POWERSHIFTS, PANDEMIC AND POPULISM IN EUROPE:

Reflections for Canadian Financial Services

SEPTEMBER 2021

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EXECUTIVE SUMMARY

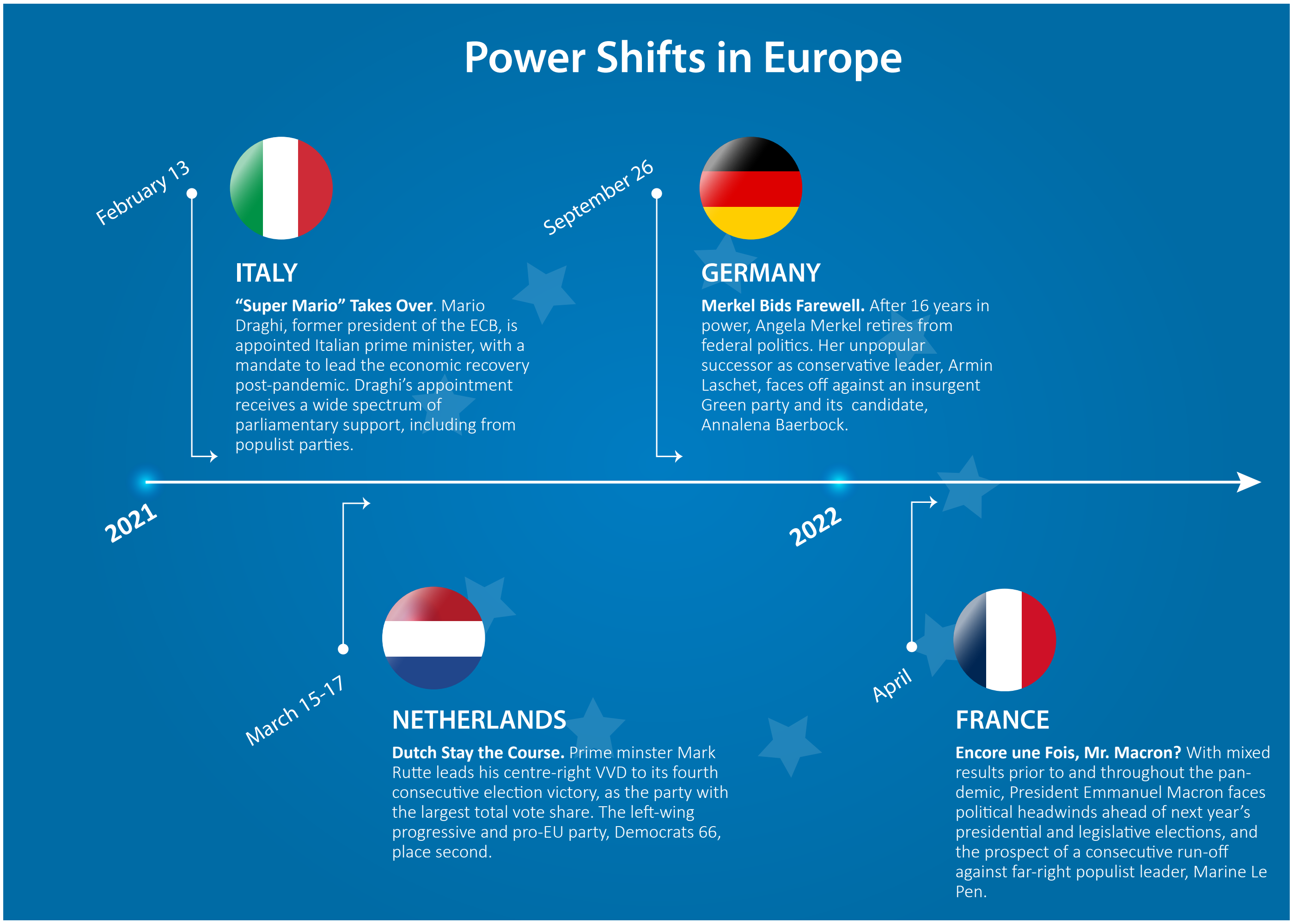
This paper explores recent political changes, or "power shifts", in four of the largest European economies. Over the course of 2021-22, Italy, the Netherlands, Germany and France have hosted or will soon play host to major elections and/or leadership transitions. These countries are all principal architects of continental integration, dating back to the creation of the European Coal and Steel Community in 1952. At times, the four states also reflect conflicting viewpoints in deliberations over political and macroeconomic policy.

