POLITICS

Political Fragmentation Rising in Europe

Look for Uncertainty to be a Major Trend

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Last year, we looked ahead to 2016 as a transitional year in Europe. Since then, the United Kingdom's (UK) vote to leave the European Union (EU), the rising terrorist threat and the bloc's ever-more complex relationship with Turkey have rocked markets. In 2017, if France, Germany and the Netherlands go to the polls they might be joined by Italy. While decision-makers in Westminster, Brussels, and major European capitals are still trying to find a strategy towards the UK referendum result of Brexit, the worst in terms of growing political fragmentation might, in fact, still be ahead.

In all the founding EU member states' elections in 2017, populist forces of the radical right – and at times also of the radical left – will perform well. As shocking as the UK's decision has been to leave the EU, the growth of Euroscepticism at the continental heart of the European project adds a new dimension to the problem of rising political fragmentation.

What is behind these trends? What results will they have in the political space? And what does this mean for investors and CEOs? As always with politics in Europe, the consequences are far less straightforward than news headlines might lead us to expect.

Driving Forces: Inequality

Broadly, there are two ways to look at the surge of populist parties across developed democracies. The first assumes economic voting. The most important factor in this context is the uneven distribution of the welfare gains that have undoubtedly been associated with globalization ever since the collapse of the Soviet Union in 1991.

Whether in debates about the infamous top one or 0.1 percent, or about the rise of hundreds of millions of Chinese citizens out of extreme poverty, it is evident that globalization has enormously increased overall wealth in the last quarter of a century – but also that inequality has grown dramatically.

The need to accommodate the "losers" to ensure that globalization can advance further has been a standard component in the work of trade theorists for a long time. However, as the rise of populist forces moves economic inequality into the center of the political debate, it seems that too many decision-makers are still struggling with a seeming contradiction: economists rightly tell us that greater openness has been tremendously favorable to overall wealth creation – so why is it that rational voters suddenly turn against it?

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In other words, coming out of 2016 and going into a year of likely unprecedented levels of political fragmentation in Europe, it turns out that the politics of the last 25 years have been remarkably successful at opening up global channels of economic exchange. However, they have largely failed to take inequality seriously as a major risk – and they are still struggling to catch up.

Needless to say, the global economic crisis and the uneven distribution of the cost of economic adjustment in the Eurozone have only made things worse. The North European liberalization wave of the early 2000's first put the burden of change mainly on low-income voters – consider the Schroeder reforms in Germany, the so-called polder model, that of consensus-based decision-making, in the Netherlands, and various versions of "flexicurity" (a welfare state with a pro-active labor market policy) in Scandinavia. Once the resulting imbalances fed into the euro crisis, it has almost exclusively been the wider European South which has been forced into politically toxic attempts at structural reform – as seen with Greece, Portugal, and Spain (as well as Ireland), but, going into 2017, be sure to also remember Italy and, eventually, France.

...and Identities

Things do not become any easier if taking into account the second perspective of viewing the rising populist tide: the cultural dimension. Not that policy-makers would have been particularly good at addressing – or even at being especially alert to – the distributional challenges associated with the overall success story that has been globalization. The case of the rising tide of identity politics, however, is even more complicated as it is difficult to address via standard political strategies which remain primarily based on the allocation of fiscal resources.

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It would be a mistake to see resistance to globalization on cultural grounds as merely a function of growing economic inequality. In Europe, the new era of economic openness would have been unthinkable without the world's by far most successful integration project, the EU's single market, since 1988. However, as has become overtly clear in the British referendum, and as will be hotly debated in the French, German, and Dutch elections in 2017, part and parcel of the lifting of borders for goods, services, and capital has been the scrapping of restrictions on the movement of people ¬– the EU's famous four freedoms.

Already in the 1990's this broad liberalization project went hand in hand with a surge in the vote for parties of the radical right across Europe, from Joerg Haider's Freedom Party (FPO) in Austria to Pim Fortuyn's list in the Netherlands, and National Front (FN) leader Marine Le Pen's father, Jean Marie in France. A new scale of labor mobility since the accession of the East European member states around the turn of the century drove yet another backlash against the political establishment across Western Europe, including in the UK.

With the noteworthy exception of the Swiss People's Party (SVP), the economic message of these parties has evolved along the way, from the initial advocacy of market-liberal policies to a broad preference for protectionist measures today. The cultural component of identity politics has, however, remained remarkably stable. It usually trumps economic concerns, as seen not only in the Brexit vote, but also in the 2014 Swiss decision to put EU market access at risk for the sake of limiting immigration, or Geert Wilders' Freedom Party (PVV)'s continuous flirt with a Dutch "Nexit" from the EU.

Key aspects of the populist surge such as fear of immigration may be more than just a function of the economic decline of large parts of the old lower middle classes in rich democracies. The standoff between the West European winners and losers of the last three decades of liberalization may go far beyond monetary questions. Instead, it touches upon the very core of what globalization is about.

The cultural diversity that comes along with enhanced global mobility and the decreasing importance of traditional representational arenas, such as the nation state, are welcomed by a new generation of winners. These gains, however, seem distant and, in fact, often undesirable to many missing an old sense of belonging, identity, and the ability to communicate in their own – often only – language, while also fearing new and direct threats such as continued, large-scale terrorist attacks at the heart of West European cities. The promise of more rational decision-making on the European level is broadly welcomed at the political center, but on large parts of the fringes, it is deeply detested.

