



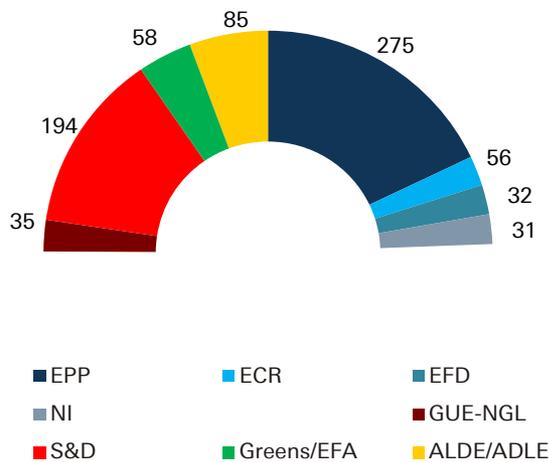
A grand coalition for Europe but eurosceptics increase political noise

- **Conservatives take the lead as strongest political group in the EP despite significant losses.** The social democrats came in second followed by the liberals and the left. The elections will be followed by tough bargaining between the parties and their prospective political groups which might still lead to a shift in the distribution of seats over the next weeks. The lead of the conservatives appears comfortable enough, though, to give its candidate Jean-Claude Juncker a strong position in the negotiations for the next Commission president.
- **Another grand coalition for Europe. Only the involvement of the two large political groups will allow majority ruling in the EP.** Such a de-facto grand coalition was well proven already in the last term and reflects political relations in some member states. However, it has supported and will support the emergence of fringe populist parties.
- **The eurosceptic parties increased their share substantially but winning parliamentary representation is not equivalent to gaining actual political influence.** Given their fragmentation and lack of common political narratives, their extent of influence should remain limited even if a new political group should be formed under the French far-right.
- **A risk of less-business-friendly majorities cannot be ruled out.** With the relative loss of the conservatives and the liberal forces, market-friendly orientation in some dossiers could come under pressure. In terms of banking and financial market regulation, it is good news that the conservatives remained the largest political party as there are various regulations in the pipeline that will influence the scope of action of the financial sector.
- **Repercussions on national level likely to weaken consolidation efforts and structural reforms.** The improved showing of the populist parties will affect national-level politics and, in turn, the position of governments towards Brussels. Where established parties have the most at stake and populist parties consolidated their positions, domestic tensions are likely to increase.



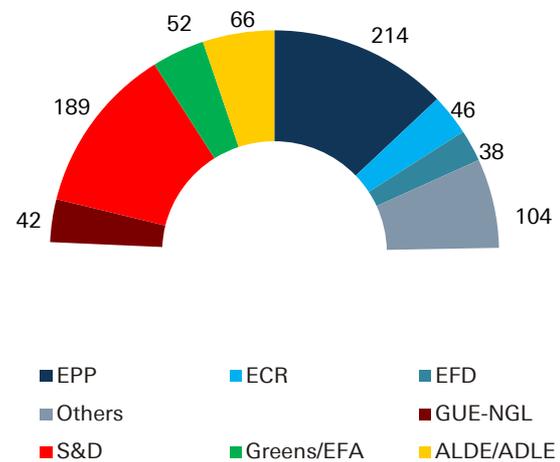
The preliminary results show the conservative EPP winning over the social democratic S&D with a lead of 25 seats (214 vs 189). The conservatives suffered a loss of around 20% of their share compared to 2009, though. The Liberals came in as the third-strongest political group followed by the Greens. The elections will be followed by tough bargaining between parties and their prospective political groups. Picking up a few MEPs from other groups or incorporating non-affiliated ones will be vital to determine the final political groups' distribution in the new parliament. The lead of the EPP should be big enough to not threaten its position as the largest political group in the EP. This also gives their candidate Jean-Claude Juncker a strong position in the negotiations on the new president for the European Commission – but it is not yet a certainty.

