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EUROPEAN POLITICAL UPDATE: BEYOND THE NOISE

Berenberg Macro Flash

Let us look beyond the noise. On Sunday night, a potential double-digit result for the right-wing AfD and some losses for chancellor Angela Merkel's centre-right CDU/CSU in the **German election** may make headlines. Also, passions are running high in the bitter standoff between Madrid and Barcelona ahead of the disputed **Catalan independence referendum** on 1 October. However, against the backdrop of a firm economic recovery throughout Europe, the more interesting trends are those in France and Italy: by and large, those who want to break up the EU and leave the euro are losing out to more moderate positions. As a side effect, this makes the Brexiters look even more isolated in Europe, further raising the probability that any Brexit deal between the EU27 and the UK will be done largely on the terms of the much bigger EU27.

On **Germany**, we have little to add to yesterday's [Berenberg guide to the German election](#). Although Merkel could lose a chunk of votes to the AfD according to the latest polls, she looks set to win a fourth term as chancellor, heading either a novel "Jamaica" coalition with the liberal FDP and the Greens (45% probability), a renewed "grand coalition" with the SPD (35%) or – less likely – a two-way alliance with the FDP (15%). In any of these three cases, the impact on European and foreign policy would remain small.

In **Catalonia**, the standoff between Madrid and Barcelona may well get worse ahead of 1 October. But at some point thereafter, both sides will have to strike the obvious deal: more fiscal autonomy and a clear acknowledgement of the distinct nature of Catalonia within Spain. Whatever the short-term irritations, the long-term impact on markets and European politics should remain very limited (see [Catalonia: not all dreams can come true](#)).

In **France**, the ultra-right Front National is in disarray after party boss Marine Le Pen booted out her deputy Florian Philippot. As Le Pen's closest advisor until recently, Philippot had stood for two things: a clear commitment to leaving the euro and the "detoxification" of the Front National brand. Le Pen has drawn the consequences from the fact that the "no" to the euro cost her votes in the elections earlier this year. Even many disgruntled French who are nostalgic for supposed certainties and glories of the past do not want their income and assets to be converted from a strong euro into a much softer new national currency. With the dismissal of Philippot, Le Pen is backing away from the anti-euro line in order to steer the Front National back to its old core message: we don't like foreigners. However, such xenophobia could undo some of the "detoxification" of the Front National brand which Philippot had engineered. If so, this could confine the Front National to some extent back to the fringe from where it had come.

Separately and probably more importantly, the French government looks set to approve the **labour market reform** decrees today. By French standards, the protest against the [significant reform](#) have been fairly muted so far. President Emmanuel Macron has lost popularity, but mostly for the right reason: he is not shying away from controversial but necessary reforms.

In **Italy**, the major parties of the centre-right (Forza Italia) and right (Lega Nord, Fratelli d'Italia) are jockeying for positions in a potential alliance of their groups for the national election to be held between March and early May 2018. As his opening gambit, Forza Italia founder Silvio Berlusconi has returned to a pro-EU position and claimed the right for himself to name the potential prime minister if such an alliance wins the election. As Berlusconi is still barred by the courts from assuming public office, his preferred candidate to



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lead Italy in his stead is Antonio Tajani, the current president of the European parliament. That does not look like the first move in a game that could eject Italy from the euro. Unsurprisingly, Lega Nord leader Matteo Salvini would like to govern instead, claiming that whichever part of a potential centre-right/right alliance gets the most popular votes should nominate the prime minister. In any case, if the Lega Nord really renews the old alliance with Forza Italia, which had once brought Berlusconi to power, leaving the euro would very likely not be on their joint agenda.

Also heeding the lesson from Le Pen's lost elections in France, Italy's radical **5 Stars** are moving away from their earlier demand for a referendum on euro membership. Luigi Di Maio, who had relegated the euro referendum to "Plan B" back in June already, is widely expected to have won the internal ballot as to who will lead the 5 Stars into the election. The result of the internal ballot held yesterday will be announced at the 5 Star's annual meeting on Saturday.

Opinion polls suggest that the outcome of the **Italian election** next spring could be messy. The centre-left Democrats of prime minister Paolo Gentiloni and his ambitious predecessor Matteo Renzi are neck and neck with the 5 Stars at roughly 27.5% each, well ahead of the Lega Nord (14.4%, Forza Italia (13.3%) and Fratelli d'Italia (4.7%). Even in a three-way alliance, the parties of the centre-right/right with a combined 32.4% would fall far short of a majority. Italian politics could be somewhat noisy next year. That would not be unusual for the country, though. It may not even damage the ongoing recovery very much. Fortunately, the ultimate and potentially highly damaging tail risk, that of euro exit, seems to have receded even further.

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