As the fog of war dissolves after elections, the contours of a new political equilibrium are emerging across Europe. Against eurosceptic predictions, France is likely to reject populism choosing Emmanuel Macron and voting down Marine Le Pen, as did the Netherlands with Geert Wilders, Spain with Podemos and Austria with Hofer. In a few months, Germany will vote too: Chancellor Merkel's leadership remains stable while pro-European SPD has gained ground.

In February, we wrote that 2017 was going to be a make-or-break year for Europe. Our view remains that the combination of elections in the Netherlands, France and Germany will mark a turning point towards greater integration.

Investors have repriced European risk after the French vote – but we believe there are other consequences of this new political equilibrium, which markets have yet to grasp.

**European leaders have a window of opportunity to strengthen the union, from today until the next economic slowdown.** The global rise in populism as well as the UK’s exit has – ironically for Brexiteers – inspired a sense of urgency and unity across the 27 remaining EU member states and their leaders. And yet the challenges ahead remain many, most importantly to use Europe’s still fragile political capital to bring together divergent economies.

This is how we see the future of Europe and the Eurozone shaping up over the coming quarters:

1. **Europe’s future institutions: the optimal way between federalism and intergovernmentalism.** With a single monetary policy but structurally different economies, the Eurozone has often been described as an economic impossibility. The dilemma is you cannot have a common currency and a one-size-fits-all monetary policy without rebalancing regional economies with fiscal policy and without a banking union to contain deposit outflows in a crisis. The United States government can let Puerto Rico default, but there is no discussion about the island leaving its status of U.S. territory, or going back to its own currency. Not so in Greece, where investors have long argued about a potential exit from the Eurozone, banks have lost deposits despite the ECB’s emergency liquidity assistance (ELA), and there is still no plan for growth. Meanwhile, Greece continues to focus on meeting budget surplus targets and the Greek people struggle with high unemployment.

So far, Europe has been doing it wrong: the lack of a full-faith framework for European institutions to manage crises, recapitalise banks in a member state and even allow that state to restructure its debt has made investors call into question the common currency as a whole. As Emmanuel Macron said, the EU and the Eurozone will not survive long, without further integration. The question is – what is the way forward?
Ahead of us are two different paths for Europe: integration or dis-integration. On the one hand is federalism, which implies sharing sovereignty, economic resources and common public goods like defence, healthcare and infrastructure spending. On the other is pure inter-governmentalism, a reversal to national sovereignty where the EU and Eurozone go back to being a common economic area and nothing more.

Many eurosceptics would argue that without a full-fledged federalist structure as well as transfer mechanism, Europe and the Eurozone are doomed to break up. And a fully federal structure is indeed the most difficult to achieve politically, as it would need bridging different interests across countries. The latest eurosceptic theories argue that the EU will eventually fall into a “variable-geometry” or “multi-speed” union. At the core of these arguments is a substantial flaw: that the only alternatives are either an inflexible union or a breakup.

Like those who argued that a plane with fixed wings couldn’t fly, we believe eurosceptics are likely to be proven wrong over the coming years.

There is a middle ground between federalism and inter-governmentalism, where the necessary flexibility is provided by European institutions and common public goods. Even without becoming a federation, Europe can strengthen its institutions and frameworks to be able to solve economic and military crises, promote growth and investment and ensure a level playing field for economic participants across member states. EU countries do not need to give up sovereignty to a federation, but they can invest in common European public goods, benefiting from the stability and economies of scale that a common system provides.

Some examples of existing European institutions and frameworks include the ECB, the EIB/EIF, the EBA and the ESM, whose €500bn of ammunition remains almost untapped. The ESM has suggested on various occasions that it is ready to take on a larger role, potentially a sort of European Monetary Fund to deal with crises (FT). The existing frameworks include the banking and capital markets union – while banks are now under common supervision and have similar disclosure requirements thanks to the ECB and EBA, they still lack a robust European deposit guarantee scheme. The single resolution framework under the SSM/SRM also remains untested. The capital markets union, which could benefit corporates by increasing bond market funding, remains still in its early stages: securities laws and standards still differ widely across countries, and so does commercial law.