Figure 1: Seats in the European Parliament 2009-2014



Source: European Parliament

Figure 2: Projection of seats for 2014-2019

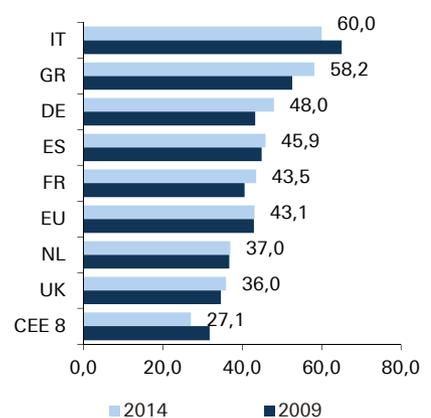


Source: European Parliament

Another grand coalition for Europe. The new majority dynamics will not allow decision-making without involvement of the two large groups, the conservatives and the social democrats, in the EP. Such a de facto grand coalition has been well proven in the last term with the two parties collaborating in 70% of the roll-call votes in the parliament. It should prevent gridlock resulting from a more fragmented and more polarised assembly. It also follows a "centrist convergence" in politics that can be observed in some EU member states with a broad consensus on fiscal and economic issues and social welfare. However, it does not help the EP to broaden its legitimacy as a forum for competitive political debate and supports the emergence of fringe populist parties.

The estimated average voter turnout of 43.1% is more or less unchanged compared to 2009. This dashes the hopes of the EP to obtain greater legitimacy through the new electoral procedure, i.e. to present lead candidates for the political families who should stand for next Commission president. It will not help the EP to strengthen its role in the European institutional triangle of Commission, Council and EP. On a member-states basis, though, voter turnout has been higher in a number of countries such as Germany, France, Greece and UK (see chart). This can be traced to a higher mobilization of populist parties – a development that is contrary to widespread expectations that populist parties would profit most from a low voter turnout.

Figure 3: Average turnout unchanged but large variation



Source: European Parliament



Eurosceptics: Stronger representation does not mean gaining political influence

The eurosceptic parties substantially increased their share in seats compared to the 2009 elections. Depending on the definition, they achieved around 20% across all political camps but remained at the lower end of pre-election polls. Most populist parties could successfully position themselves with particularistic opinions along national EU sceptic narratives and clear-cut counter-positions against their national governments. This holds true for Finland where the Finns Party scored 13% of the votes (+3.4pp) but slightly below recent polls, and Denmark where the right-wing populist Danish People's Party (DPP) became the strongest political power. In Austria the right-wing populist FPÖ could increase their share of votes to 19.5% (+6.9pp) and became the third-strongest power right behind the conservative ÖVP (27.3%) and the social democrat SPÖ (23.8%). Detailed country analysis of selected EU member states can be found below.

The political implications of the recent gains of populist parties will mainly derive from three major factors. (i) **National feedback effects.** The strong results of populist forces in some countries could lead to feedback effects on national political attitudes (see below). Thus, they can be expected to use speeches in the plenary primarily to raise their profile in their home country which will have repercussions on the national level. In respect of future intergovernmental negotiating rounds – say on an overhaul of the ESM or EU treaties – this could weigh on collaboration which, to date, has been pragmatic and geared to finding a consensus. Even if the danger of a full blockade is unrealistic, there is certainly a risk that special interests could lead to extensive opt-out clauses, delays in the negotiations and thus to inconsistent negotiating results. (ii) **Successful formation of a political group.** In the EP, creation of a political group needs a quorum of least 25 MEPs from 7 countries. It remains to be seen whether the right-wing French Front National will be able to unite parties from six other countries. Both UKIP and the German AfD have already declared that they would not see any possibility of cooperating with a potential new right-wing formation. Also, it remains to be seen what will be the future of the current eurosceptic political groups European Conservatives and Reformers (ECR, including inter alia Forza Italia) and Europe of Freedom and Democracy (EFD, including inter alia Danish People's Party, UKIP and the Finns Party). If some of their member parties should decide to join the group around the Front National, both ECR and EFD could fall below their quorum. (iii) **Degree of unity in policy positions.** Given their fragmentation and lack of common political narratives, the low consensus in the political group and weak party discipline, influence in the decision-making process and the scope of legislation is likely to be limited, though.