Canadian financial institutions (FI) have exposure to the European markets to varying degrees. Power shifts in these markets may have a significant impact given the exposure. After providing a contextual overview of the EU's COVID-19 response, and background on each of the power shifts, this paper outlines three future narrative scenarios which may be used by FIs for risk management planning and assessment purposes. The three scenarios are:

> ***Muddling Through*** — A scenario in which political developments, and the economic recovery from the global pandemic, are uneven and incongruous across the EU. Tensions rise between member-states over the deployment of the European recovery fund. National political changes trend toward the centre-right, or in one case, toward rancorous but ineffective populism. The European project stagnates as the prospects for greater fiscal union dim and financial stability risks increase.

Ever Closer Union — A scenario in which the EU and its member states mount a coordinated and pervasive recovery from the COVID-19 pandemic. The European recovery fund is methodically distributed and powers inclusive economic growth, with a focus on sustainability and digitalization. Early successes in "building back better" help to restore popular faith in both national and European institutions. National politics leans definitively toward an activist centre-left, while populist parties lose ground. Support for European integration improves, with movement toward more permanent joint fiscal arrangements, and the commensurate benefits to financial stability and investment. Supply chain resiliency stops short of outright protectionism.

Fury & Fragmentation — A scenario in which the backlash against neglected economic disparities post-pandemic, and the criteria for the recovery fund, nurture far-right populism in recipient nations. Cooperation in Brussels breaks down and Euroscepticism begins to rise. Voters in some of the largest economies elect nationalist governments that threaten EU solidarity and the single market. In others, centre-right governments grow more fiscally conservative. Attempts at further European integration falter, financial risks increase, and opportunities for new investment narrow. Calls for greater supply chain resiliency impose new protectionist barriers. Yet local political risks to foreign investors are limited by national economic interests.



SECTION 1: EU RESPONSE TO THE GLOBAL PANDEMIC

Public Health

There were marked asymmetries across members states in terms of the reported severity of the pandemic in the first wave. Some states like Germany, Austria and Greece had significantly lower infection and death rates than others, like Italy, Spain and Belgium. As the pandemic entered subsequent waves, however, there was some measure of convergence between previously incongruent countries in terms of the surge in transmission and fatalities. Improved testing regimes could offer some explanation for this shift.[1]

Public health measures were largely determined at the national/subnational rather than supranational level. Per its treaties, the EU plays a secondary role in public health relative to the governments of its constituent states. As set forth in Article 168 of the Consolidated Treaty on the Functioning of the European Union, the EU's role is limited to functions like monitoring, information-sharing, coordination and the setting of standards. A core supranational authority for public health is the European Centre for Disease and Prevention Control (ECDC). This limited institutional architecture may have contributed to a sub-optimal European response in the early days of the outbreak.[2] At one point, in March 2020, states like France and Germany controversially imposed controls on exports of personal protective equipment (PPE) to other countries within the single market.[3] With the development of effective vaccines, the European Commission took over the procurement process from a smaller group of members states – the Inclusive Vaccine Alliance (Germany, France, Italy, Netherlands) – so as to provide inoculations equitably across the EU. Yet, factors like the prioritization of internal solidarity, demands for greater accountability for suppliers and a focus on lower pricing, may have contributed to the EU falling behind in its vaccine rollout when compared to global leaders like the U.S. and U.K. That said, Brussels is set to make up for lost ground in its procurement campaign over the spring and summer of 2021.[4]