### Gini Index

<table>
<thead>
<tr>
<th>Country</th>
<th>Gini Index</th>
<th>Income ratio of 10% richest/10% poorest</th>
</tr>
</thead>
<tbody>
<tr>
<td>Finland</td>
<td>0.26</td>
<td>5.5</td>
</tr>
<tr>
<td>Austria</td>
<td>0.28</td>
<td>6.8</td>
</tr>
<tr>
<td>Netherlands</td>
<td>0.28</td>
<td>6.7</td>
</tr>
<tr>
<td>Germany</td>
<td>0.29</td>
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</tr>
<tr>
<td>France</td>
<td>0.29</td>
<td>6.9</td>
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<tr>
<td>Ireland</td>
<td>0.31</td>
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<td>Italy</td>
<td>0.33</td>
<td>11.4</td>
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<td>UK</td>
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</tr>
<tr>
<td>US</td>
<td>0.40</td>
<td>18.5</td>
</tr>
</tbody>
</table>

Source: Algebris (UK) Limited, OECD

### The EU’s way forward

**Inter-governmentalism**

- **Trade agreements**
- **Production quotas**
- **Product standards**

**Feasible solutions**

- **Complete Banking Union and Capital Markets Union**
- **European Deposit Guarantee**

**Federalism**

- **European Defence Force**
- **European SAFE Bonds**
- **European fiscal automatic stabilisers**

Source: Algebris (UK) Limited. *Boxes with dotted lines = potential or work in progress*
This does not mean that the road ahead will be easy. Europe needs new institutions too, including a credible plan for investment and infrastructure, and potentially more cooperation on defence to make up for a potential reduction in NATO’s support. But the crucial point that many economists have failed to take into account of is the political willingness and capital invested in the European project. As we argued previously, Europe’s higher taxes and its welfare and education system may have capped corporate profits and GDP growth vs Anglo-American economies over the past decades, yet they’ve also helped to contain inequality: most of the world’s happiest countries are in Europe, despite not making it to the top for GDP. This may also explain why populists have found more fertile ground in the US and the UK vs France or Spain. After being diagnosed a failed project from the start, perhaps it is time to recognise that Europe may be doing something right.

There are several positive consequences stemming from more European integration. Greece will likely move closer to a solution with its creditors. A common front may make the UK’s Brexit negotiations tougher. What will be of Italy – the periphery country with the highest public debt – remains a question mark, but the situation may be better than you think. Finally Mario Draghi at the ECB will have to recognise the progress in political stability and macro data.

2. Greece: we are getting closer to a solution. Greece is often a case in point of euro sceptics to demonstrate the lack of coordination across European countries. Today, one out of two young Greeks is without a job and the country has lost a quarter of nominal GDP since the crisis. The IMF remains largely involved in negotiations despite its wish to withdraw. The Greek experience makes the clear point that an established and pre-approved framework must exist for EU members to be rescued in case of crisis – relieving EU leaders from having to wrangle with their electorates on each decision or tranche of aid. The economic case for unity is, in fact, much stronger than the cost of rescuing members in difficulty: McKinsey estimates €350bn a year in savings from the single market and currency, most of which go to core countries. It is their responsibility to redistribute these gains.

In the case of Greece, the economic size of the problem is small. With a population of 10mn and the GDP size of Milan or Dusseldorf, Greece was always a solvable issue. Today, policymakers are moving towards a solution, with the country outperforming on budget surplus targets and meeting most reform and privatisation objectives. We think the solution will be a debt extension, post German elections. Yet the key remains a plan for growth, and in the future, a framework to allow for a faster resolution of crises.