Policy impact will differ on topics and domestic situation

Risk of less-business-friendly majorities. With the relative losses of the conservatives and liberal forces and the stronger influence of the social democrats and left-wing parties, market-friendly orientation in some dossiers could come under pressure. Trade agreements under negotiation, such as the T-TIP between the EU and US, are a case in point.

Concerning banking and financial market regulation the conservative EPP, though the strongest political group, will - also due to slight losses of the Liberals - most likely need to make more concessions to the socialists and social democrats in the S&D. These have so far been in favour of more far-reaching regulation of the financial sector. There are various regulations still in the pipeline in the EP that aim to change the scope and rules of action of the



financial sector, eg. on shadow banking, benchmarks and payment services. Another major file under discussion is the Liikanen proposal on bank structure reform tabled by the European Commission in January. Traditionally, the largest political group can pick the dossiers in line with a "point system" so that the EPP could claim the rapporteur for the files they want to make a priority. However, with a smaller EPP group in the next EP, they can be expected to have to make further concessions to the other groups, in particular the S&D. After more than 40 legislative dossiers on the financial sector in the last legislation period, in general a shift is likely to be seen from the regulatory agenda to its implementation, reviews due built into them and a stronger focus on measures to promote growth and investment in Europe. Composition of the ECON Committee is expected to be known in the second half of July while clarity on the Commissioner for Single Market/Financial Services will depend on the speed of negotiations between the European Council and the EP on the President of the Commission and approval of the full Commission by the EP (base case assumption for the latter is October 2014 but could slip in case of a 'power game' between European Council and EP).

[The increase of populist votes will fuel the debate on a potential competence review of the European Union which is already on the political agenda of the next legislative period.](#) Established parties which consider themselves as "pro-European" will have to pursue a tightrope act between respecting the constructive criticism from their electorates on the one hand while keeping distance from populist forces on the other hand – in an intergovernmental political and legal environment where fast and pragmatic decisions cannot be taken.

[Repercussions on a national level are likely to weaken consolidation efforts and structural reforms. The improved showing of populist parties will affect national-level politics and, in turn, the position of governments towards Brussels.](#) Where mainstream parties have the most at stake and populist parties consolidated their positions in Italy or Greece and - above all – France, domestic tensions are likely to increase. Reform processes already under way or envisaged will be put into question, structural reforms and consolidation probably delayed. Election results in France will likely prevent constructive work on the euro area's institutional framework. Given that UKIP is the strongest party in the UK, relations between the UK and its EU partners are likely to become even more difficult.

Election outcome in selected EU states

[Germany: Continued support for the governing grand coalition](#)

Chancellor Merkel's CDU/CSU came in at 36.3% and became the strongest party but suffered losses – minus 2.6pp compared to the 2009 EP elections and minus 5.2pp compared to the federal elections in 2013 – which are mainly attributable to the Bavarian party wing, CSU. Despite the eurocritical tone in the CSU campaign, the main beneficiary was the anti-Euro party AfD. The SPD scored slightly above expectations (27.3%) and much better than the mere 20% it achieved in 2009. The fact that Martin Schulz is running as the European Social Democrats' candidate for President of the Commission has certainly helped to garner votes especially from left-leaning voters. Schulz's candidacy also might have helped to increase voter turnout compared to 2009 – 48.0% vs. 43.4%. However, the fact that there were also municipal elections in 10 out of 16 Länder may have played an important role as well.