Macroeconomic Policy

Monetary: As the principal monetary authority for the 19 members of the currency union, including the five largest EU economies, the European Central Bank (ECB) was a crucial pillar of the macroeconomic policy response to the global pandemic. The ECB's emergency measures focused on interest rate policy, balance sheet activity and banking supervision. The Governing Council continued along the course of ultra-low interest rates that it adopted after the GFC/sovereign debt crisis and sustained through to the onset of the pandemic. The facility on overnight deposits remained at -0.5%, the marginal lending facility at 0.25%, and the main financing operations rate at 0%; the deposit and marginal lending rates define the "corridor" for the overnight lending rate between commercial banks. The ECB opened additional liquidity support in the early days of the crisis. Building upon its existing purchases, the Bank applied additional Quantitative Easing (QE)/Credit Easing (CE) through its €1.85 trillion total Pandemic Emergency Purchase Programme (PEPP). Macroprudential changes included the easing of capital requirements, lending restrictions and other regulatory requirements, and recommendations to freeze (or limit) dividend payments and/or share buybacks.[5]

Fiscal: While national governments serve as the primary fiscal actors, the EU played a major supportive role in the pandemic response given the scale of the crisis. Among the temporary adjustments made to EU regulations and existing funds, Brussels quickly activated the "escape clause" of the Stability and Growth Pact (SGP) which allows national governments to deviate from fiscal rules and increase their deficit spending in an economic crisis. The EU also set forth a temporary framework for state aid measures which allowed governments to provide certain forms of direct support to the private sector that are otherwise prohibited by European treaties. Finalized in May 2020, the EU provided critical financing through three emergency "safety nets" with a total allowance of €540 billion. These schemes offered loans to maintain employment for workers, sustain businesses and directly support member states. By November/December 2020, via negotiations in the European Council, the EU resolved to pass massive additional stimulus with its new seven-year budget and accompanying NextGenerationEU Recovery Fund (NGEU). The €750 billion (2018 prices) NGEU not only provides more loans to member states, but also includes over €300 billion in non-repayable grants under its Resiliency and Recovery Facility (RRF). Key strategic focuses for the initiative include support for the digital and green transitions in the economy. Importantly, the NGEU is funded through common debt issuance, to be fully repaid by the end of 2058.[6]

Largely the product of a Franco-German compromise, the decision on joint debt issuance led to some proclamations that the EU had arrived at its "Hamiltonian Moment." This label references the U.S. federal government's move, as orchestrated by the first Secretary of the Treasury, Alexander Hamilton, to adopt the outstanding debts of the original thirteen states.[7] However, some scholars have rejected the association given that the program fails to provide the "joint and several guarantee" that would characterize full debt mutualization.[8] In order to qualify for the RRF, national governments must submit recovery and resiliency plans for assessment by the European Commission (EC). Yet any member state can also intervene to temporarily block payments to another recipient via an "emergency brake" in cases where that partner significantly deviates from its prescribed targets. The ultimate decisions on compliance remain with the EC. The emergency brake amounted to a compromise after initial calls from the Netherlands for outright veto powers over the spending of other member states. The Dutch proposal was reflective of wider pushback from the so-called "frugal four" (including Sweden, Denmark, Austria) which collectively opposed the size and inclusion of non-repayable grants afforded under the NGEU. In exchange for their consent to the recovery package, the frugal four were also granted larger rebates on their contributions to the EU budget.[9]

The execution of the NGEU requires ratification of a new Own Resources Decision (ORD) by all EU countries per the terms of their respective constitutional processes. These decisions empower Brussels with the authority to finance its budget. Although usually a multi-year process, the ratification of the ORD was expediated in 2020-21 in order to facilitate the prompt roll-out of the NGEU. The new agreement permanently raises the ceiling on financial contributions from national governments, with an additional temporary increase designed specifically to back the recovery fund. It also includes a new EU-wide tax to be levied on non-recyclable plastic waste. As of May 31st, 2021, all 27 member states had approved the ORD, and it went into effect on the 1st of June.[10]

SECTION 2: POWERSHIFTS 2021-22

Italy: "Super Mario" Takes Over

Appointment Date: February 13, 2021

Governance Structure: Italy is a democratic republic. Its bicameral parliament consists of a Chamber of Deputies (lower house) and Senate (upper house). Members in both houses are elected via proportional representation for five-year terms, although a small number of senators are lifetime appointees. The president of the republic serves as head of state. As part of their duties, the president appoints the President of the Council of Ministers, or the "prime minister," who serves as the head of government. Both the PM and the other Council members (together referred to as "the government") must pass a confidence vote in both the House and the Senate within the first 10 days into their appointment. The power transition in February 2021 involved the selection of a new PM and Council of Ministers following the dissolution of the previous government.