There are various types of instruments that can help prevent a future painful crisis like the one in Greece. First, European institutions like the ESM should be empowered to rescue member countries. Second, a fiscal mechanism should be active to balance shifts in monetary policy which may not always align with the economy of smaller Eurozone members. For instance, the ECB may hike if core inflation spikes higher in Germany and France even though Greece, Portugal and Malta may be in low inflation. These smaller economies may need fiscal shock absorbers. We have proposed about GDP-linked debt as a potential solution, which could work when coupled with a stronger European investment framework.

3. Brexit: negotiations get tougher for the UK. The irony of the UK leaving the EU is that it may have made the EU stronger, not weaker. Macron’s likely victory in France and a potential Franco-German alliance after German elections could mean a united negotiating front and a weaker bargaining position for the UK. Firstly, a Macron win would be the strongest defeat so far against rising euro scepticism and against Le Pen, who strongly linked herself to Brexit supporters. This would serve as a testament to the people’s belief in an integrated Europe, strengthening the EU’s unity in Brexit negotiations. Secondly, as the most pro-EU candidate in French elections, Macron already made clear his hard stance towards the UK: he vowed to push for an unbreakable “Franco-German position” to defend the collective interests of the EU, with no “caveat or waiver” for the UK. Thirdly, as EU leaders place more attention on
further integration matters after domestic elections, the political costs of appearing soft on Brexit will increase, as that would go against the integration strategy.

As we discussed previously from a game theory perspective, the EU is incentivised to give the UK a bad deal (although not a disastrous one) in order to deter future exiteers. The UK is incentivised to take any deal, as that is better than no deal at all. So far, the EU has stuck to its stance: on 29 April, the 27 EU leaders unanimously agreed to a tough set of negotiation guidelines. The key points are:

- **Unity**: the 27 countries will negotiate with the UK as a unified block with no separate negotiations between individual member states and the UK.
- **A single package**: the four freedoms of the Single Market (goods, services, capital and people) are indivisible, with no cherry picking allowed for the UK.
- **A phased approach**: the EU insists on achieving “sufficient progress” on the withdrawal arrangements before starting negotiations on future trade deals. The withdrawal discussion will focus on UK’s existing financial commitments to the EU, safeguarding EU citizen’s rights and avoiding a “hard” border between the Irish Republic and Northern Ireland.
- **The “divorce bill”**: the UK needs to pay an exit bill to settle its existing financial commitments, including contingent liabilities. The latest estimate of the bill comes to €100bn, up from €60bn suggested earlier by Chief Negotiator for Brexit Michel Barnier.

These guidelines serve as a clear reality check for UK leaders, who believed it was possible to leave without paying an exit bill, wanted to negotiate withdrawal and trade deals concurrently, and hoped to have both control over immigration and new trade deals similar to existing Single Market agreements. In response to the EU’s tough stance so far, PM May has called for a snap election and urged voters to vote for her to strengthen her negotiation position vs Brussels. However, this may again be wishful thinking, as a pro-European Labour MP put it: “the basic principles and terms of the negotiation won’t change, no matter what the election result”.

4. **Italy: will Europe’s economic black sheep wake up?** Our base case is Italian elections will not take place in 2017, absent a clear majority and consistent with previous statements by President Mattarella. Additionally, we think that the several challenges an incoming government would need to address (bank rescues and Alitalia’s bankruptcy) may serve as a deterrent to early elections.

In the coming months, investors may focus on the possibility of protest-party M5S forming a government with the nationalist Northern League, given their shared anti-Euro stance. However, we think M5S’s inability to collaborate effectively with other parties due to their continued position as a protest movement limits the likelihood of them leading an alliance, while Mr Renzi’s recent confirmation to lead the Democratic Party suggests that he may be well prepared to stage a comeback.

While political gridlock and lack of reforms remain the current state of things in the run-up to Italy’s elections, we remain mildly optimistic on progress made by large banks to recapitalise and reduce their volume of non-performing loans. That said, Italy’s public institutions appear still too complacent in applying mutualistic solutions to recapitalise mid-tier banks, without enough focus on improving profitability for the financial system as a whole.