The AfD scored in line with optimistic forecasts and received 7.0% of the votes. [The fact that the AfD could increase its share compared to the last federal elections \(+2.3pp\) appears natural since it is the only party with an agenda](#)



almost exclusively focused on an issue with a European dimension, i.e. the dissolution of the Eurozone in its current composition. The favorable result will improve the AfD's chances of gaining seats in the regional elections in three German Länder later this year. As Germany has 96 seats in the EP, the number of each party's seats is roughly equivalent to its vote share. The CDU/CSU will get 34 seats, the SPD 27, the Greens 11, and both the Left and the AfD 7.

We do not expect a change in Germany's European policy course despite the good showing of the AfD. Chancellor Merkel and Finance Minister Schäuble have recently re-stated that the German government would like to see a further strengthening of eurozone governance including the bilateral reform agreements and some sort of EU finance minister. The government also supports a review of the balance of powers between the EU institutions and the member states – though rather limited in scope and far from what is being discussed in the UK, for example. The good performance of the SPD might support their position to push for a more growth-oriented policy in the EU.

France: Far-right victory and poor performance of Hollande's socialists

In France, it is not a surprise that the far-right, anti-European National Front came out first at 25% – but the magnitude of the spread relative to the centre-right (5pp) and even more importantly the ruling socialist party (10pp) exceeded expectations, in spite of slightly higher electoral participation (normally impairing extremist parties). The National Front vote, confirming the results of the recent local elections, is entrenched and spreading to traditionally moderate regions. It would be wrong to see this as a mere "bad mood", knee jerk reaction to a disappointing economic situation. The traditional government parties (UMP, socialists, centrists) taken together controlled only 45% of the votes. For the socialists, this vote suggests that reformist PM Valls' personal popularity is not translating into votes. The National Front is calling for snap general elections. This is unlikely to occur, in our view. Given the extreme weakness of the socialist party and the divisions of the centre-right, the National Front is likely to remain isolated on that particular issue, and we therefore expect only limited immediate consequences for national politics.

The traditional parties - particularly the socialists - are likely to seek to deflect attention on domestic issues to focus on the "responsibilities" of Europe in the emergence of extremist parties. We think Hollande will use the far-right vote to argue in favour of a relaxation of the deficit-busting macroeconomic governance of Europe - in line with the recent rhetoric of the French government in favour of forceful ECB action to curb euro appreciation. On substance, we think Hollande is now unwilling, and probably politically unable, given his limited 'personal legitimacy', to deliver on any more meaningful structural reform. From our perspective, today's vote is a reflection of a "stuck" country. The political configuration now emerging will, we believe, lead to further immobilism. (Gilles Moec +44(20)754-52088)

UK: Deepening concern about Europe

In the UK, with almost all results (with the exception of Scotland) declared, the UK Independence Party for the first time in a hundred years ensured that neither Labour nor the Conservatives won the election. It topped the polls with 27.5% of the vote, the Labour (centre-left) opposition coming in second and Conservatives (centre right) third. In coming fourth, the Greens pushed the coalition partner Lib Dems into fifth.

What's interesting is that summing the UKIP and Conservative vote (i.e. parties that are either wanting to leave the EU or proposing a referendum on



membership) amounts to over 50%, highlighting deepening concerns among the British electorate about European political integration.

This result seems unlikely to be replicated in the general election in a year's time (May 7 2015). After all, UKIP does not have a single seat in the House of Commons, partly on account of the first-past-the-post system. Nonetheless, a good showing next May could have important repercussions for the end result depending on which major Westminster parties suffer as a consequence of UKIP's rising popularity. (George Buckley +44(20)754-51372)