Description: The past decade or more has been a disruptive time in Italian politics. The global financial crisis, and following sovereign debt crisis, inflicted sharp economic pain and strained Italy's relationships with EU institutions and fellow member states. Since their peak in 2015, the country's southern coast has also been a primary transit destination for refugee and migration flows. From mid-2018 to early 2021, under the leadership of centrist Prime Minister Giuseppe Conte, coalition governments featured one or both of the anti-establishment Five Star Movement (M5S) and the Far-Right Northern League in co-leadership roles. In early 2020, Italy was the first Western nation to be severely affected by the initial wave of the coronavirus pandemic.[11] In response, Rome oversaw massive emergency spending and economic stimulus. It is also set to benefit greatly from the NGEU recovery package from which it will receive one of the two largest shares of grant funding under the RRF.[12] Over the course of the pandemic's first year, PM Conte did benefit politically from the tendency of voters to "rally around the flag" in a crisis. Yet he was eventually compelled to resign from office in January 2021 after a coalition partner, Matteo Renzi, pulled his party's support from the government in a dispute over the use of the recovery funds.[13]

The successor called upon by President Sergio Mattarella to lead the Council of Ministers is a figure renowned in political and business circles. Mario Draghi accepted the premiership in February 2021, continuing Italy's tradition of technocratic governance at moments of political and economic crisis.[14] Draghi previously served as President of the ECB from 2011 to 2019, during which he oversaw the Eurozone response to the sovereign debt crisis. Draghi's famous pledge to do "whatever it takes" to preserve the single currency made his reputation as a defender of European integration. His leadership of the Eurozone through the crisis also earned him the popular moniker, "Super Mario." As the new PM, Draghi selected a cabinet comprised of technocratic and political appointees. His new government has garnered the support of nearly all parties in the Italian parliament, including the M5S and the Northern League.[15] Draghi also received a positive reception from both Italian voters and financial markets. A clear majority of respondents in a February poll approved of Draghi's appointment. And upon the announcement of his selection, credit spreads between German and Italian 10-year bonds shrunk to their lowest level since 2015.[16]

Draghi has a clear mandate to oversee Italy's recovery and implement the important structural changes upon which receipt of NGEU funding depends. A problematic legal system and a cumbersome business environment have impeded Italian growth. After the failures of successive governments before him, the new PM could finally make real progress on these issues and contribute to stronger European cooperation.[17] But looming political conditions darken the prospects of an economic renaissance and run against hopes for a more lasting boost to the cause of European unity. Parliamentary elections may come earlier than scheduled and cut short Draghi's agenda, or the PM himself may decide to leave office early to run for the Italian presidency.[18] Although the Northern League, led by Matteo Salvini, has lost some support over the past year or more, it is now joined on the far-right by an even more extreme party with neo-fascist origins. The Brothers of Italy (FdI), under Giorgia Meloni, remains hostile, but not opposed to the EU and the single currency. The party also refused to support the new government upon its investiture. The FdI has concurrently gained in the polls so that it and the League together account for just over 40% of voter intention.[19] Combined with the remaining support for the M5S, polling suggests that more than half of Italians remain favorable toward Eurosceptic parties. A new government led by one or more of these parties could be a source of real opposition to Brussels, albeit limited by their interest in maintaining access to EU financial support.[20]

Italy's status as the third largest market elevates its significance relative to other precarious economies in the EU. It will likely remain the primary target of scrutiny for those frugal four countries particularly averse to fiscal deficits and debt mutualization. Member states left unsatisfied with Italy's reforms could pull the emergency brake included in the terms of the NGEU and challenge Rome's fiscal lifeline. The breakdown of the economic recovery process on these terms could not only result from rising Euroscepticism among fiscal hawks elsewhere (see "Netherlands" below), but inspire new resentment toward Brussels within Italy and strengthen populist parties like the Northern League and FdI.