5. **ECB: about to make a (slow) turn.** At the ECB’s latest press conference, President Draghi highlighted that economic data confirmed that the Euro area’s economy was becoming “increasingly solid” and that “downside risks have further diminished”. In our view, the stage is set for the ECB to begin normalising monetary policy as Europe’s political outlook stabilises and macro data continues to improve as shown by recent PMI and unemployment data. We expect the ECB to start this normalisation in June by removing language which says that the Euro area’s growth outlook remains tilted to the downside or removing that interest rates will be at lower levels. Before the end of the year, the ECB could signal shortening the length of the QE programme and potentially begin normalising the deposit rate.
Conclusions: A Turning Point for Europe

1. Europe is at a turning point. Investors have overestimated Eurozone break-up risk for a long time, in our view. Today, a new scenario is opening up: a window of opportunity during which European leaders have the chance to strengthen the union and its institutions. Unlike eurosceptics say, federalism is not the only path available for further integration: there is a middle ground, achievable without member states having to give up their sovereignty. In addition, the potential for a Macron-Merkel Franco-German alliance means also that:

2. Greece is closer to reaching a deal. Greek bonds still yield a lot more than many EM sovereigns, and they remain triple-C rated, which means rating agencies have not incorporated any assumption about creditors’ intention to restructure Greek debt. As discussed earlier we believe this will change and Greece will get a restructuring/extension deal by year-end, as recent headlines suggest.

3. Brexit negotiations will get tougher for the UK. The UK has the weaker hand in negotiations due to the trade and capital inflow dependence of its economy, as we highlighted in the past (The Silver Bullet | Introducing the Brexit Walrus).

4. Italy remains the economic black sheep of Europe, but it isn’t as bad as you think. Italy remains the periphery country with the highest level of debt, burdened by slow productivity and lack of reforms. The current government remains stable yet very slow on streamlining the financial system, modernising the legal system and easing hurdles to investment. While there is no clear majority in current polls, Mr Renzi’s recent confirmation to lead the Democratic Party suggests that the risk of populist parties gaining ground may be overstated. We believe elections are unlikely until 2018.

5. The ECB is likely to have a better look at macro data and change forward guidance. As we wrote earlier in the Financial Times, we believe the ECB should normalise interest rates before reducing QE further. We expect a change in forward guidance before summer, a reduction in QE and some normalisation in deposit rates.

6. Investment views: We started the year with a contrarian investment view, saying that investors were overestimating the risk of populism and tail events in Europe and underestimating the same risks in the US and UK. After five months and almost two elections, Europe is proving to be more resilient to populism than Anglo-American economies, perhaps thanks to its stronger social stability and lower inequality, as we argued earlier. Growth and inflation are also surprising to the upside. This, in our view, will continue to lift European cyclical equities, bond yields and the Euro as well as compressing spreads in credit. While there is less upside left in credit, European corporates continue to manage their balance sheets conservatively, unlike their peers in the US. In the UK, we see further downside for Sterling, Gilts and the consumer sector, as higher inflation and weaker growth squeeze incomes. After so many gyrations, unloved Greek debt may likely offer more value to investors than supposed safe-haven UK Gilts.
Previous articles:

The Algebris View | Investing in the Time of Populism, Fiscal Excesses and the End of QE Infinity, April 20, 2017
The Silver Bullet | Introducing the Brexit Walrus, March 31, 2017
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Additional reading:

Democracy Index 2016: Revenge of the “deplorables”, The Economist Intelligence Unit, 2016
Cœuré, B., Rebalancing in the euro area: are we nearly there yet?, 15 January 2016
European Safe Bonds (ESBies), The euro-nomics group, April 2012
Weizsäcker, J., Delpla, J., The Blue Bond Proposal, Bruegel, 5 May 2010


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