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EUROPEAN POLITICAL UPDATE: BREXIT, POPULISM AND OTHER RISKS

Berenberg Macro Flash

Although the migrant crisis is receding from the headlines as the flow of migrants from Turkey into Greece has slowed to daily trickle of around 100 from a peak of 7000 last October, political risks continue to loom large in Europe. Rampant populism and potential policy mistakes may still jeopardise the cohesion of Europe that underpins the region's prosperity.

UK: HOPING FOR OBAMA?

The top concern remains the disruptive Brexit risk, which we continue to put at 35%. Despite the easing of the migrant crisis, the small lead of 2-3 points for the "in" campaign in opinion polls (average of online and phone polls) evaporated last week after prime minister Cameron's hesitation about revealing details of his finances in the wake of the "Panama papers" scandal hurt the credibility of the foremost campaigner for staying in the EU. Of course, such knee-jerk fluctuations in polls may be short-lived unless the scandal worsens. Also, US president Obama, who seems to be more popular in Europe than the US, is expected to remind Britons during his brief visit to London late this week that the US clearly prefers the UK to stay in the EU. Kallum Pickering will send out a more detailed comment shortly.

SPAIN: LAST ATTEMPT TO AVOID REPEAT ELECTIONS

In a last ditch attempt to avoid new elections, Spain's king will formally consult with the leaders of all major political parties on 25-26 April. If no new government can be formed by 2 May, new elections will be held on 26 June. Last December, prime minister Rajoy's conservatives had won more seats that any other party. However, he had fallen short of a majority for his party or a pro-reform coalition between conservatives and liberals. A potential alliance between socialists, liberals and the radical left Podemos could not be formed partly because the socialists and liberals oppose Catalan independence whereas Podemos wants to grant Catalonia an independence referendum.

According to opinion polls, a new election would replicate the current stalemate. Rajoy's party would remain the strongest force with around 29%, ahead of the Socialists (21%), Podemos (20%) and the Liberals (16%). If so, neither a potential conservative-liberal nor a somewhat unlikely left-left coalition of Socialists and Podemos would have a majority of seats.

Sometimes, the best service a seasoned policy maker can do for his country is to step aside. Rajoy has done an admirable job as a reformer. Unfortunately, no other party wants to form a coalition with Rajoy who is seen as tainted by allegations of sleaze against former prominent political friends. That his industry minister Soria had to resign last week in the wake of the Panama papers scandal has not made his situation easier. If Rajoy were to step aside in favour of his deputy, Maria Soraya Saenz de Santamaria, chances would improve that the socialists could enter a grand coalition with the conservatives. Such a coalition would probably keep Spain broadly on the right track despite some potential reform reversals which the socialists would probably demand.

Our best bet remains that Spain's political stalemate will eventually be resolved by a broad coalition of mainstream parties led by a new conservative leader. Unfortunately, it may take additional months of uncertainty and new elections on 26 June until we get there. Fortunately, the risk of a Greek-style political accident looks small. Spain continues to benefit from the Rajoy reforms. While growth will likely slow down from 3.2% last year to around 2.5% by the end of this year, Spain looks set to outperform most other major developed countries in the absence of a major reform reversal. For the time being, Europe will probably have to tolerate a Spanish deficit overshoot.

ITALY: RENZI STILL AHEAD

Prime minister Renzi remains an ardent reformer. However, he is now paying the price for not having tackled the non-performing loans in Italy's banking system before the unpopular "bail in" rules came into force early this year. The political desire to avoid bail ins, which would hurt many Italian savers, now complicates the restructuring of the banking system. Still, the real news is not that Italy has a problem with part of its banking system. The real news is that it is finally doing something about this legacy issue.

Despite the wear and tear of office, Renzi remains broadly popular. In political terms, Italy's major problem is that – since the demise of Berlusconi – it has no strong centre right. That leaves a political vacuum for more radical forces to expand into and makes it even more important that Renzi stays in power until a credible alternative has come to the fore. As the current parliamentary term runs until May 2018, Italian politics are not one of our top concerns for the time being. Still, we need to keep an eye on the referendum in October 2016 about the de facto abolition of the upper house (Senate) which Renzi has already pushed through parliament. Around 65% of Italians back that move according to opinion polls. But as Renzi had suggested in January that he may resign if he does not win that referendum, we need to watch for potential signs of broader discontent in Italy. The country may become the new focus of migration issues in Europe as the number of people crossing over from Libya is rising. As to the standing of political parties, most recent opinion polls still give Renzi's centre-left the edge with 32% ahead of the ultra-left "5 star" movement with 27% and the ultra-right with 14%.