Netherlands: Dutch Stay the Course

Election Dates: March 15-17, 2021

Governance Structure: The Netherlands is a constitutional monarchy, with a King/Queen as head of state and the national parliament or "States-General" as the primary governing body. The States-General comprises both the indirectly-elected "Eerste Kamer" (Senate) and the directly-elected "Tweede Kamer" (House of Representatives). Elections in the Tweede Kamer are conducted every four years through a system of proportional representation. A process of interparty negotiations begins after election day, leading to the formation of a new governing coalition. The March 2021 general election decided the allocation of all seats in the Tweede Kamer, and by extension, the composition of the next government.

Election Result (By vote share):[21]
People's Party for Freedom and Democracy (VVD) – 21.9%
Democrats 66 – 15%
Party for Freedom (PVV) – 10.8%
Christian Democratic Appeal (CDA) – 9.5%
Socialist Party (SP) – 6.0%
Labour Party (PvdA) – 5.7%

Description: Prime Minister Mark Rutte entered his 11th year in office in 2021, as head of three consecutive governing coalitions. With his centre-right People's Party for Freedom and Democracy (VVD), Rutte has garnered a reputation for normality and prudence that has helped to sustain his base of support. With the onset of the global pandemic, the coalition government implemented comprehensive economic measures to protect workers and businesses at home.[22] PM Rutte led the frugal four in resisting the Franco-German proposal for an EU-wide recovery fund compromised of grants to member states and funded through shared debt. Concessions to an emergency brake and larger fiscal rebates eventually brought the Netherlands and its partners onside with Paris and Berlin (refer back to Section 1). The government's poor performance in terms of public health, however, tarnished Dutch self-perceptions of technocratic competence.[23]

Apart from its uneven performance on public health, the ruling coalition also faced a political scandal related to social services in early 2021. The Rutte Government became embroiled in a controversy over a child welfare scheme. Over 20,000 parents were wrongfully accused of fraud when receiving subsidies for private childcare. The administrative debacle disproportionally affected minority communities and left many parents in desperate financial circumstances. In January, Rutte and his cabinet were forced to resign prematurely, ahead of the general election.[24] The welfare scandal, combined with the pandemic failures, could well have sunk the VVD's chances at the ballot box. Yet Rutte and his party managed not only to keep but widen its margin of victory, gaining 0.6% more of the vote share over its 2017 election result. The left-wing, pro-EU Democrats 66 (D66) surged to finish in second, reflecting the convergence of left-wing voters in order to strengthen progressive representation in the next government.[25] And the far-right populist Party for Freedom (PVV), led by Geert Wilders, dropped to third place, with a loss of just over 2% of its vote share. Fourteen other parties gained sufficient votes to qualify for parliament, including another far-right populist party, the Forum for Democracy (FvD), which seized upon pandemic denialism in its campaign. The FvD gained approximately 3% over its 2017 finish, and so the vote share for the far-right in the 2021 election cycle grew on the aggregate.[26]

The election results portend relative consistency for the Dutch position within the EU. The Netherlands under another VVD-led government is unlikely to impede the continued roll-out of the NGEU under the revised terms that it played a role in shaping. Despite the prominent role that PM Rutte played in the negotiations, the European recovery fund garnered little attention in the campaign. The VVD's more centrist platform, and the D66's second-place finish, even suggest that the Dutch attitude toward fiscal matters could somewhat mellow in Brussels.[27] Yet the Hague could still react in opposition to the recovery spending of major recipient states, like Italy, if dissatisfied with the fulfillment of reform commitments. Over a longer-time horizon, it remains to be seen whether the Netherlands will continue to push as hard a line on structural reforms and budgetary conservatism within the EU if Germany softens its attitude toward fiscal activism under a Green-led or influenced coalition (see "Germany" for more). The pushback of the frugal four against the recovery fund may reflect a more profound disagreement over the limits of European integration, one with which the Netherlands and its peers may have to grapple in the future.[28] If Germany grows more accepting of deficits and fiscal union, the frugal four could face pressures to accept even wider ORDs. This could instigate a rise in Euroscepticism in a Dutch electorate, sensitive to questions of EU finance.[29]