Is the new nationalism really that bad? Regional independence projects that will continue to create noise in 2017 – Catalonia's drive for independence and the renewed push for Scottish self-determination in the context of Brexit – are often invoked as examples of a more benign version compatible with EU membership, the latter being a goal at the core of the nationalist agenda. Make no mistake, though: as long as viable alternatives are required for these regions' current place in larger political entities such as Spain and the UK, the EU offers a convenient way out. However, in the unlikely event that, for instance, Catalonia would gain independence in the near term, there is little reason to believe that its strong nationalist currents would somehow be more amenable to EU cooperation than the current nationalistic decision-making and priorities complicating EU compromise on vital issues such as the relocation of migrants and refugees.

Channels of Influence

However gloomy the outlook may be, the idea that in 2017 new populist forces driven by growing inequality and new identity politics will take over Europe in sweeping landslides is probably too far-fetched. Instead, influencing channels will remain rather indirect – but by no means less effective.

In the run-up to the 2016 Brexit referendum, a new level of active Euroscepticism took over the backbenches of the UK's center-right Conservative Party, largely in response to the good performance of the UK Independence Party (UKIP) in the previous general election. This reaction came even in spite of the fact that the strictly majoritarian electoral system rewarded some five million UKIP votes with exactly one MP in Westminster.

Comparable patterns should be expected elsewhere in Europe in 2017. In France, Germany, and the Netherlands, it remains unlikely that the populists will become part of the government. Still, their presence will further limit coalition options at the political center, thereby at times complicating government formation and curtailing mainstream parties' room for maneuver.

Come summer 2017, France's next president – a centrist – will likely have won in a second-round run-off against Marine Le Pen. This will serve as a reminder to tread very carefully in Europe throughout his entire term in office. Finding majorities for large-scale economic reform at the national assembly (to be elected shortly after the president) will remain a formidable task in any case, not least because the French center-right is by no means less statist in economic orientation than the currently ruling socialists.

For the master tactician Chancellor Angela Merkel in Germany, the rise of the anti-bail out and anti-migrant Alternative for Germany (AfD) may turn out to be helpful in strategic terms: political fragmentation will be much higher after the September 2017 Bundestag elections, which may force the suffering Social Democrats (SPD) into yet another grand coalition with her. The idea that Berlin may take a fundamentally more lenient stance towards its Southern Eurozone partners once the elections have passed is, however, elusive.

The outside threat of the AFD pulls Merkel into the direction of incremental inter-governmentalism and austerity, a path in direct opposition to the policies that would be required to address growing populist dissent in Southern Europe: consider Greece, which remains prone to hiccups with every bail-out review; and in France. In the North, Merkel is not alone: in the Netherlands, her colleague Mark Rutte will likely be able to form a center-right coalition looking much like a Dutch government from the 1990's. However, the largest party in parliament will likely be Wilders' PVV, posing a very real constraint for Dutch cooperation in the Eurozone and in Brexit talks.

Meanwhile, whether or not elections will be held in Italy in 2017 remains an open question. More precisely, whether they could be triggered by Prime Minister Matteo Renzi or a care-taker government, and if so, under which electoral system. The largely unpredictable mess that is Italian politics will continue to allow only one way forward – that is with small steps to address problems in the moment they arise. A case in point is the lender-by-lender approach to the fundamental problems of the banking sector. As elsewhere in Europe, the presence of the populist Five Star Movement (M5S) will constrain reformist forces – regardless of the electoral system.

So What?

From the perspective of business, things would potentially be easier if a populist surge would immediately force the newcomers into political responsibility. We have seen after the Brexit vote how the strongest backers of leaving the EU quickly retreated in light of the impossible challenge they had brought upon their nation; in a North European country like Finland, support for the populist Finns Party (previously, “True Finns”) has dwindled ever since they became part of the government and had to back difficult compromises over bailing out Greece and handling the migration crisis.

But the rising tide of political fragmentation that is ahead in 2017 is a much more complicated phenomenon. For investors and companies, the main risk associated with this trend is therefore likely uncertainty.

The Brexit negotiations will probably have a slow start, and it is all but clear that they will be concluded within the expected two-year timeframe. To fully establish a new trade relationship could take closer to a decade. In an ironic twist, the initial UK response to Brexit looked much like policy-making in the Eurozone (much-criticized in Britain): in the absence of any political contingency planning, the heavy lifting was down to the Bank of England.

Going into 2017, the British government will begin to be confronted politically with highly charged domestic stand-offs: which sector is going to pay the economic cost for limiting immigration, how high of a price is acceptable, and how to counter the ensuing economic slowdown? Uncertainty over the timing and shape and size of fiscal expansion will move to the forefront, posing a first major test for Prime Minister Theresa May and her Chancellor Philip Hammond – all against an uncertain political backdrop of extreme polarization, pitting the old against the young, Scotland versus England, manufacturing against financial services, and London versus the rest of the country.

The Eurozone is already one step ahead: political fragmentation eventually forced Mario Draghi's European Central Bank to come to the rescue, but the resulting, decreasing levels of market pressure, coupled with an even cloudier political outlook, have only worsened the problem of political inaction. Draghi will extend and expand his bond-buying activities, but the power of central banks is clearly reaching its limit as long as politicians cannot do their part to stimulate growth.

Fiscal expansion, meanwhile, remains an unrealistic dream in the markets. True, 2016 saw Portugal and Spain get away with another round of blatant breaches of European deficit rules. But the slow death of the Stability and Growth Pact is one thing – a coherent plan marrying structural reform in the South to a more expansionary stance in the North would be quite another.

No example serves better to drive home the main point: going into a year of unprecedented levels of political fragmentation, the main risks for business in Europe are inaction, incrementalism, and overall lack of policy coherence. In 2017, uncertainty remains the only certainty.