run for the CDU leadership in the December party congress triggered concerns about how Europe will change after her departure. Ms Merkel is the EU’s longest-serving government leader, having held office through many crises, from the euro zone sovereign debt crisis to the public backlash from the refugee crisis and the drift towards illiberal democracy in Poland and Hungary.

Ms Merkel’s fading authority—and the likelihood that she will step down as chancellor before the end of her term—could make frictions between member states more evident. Ms Merkel’s departure, and with it the departure of her diplomatic heft, might bring some uncertainty to the bloc in the short term. However, Germany’s stance on the EU will likely remain unchanged. The main contenders for the CDU leadership represent slightly different routes for the party, but not for Europe. Annegret Kramp-Karrenbauer, the frontrunner in the polls, is the continuity candidate, and Ms Merkel’s anointed successor. Friedrich Merz represents an economically more conservative stance. Jens Spahn, the current health minister, is trailing in the polls, and his stance on migration appears controversial.
Regardless of who succeeds Ms Merkel, Germany’s stance at the European level will not change—in particular, it will not mean a step towards significant fiscal integration. Ms Merkel’s reluctance to accept more euro zone integration was never a result of her political ideology, but rather of constraints such as a lack of appetite for change on the part of the German electorate; a strong domestic political and public consensus against fiscal transfers within the euro zone; and, more recently, an increasingly fragmented parliament and unstable coalition arrangement.
Part 3: Is the ECB’s work done?

The outlook for the euro area economy is brighter than it was two years ago, but growth is now decelerating. Annual real GDP growth is on course to reach 2% in 2018, having peaked at 2.5% in 2017—the strongest expansion in a decade. However, we expect the annual growth rate to slip further in 2019, to 1.8%. While this remains solid, the downward trajectory since 2017 has raised concerns about the strength of underlying activity in the euro area and whether growth is sustainable.

Euro zone real GDP growth
(% change, year on year)

In our view, and for two reasons, such concerns are overblown. First, some of the slowdown observed in 2018, particularly early in the year, can be viewed as a natural moderation of economic growth from unsustainably high levels in late 2017. Second, since the beginning of 2018, temporary and event-driven factors—including adverse weather conditions, extensive rail strikes in France, political instability linked to the general election in Italy and escalating global trade tensions—have weighed on the pace of growth. The fundamental strengths of the euro area economy, such as broad-based economic expansion and robust labour market improvements, will continue to drive growth in 2019.

A new phase for monetary policy?

The healthier economic outlook has prompted the ECB to make its first move away from the exceptionally accommodative monetary policy stance that has been in place since the global financial crisis. The amount of monthly asset purchases made under the quantitative easing (QE) programme was stepped up to €80bn in April 2016, but has been gradually tapered in 2017-18 as the region’s economic recovery has made this extraordinary monetary support less necessary. Monthly asset purchases will end in 2019.

The end of QE marks the beginning of a new phase in the recovery of the euro area. In tandem with near-zero interest rates and in the wake of a pivotal confidence—boosting commitment in 2012 from
ECB president Mario Draghi to do “whatever it takes to preserve the euro”. The stock of acquired assets will be maintained at end-2018 levels of almost €2.6trn in 2019, meaning monetary policy will remain extremely loose. Mr Draghi has promised to keep interest rates unchanged “through the summer” at least, as underlying inflationary pressure has remained disappointingly subdued. High global energy and food prices have pushed headline inflation above the ECB's target of “below, but close to, 2%” since May 2018, but this effect will fall out of the annual comparison in 2019, pulling inflation lower.

However, as domestic price pressure drives inflation higher, offsetting a diminishing contribution from external price pressure, we expect a shift in communication from early 2019—and, eventually, policy stance—from the ECB. There remains enough slack in the euro area labour market to allow wage pressures to rise without creating a situation of overheating, but the ECB is looking at a 2-3-year time horizon and will want to pre-empt a stronger wage/price spiral, which could develop in the final years of our five-year forecast period.

In part driven by this consideration, we expect the ECB to want to start very gradually to tighten policy by late 2019. With the QE programme no longer active, Mr Draghi’s forward guidance on interest rates will become the main policy tool through which to communicate this intention. We expect the ECB to start to increase the deposit rate, which currently stands at 0.4%, in the fourth quarter of 2019, easing the pressure on banks’ lending margins and supporting profitability. We expect the ECB to signal a first increase in the main refinancing rate in the first quarter of 2020.

Risks to this forecast stem from weaker than anticipated growth or inflation outturns, or a political risk event that pushes bond yields up, causing an undue tightening in financial conditions. However, we think the economic environment would have to deteriorate considerably, and fairly broadly, to prevent the ECB from moving ahead with policy tightening by late 2019.
● Sticking to the ECB script
Forthcoming personnel changes at the ECB could alter our outlook for monetary policy in 2019 and beyond. Our expectation for the timing of the first increase in the main refinancing rate means that it will be delivered after the end of Mr Draghi’s term, which expires in October 2019, and also after the end of the terms of ECB vice-president, Vítor Constâncio, and current chief economist, Peter Praet, in May 2019. There is a chance that the ECB’s policy approach could, therefore, be altered by personnel changes during 2019, potentially leading to a more hawkish stance than we currently assume.

However, this is not our baseline forecast. The risk of this possibility has receded since it became less likely that Jens Weidmann, the president of the Bundesbank (the German central bank) and a sceptical supporter of the ECB’s recent accommodative policy, would take the role. Germany indicated in August that it will favour the presidency of the European Commission over that of the ECB. In keeping with the long tradition of horse-trading within the EU, a Germany Commission presidency might require a compromise with France, which could then get the presidency of the ECB.

France’s frontrunner is Francois Villeroy de Galhau, the governor of the Bank of France (the central bank), who is expected to continue in the vein of Mr Draghi’s relatively cautious and dovish stance. Other contenders for the top ECB job are Erkki Liikanen, a former governor of the Bank of Finland (the central bank) and Philip Lane, the governor of the Central Bank of Ireland, although neither would be considered a significantly more dovish or hawkish replacement for Mr Draghi.

The personnel changes are, therefore, likely to affect monetary policy only at the margins. Our view is that even a hawkish successor would not want to damage the credibility that the ECB has built up under Mr Draghi in terms of willingness to support a recovery with easy monetary policy. However, political instability in Italy this year has highlighted that the bond and currency markets remain vulnerable to shifts in investor sentiment triggered by problems in the bloc’s weaker members. Mr Draghi’s successor may want to remain vigilant in this respect.
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