Germany: Merkel Bids Farewell

Election Date: September 26, 2021

Governance Structure: Germany is a federal republic made up of 16 constituent states. At the national level, the president serves as head of state over a five-year term. The bicameral legislature is composed of the Federal Diet or "Bundestag" (lower house) and the Federal Council or "Bundesrat" (upper house). Elections for the lower house are held every four years, via a mixed proportional representation/constituency-based voting system. The chancellor serves as the head of government. A candidate for the office is nominated by the president, and elected by the Bundestag in a majority vote. Cabinet members are usually drawn from parties of the governing coalition in the lower house. The 2021 fall election cycle will determine the members of the Bundestag, and by extension, the next Chancellor.

Party Ranking in Opinion Polls (as of July 27, 2021):[30]
Christian Democratic Union (CDU)/Christian Social Union (CSU) – 28%
Alliance '90/Green Party – 19%
Social Democratic Party (SPD) – 16%
Free Democratic Party (FDP) – 13%

Alternative for Germany (AfD) – 11%
Die Linke (The Left) – 7%

Leading Candidates for Chancellor:
Armin Laschet (CDU/CSU)
Annalena Baerbock (Greens)
Olaf Scholtz (SPD)

Description: The 2021 federal election could mark a paradigm shift in German politics, as Chancellor Angela Merkel, having chosen to step down at the end of her fourth term, concludes 16 years in office. The end of her tenure has been far from uneventful. Merkel garnered widespread praise in the initial months of the global pandemic. Informed by her own scientific expertise, Merkel's effective communications, and those of other officials, helped to mitigate viral spread and fatalities through the first wave.[31] In March 2020, the government released a supplementary budget to fund billions in emergency public health and economic support. Berlin passed a further €130 billion stimulus package in June.[32] At the supranational level, Merkel broke with precedent when she conceded to joint debt issuance under the NGEU scheme, albeit as a one-time emergency measure.[33] Yet confusing policy and a slow vaccine rollout through the third wave of infections, coupled with an internal party scandal, threatened to tarnish Merkel's record on the pandemic and inflicted a political cost on the CDU/CSU.[34] Her successor as conservative leader, Armin Laschet, Minister-President of North-Rhine Westphalia, is also singularly unpopular. The party endured a precipitous decline in the polls over the first half of 2021, from which they have not entirely recovered.[35] Meanwhile, the CDU/CSU faces an insurgent challenger in the Alliance '90/Green Party. The Greens' young and high-profile candidate for chancellor, Annalena Baerbock, came of age in the post-unification era. Baerbock has positioned herself as the candidate for change, standing apart from older establishment figures like Laschet and Olaf Scholtz of the SPD. Detractors have pointed to Baerbock's relative lack of experience, which could dissuade a stability-minded German electorate from supporting her.[36] Critiques of the Green leader were bolstered as Baerbock faced allegations of plagiarism, misrepresentation on her resumé and failures to properly declare income. The party has experienced a decline in its support to below 20% since her nomination.[37]

The positions of the two leading candidates hint at the possible directions for German policy in the coming years. As head of the CDU, Laschet largely aligns with Angela Merkel at the political centre. He leans toward pro-business policies and fiscal restraint, and has taken modest positions vis-à-vis Russia and China. Laschet supports strong cooperation within the EU and the existing pandemic recovery scheme, but opposes more permanent structures for debt mutualization.[38] In contrast, Baerbock and her party have charted a distinct course in both domestic and foreign policy. Naturally, the Greens elevate climate change to a focal point of their agenda. In part, they call for larger public investments to support the green transition. This inclination toward more government spending and a softening on deficits breaks with the CDU's tradition of staunch fiscal conservatism.[39] In a similar vein, Baerbock's international approach is ambitious when compared to Merkel's and Laschet's cautionary style. She favours strong cooperation with likeminded democracies and takes a more assertive posture toward Moscow and Beijing. And with respect to the EU, the Greens support greater political and economic union, including more permanent fiscal arrangements to fund investment and manage economic crises. Despite its shortcomings, Baerbock has also defended the EC's role in vaccine procurement as a necessary act of solidarity.[40]