Netherlands: Populists suffer a setback

The election results show a clear setback for Geerd Wilders' right-wing populist Freedom Party (PVV) with only fourth place while the liberal-left D66 party could increase its share of votes up to 15.6% (+4.5%) and scored ahead of the Christian Democrats (15.2%). The governing right-wing VVD reached 11.9% (+0.5pp) and its governing social democrat coalition partner PvdA 9.4% (-3pp). However, the next political campaigning phase is in the remote future since the next parliamentary elections are not scheduled until September 2016 and the currently governing coalition of VVD and PvdA is regarded as being stable – despite its narrow majority of 79 out of 150 parliamentary seats. The setback for the populist parties does not mean that public debate in the Netherlands will return to its very pro-European tone of earlier years. Both D66 and Christian Democrats did not hold back their criticism on the current course of political integration in Europe. Apart from that, the Dutch government presented a “subsidiarity review” in June 2013 where it identified a number of policy areas it believes should better be left to member states instead of the European level. While it is very moderate compared to the British ideas, the government seems likely to want to see a follow-up on that after the elections.

Greece: Status quo likely to continue

The Greek European and municipal elections results had something for everyone. The main message is that the current status quo will likely continue: there is enough for the government to claim legitimacy, but not enough to provide certainty that the ruling parties will win come the next election. Similar to other EP election results, the main message seems to be one of protest, but with a desire to maintain stability.

In more detail, the main source of what markets are likely to interpret as a disappointment is SYRIZA's greater-than-expected lead over New Democracy in the European election. Opinion polls indicated a lead of around 3%, versus a (preliminary) lead of close to 4%. In the regional elections, the SYRIZA candidate is also running slightly ahead in the key Attica region, though the race is exceptionally tight. On the positive side, junior ruling partner PASOK has polled around 8% in the EP elections, close to double what was indicated in opinion polls. And government candidates have done much better than SYRIZA in regions and municipalities outside of Athens.

The outcome allows both sides to claim victory: opposition SYRIZA is drawing attention to a “clean win” as Greece's largest party, while the ruling coalition can point to their combined percentages as being well ahead of the opposition. Indeed, in a public address earlier today, PM Samaras called the vote a failure for SYRIZA's divisive politics and pledged to continue the government's work. In sum, nothing major to change Greece's political landscape over the next few months, with the next major political event now not until the February 2015 presidential elections, where the opposition parties can bring forward an early national election should they wish to. Next stop: OSI negotiations to start in September. (George Saravelos +44(20)754-79118)



Ireland: Significant tremors but not an earthquake.

The polls had suggested that Sinn Fein, the anti-austerity left-wing party, would build on the successes of the 2011 general election and increase its share of the vote from 10% to as much as 18%. While not quite as good as the recent opinion polls, Sinn Fein is on course to be the third party behind Fine Gael and Fianna Fail as the Labour Party continues to struggle. The eye-opener was the success of Sinn Fein in middle-class areas of Dublin, the main metropolitan area, though this was not replicated across the country. The success of Sinn Fein and independent candidates characterised this election, but the recuperation of Fianna Fail, significantly damaged after leading the country into the banking crisis, in the local elections where it is emerging as the party with the largest number of seats suggests this was not quite the earthquake election seen in some other countries.

There is talk of a government reshuffle, possibly a leadership challenge in the Labour Party, the junior coalition party. The 2015 Budget will be key to the ability of the Fine Gael-Labour to last the full duration of this legislature to coincide with the centenary of the Easter 1916 Rising, as hoped. Questions about the planned E2bn austerity package in the 2015 budget will escalate. Health spending cuts were a particularly strong point of criticism of the government according to surveys, as was the introduction of water charges. (Mark Wall +44(20)754-52087)

Italy: Large victory for Renzi's PD strengthens the government

Renzi's Democratic Party (PD) is undeniably the sole winner of the elections for the European Parliament in Italy with nearly 41% of the votes. In our view, this result strengthens Renzi's premiership and his government. A reduction of political uncertainty should be seen positively by investors. The results are undeniably disappointing for Grillo's Five Star Movement (5SM), which with 21.2% of the vote was a very distant second. The majority of the opinion polls, before the two-week blackout period ahead of the elections, gave the PD a 5-10pp lead over the 5SM but with a narrowing gap. Indeed, the Italian press suggested that private surveys in the past two weeks pointed to strong momentum for Grillo. Berlusconi's reborn Forza Italia collected only 16.8% of the votes versus its 20% declared target.