FRANCE: REFORMERS ARE POPULAR, REFORMS ARE NOT

Beyond the immediate Brexit risk, the political outlook for France remains our biggest long-term concern in Europe. Jointly with Germany, France is the indispensable cornerstone of the EU. Because of a lack of sufficiently ambitious reforms, French unemployment is bucking the positive trend elsewhere in the Eurozone, remaining virtually stable around 10.3%. While president Hollande started the year with a proposal for a potentially significant labour market reform, he has already watered it down in the face of the usual street protests. He looks set to make further amendments before a min-reform may finally become law. Measures granting slightly more leeway for companies or industrial sectors to strike flexible deals with their own workers instead of being bound by national agreements with national trade unions would still be useful. But they will probably fall far short of what is required. We will have to wait until after the April/May 2017 presidential elections to see whether or not France can finally follow the reform example of Germany (2003-2004), Spain (2011-2013) and Italy (2015).

One year ahead of the presidential elections, the political situation is marked by a sharp contrast. Support for the radical right Front National is stable just below 30% while mostly left-wing protesters manage to block real reforms through street protests. However, sensible reformers from the centre-left (prime minister Valls and economics minister Macron) and from the centre-right (ex prime minister Juppe) are among the most popular politicians in France. Macron has just taken the initiative to establish a new pro-reform movement meant to appeal to a broad spectrum from the centre left to liberals and parts of the centre right. The movement could be a potential springboard for a presidential bid in 2017.

As in the case of Spain's Rajoy, the current crop of mainstream party leaders seems to be part of the problem in France. President Hollande and ex-president Sarkozy score badly in opinion polls. If they were to let

Macron or Valls on the centre left and Juppe on the centre right run for president in 2017, the already fairly slim chances of the Front National's Le Pen to win would be diminished much further. Also, the radical right may under such circumstances fare badly at the subsequent elections for parliament. That would make it easier for a moderate government to push through key reforms. Hollande apparently wants to wait until the end of this year to make up his mind. Sarkozy's Republican party will hold primary elections on 20 and 27 November 2016 to select the candidate for 2017.

PORTUGAL AND GREECE: NOISE AT THE FRINGE?

Greece remains a headache for Europe. As the country has implemented only some 20% of what it signed up to in its new bailout deal last August, the current review of its progress is pretty difficult. That creates a significant risk of a noisy confrontation with creditors either in May or shortly after the Brexit referendum of 23 June. We will send out a separate analysis of the issues shortly. However, we expect the ECB's contagion controls to work as effectively as they did last summer in case Greece becomes a trouble spot again. Also, with top trouble maker Varoufakis gone and Greece's pro-reform opposition ahead in opinion polls, the risk that a conflict could culminate in a Grexit rather than a political improvement in Greece looks small. In the big picture, the real worry may be whether or not any Greek noise could make bad headlines right ahead of the Brexit referendum.

Following serious reform reversals by the new left-wing government in Lisbon, **Portugal** remains one debt downgrade away from potential trouble. The ECB includes Portuguese debt in its asset purchases as long as the last of the four ECB-recognised rating agencies, DBRS, maintains its BBB investment grade rating for Portugal. In February, DBRS had re-affirmed that rating with a stable outlook but with a warning that a rise in bond yields could put this at jeopardy. DBRS is due to review the rating on 29 April. Portuguese 10year yields at 3% are below the 3.4% average of February. We thus do not expect a downgrade. Still, the margin for error for Portugal's government is very narrow, to put it mildly. In case of a new crisis, unlikely but not impossible, we would expect Portugal to reverse some of the recent reform reversals as a precondition for an ESM credit line to keep the country safely in the euro.

GERMANY: MOSTLY CALM

As the inflow of migrants has largely ceased for the time being and Germany is throwing serious money at integrating those refugees that have come so far, the political situation looks mostly calm. Of course, managing the relationship with Turkey's prickly Erdogan is proving to be tricky. However, unease about ECB policies is spreading. German conservatives have always been strong stalwarts of price stability and an independent central bank. Now they seem to be deeply unhappy about getting exactly this, namely price stability and an independent central bank that sticks to its inflation mandate instead of heeding calls to guarantee German savers or French workers a risk-free income. We will analyse this special German conundrum in a separate message shortly.

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