The gravity of political change after the election may ultimately hinge on the performance of the Greens relative to the CDU/CSU; whether they win enough seats to meaningfully influence policy or even set the agenda as a ranking member in the next governing coalition. In any event, the medium-term implications of the election look reassuring for Brussels at this stage, particularly given the relegation (but not exclusion) of Eurosceptic voices. In April 2021, the German Constitutional Court ruled against a legal challenge seeking to hold-up the ratification of the ORD needed for the recovery fund. And support in the polls for the far-right populist Alternative for Germany (AfD) party has declined since the onset of the pandemic.

In June, the AfD also fell short of polling expectations with its second-place finish behind the CDU in the Saxony-Anhalt state elections.[41]

France: Encore une Fois, Mr. Macron?

Election Dates: April 2022

Governance Structure: France is a republic with a semi-presidential system of governance. The president serves as head of state, with robust executive powers, and is directly elected via a popular vote. The president appoints the Prime Minister and Council of Ministers (together referred to as "the government"), subject to majority support in parliament. The PM serves as head of government, with authority over policy and the civil services. The legislative branch is composed of the constituency-based National Assembly (lower house) and the Senate (upper house). Both the presidential and legislative elections follow a two-round system, whereby a run-off is held between the leading candidates if no one person secures more than a 50% majority after the first ballot. The 2022 election cycle will decide the next president, the new government and the composition of the National Assembly.

Potential Presidential Candidates & Opinion Polling (as of July 5, 2021):[42]

First Round Vote
Marine Le Pen (National Rally) – 25%
Emmanuel Macron (La République En Marche!) – 25%
Xavier Bertrand (The Republicans) – 17%
Jean-Luc Mélenchon (France Unbowed) – 9%
Yannick Jadot (Green Party) – 7%
Anne Hidalgo (Socialist Party) – 6%

Second Round Vote
Emmanuel Macron (La République En Marche!) – 56%
Marine Le Pen (National Rally) – 44%

Description: President Emmanuel Macron rose from relative obscurity to the centre of French politics when he and his newly formed La République En Marche! (LREM) Party claimed victory in the 2017 presidential and legislative elections. Macron's run-off against the far-right populist leader, Marine Le Pen, marked the upturn of the traditional party structure in France, hitherto dominated by the Socialists and Republicans.[43] A former investment banker, Macron championed reforms in the French economy, including cuts to corporate taxes and the easing of regulations in the labour market to spur job growth. He also called for renewed European solidarity with the Franco-German partnership at its centre.[44] Yet in pursuit of his grand ambitions, the President encountered some embittered opposition. Macron earned a reputation for elitism that alienated rural voters. Sparked by a new tax levied on top of already rising fuel prices, the rise of the *Gilets Jaunes* (Yellow Vest) protest movement in 2018 marked a popular backlash against an allegedly indifferent leader and his policies.[45] When the global pandemic struck, Macron led a mixed response. Paris provided massive emergency economic support through the first wave. The government provided a further supplement with its €100 billion "France Relance" recovery package. Macron also co-devised the European recovery fund and joint borrowing scheme with Angela Merkel.[46] But his handling of the public health response seemingly contributed to losses in public support. In April 2021, Macron suddenly announced a third nation-wide lockdown, after resisting the move despite scientific advice to the contrary.[47]

With just under one year before the scheduled election date, and the global pandemic still the overriding priority, the presidential campaign has yet to reach its fever pitch. Yet some potential challengers to Macron have attracted attention. Xavier Betrand, regional president of Hauts-de-France, is a leading figure from the centre-right Republicans. The current mayor of Paris, Anne Hidalgo, is a possible candidate from the Socialists. And Jean-Luc Mélenchon leads the far-left party, France Unbowed.[48] Macron and Le Pen are once again the clear frontrunners in the race, although conditions favour the incumbent thus far. Polls suggest that Macron is likely to draw more support from other nominees' constituents than Le Pen in a run-off vote (see aggregated figures above). Yet other variables could still affect the President's chances. As head of state, he may ultimately bear the responsibility for the successes and the failures of the pandemic response. Macron must also grapple with losses in support associated with a pre-election shift to the political Right. The President's controversial national security proposals after recent terrorist attacks and hardline defences of *laïcité* – the French tradition of secularism – have in part contributed to the alienation of more progressive voters.[49]