The strength of the PD victory appears even more relevant as the 5SM failed to capitalise on potentially favourable events. First, a series of recent alleged corruption scandals of ex-members of centre-left and centre-right could have boosted the 5SM as in February 2013. Second, Renzi campaigned on optimistic rhetoric stating that the government's growth projections were conservative. The Q1 outcome seriously dented the Government projections of 0.8% GDP growth for 2014. Third, Grillo campaigned on an anti-corruption, anti-austerity and euro-skeptic campaign which could have appealed to a country which has experienced no real recovery yet after one of the deepest recessions in the euro-area. However, not all results were undeniably positive for the government: the junior ally New Centre Right (NCD) led by Interior Minister Alfano barely passed the 4% threshold to gain representation at the European parliament with 4.4% of the votes. But at the next national election with a similar result NCD may not pass the threshold envisaged in the PD-Forza Italia proposed new electoral law.

We think the election results (i) strengthen the government and above all Renzi, (ii) increase the likelihood of modest economic reforms but (iii) are more ambiguous for institutional reforms.



Renzi will continue with his double marriage of convenience. First, he will remain in government with Alfano's new centre right, which after a poor electoral performance will be even keener to avoid elections. Second, Renzi will likely continue to push for abandoning the perfect bicameralism via a constitutional reform of the Senate with the volatile help of Berlusconi's Forza Italia. It is not in Renzi's interest to go to early elections without the Senate reform. On the economic front, Renzi needed a convincing victory to strengthen his ability to push through economic reforms. He got it. Indeed, Renzi now should have gained greater control of his party and has obtained ex-post "validation" of his government. That said, we maintain our concern that behind Renzi's headline there may not always be a detailed plan or well-articulated decision-making process on concrete steps to meet objectives.

We continue to expect Renzi to remain in power at least until the Senate reform, which in theory should be approved by end 2015. Elections could take place the following year with the new electoral law for the Lower House only – to be approved in 2014-2015 – which provides a significant advantage to coalitions. If the economy recovers and Renzi delivers meaningful economic reforms, his lead over Grillo should remain. A concrete risk is that Berlusconi could drop his support of Senate reform if he remains a distant third over the next 12-18 months. At that point the current Senate proportional system would become more attractive for him as he would have a better chance of being kingmaker after the next elections. Still, given the large victory, Renzi could try to push reform of the Senate via a simple majority in the parliament to then face a referendum to confirm the necessary Constitutional modification. There is also a marginal chance that the MPs of 5SM react to the relative poor electoral results by softening their strict adherence to Grillo's strategy of ex-ante denial of any compromise with the PD; this would weaken Berlusconi's bargaining power. (Marco Stringa:+44(20)754-74900).

The months ahead

27 May: Consultations on the EP election results. Breakfast meeting of the outgoing EP conference of presidents to discuss EP election results. Also, EU leaders meet for an informal dinner to evaluate election results and provide a mandate for EU President van Rompuy to negotiate with the EP on the nominee for the presidency of the European Commission (EC).

June: Formation of political groups in the EP. The elections will be followed by tough bargaining between parties and their prospective political groups. This will also be the time to see whether a new far-right grouping under the French FN leader Marine Le Pen will be set up. 24 June is the deadline for political groups to submit the list of MEPs. On 26 June the conference of presidents decides on the distribution of the important committee chairs by political group.

26-27 June: European Council. EU leaders could decide on their proposal for EC presidency, though this decision is likely to be part of a package on the appointment for other top jobs on EU level.

July: New EP to start its work. After having elected its own president the EP has scheduled the hearing of the candidate for EC presidency in the EP plenary – provided there has been a nominee by the EU leaders – and on 16 July the vote on the candidate with the absolute majority of MEPs.



Appendix 1

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