Thus, French politics displays both positive and tenuous signs for the coherence and stability of the single market. After four years in office, Macron remains staunchly Pro-EU in his orientation and his re-election prospects are favourable. Yet the political resiliency of Marine Le Pen remains a significant "known unknown" at this point. If able to win a surprise upset at the national level, Le Pen would be empowered to affect continental integration like never before. Despite backtracking on her calls for France to leave the EU and the Eurozone after the 2017 elections, she could reembrace Eurosceptic policies if voters grow frustrated or unsatisfied with Brussels' role in the vaccine rollout and economic recovery.[50] Le Pen could shift France's posture in the EU from a position of renewed cooperation to one of increased confrontation and obstruction. At the very least, her election could disrupt popular expectations for the Union's future in a manner that would reflect in financial markets.

SECTION 3: IMPLICATIONS FOR THE EU AND CANADIAN FIS

As explored in Section 2, recent and future power shifts in Italy, the Netherlands, Germany and France present a mixed, but generally positive narrative for the European project in a moment of crisis. The unifying force of EU institutions alone should not be underestimated, regardless of political developments at the national level. Given that important leadership changes are at play, however, some additional observations can be made about their consequences for the medium-term future of the EU and the single market as the pandemic recedes. In turn, these observations can inform better assessments of political risk to Canadian FIs.

First, the current moment of EU solidarity cannot discount the endurance of populist movements on both sides of the political spectrum. Reflecting on the state of democracy, Ivan Krastev points to the breakdown of centrist politics in Western Europe. The old consensus dominated by moderate left and right parties has broken down in the aftermath of the financial and migration crises respectively.[51] Krastev's insight at least partially aligns with the recent and future power shifts explored in this paper. Voter trends in Italy and France signal the depth of populist sentiment despite current incumbents from the political mainstream. Conditions in Germany and the Netherlands point more to a reembrace of centrist politics, but by no means one that silences the political fringes. A common thread weaves through these cases. Polarization remains a secular force, creating loyal and animated bases of support on the far-left and far-right that sustain opposition to the political establishment. As the EU rallies to mount a shared recovery, these parties may find limited appeal beyond their core constituencies. But keeping a "foot in the door" of government allows populist leaders to bide their time and exploit the divisions and grievances sown or exposed by a disruptive event like the pandemic.

This leads to a second observation, that the disparities wrought by COVID-19 could actually inspire a populist resurgence if left unaddressed. As this author highlighted back in May 2020, it is the aftereffects of the pandemic in terms of economic dislocation and inequality that could ultimately prove a boon for the political extremes. Bobba and Hubé (2021) take a similar view when they argue that populists succeed by promoting a "permanent crisis cycle" in which they can identify and exploit political "contradictions" and assign blame to particular groups. This strategy works in the early phases, or in the wake of, rather than in the climax of a crisis. The heat of moment may inspire solidarity and collective action which disadvantages populist arguments.[52]

If the crisis matters less than its aftermath, both EU institutions and national governments need to provide solutions that preempt those contradictions upon which anti-establishment parties prey. This imperative is not lost on the part of incumbent leaders. For example, French President Macron openly cast the European recovery fund as a prophylactic against populism.[53] Yet the EU's record thus far at preempting contradictions is not beyond criticism. Brussels' failures at coordinating the public health file may compromise plans for the economic rebound. Speaking about his own country, former Italian

PM Enrico Letta notes that Draghi's reform efforts will be much more challenging if the vaccine rollout faulters and fails to resolve the pandemic.[54] Unsuccessful attempts at structural changes in Italy could, in turn, inflame regional divides and increase Euroscepticism elsewhere.

Mapping Future Scenarios and Risks

Thus, assessments of national politics and European unity should consider the resilience of populist parties and their ability to leverage post-crisis disruptions for electoral gain. Lenders and investors should consider how these factors manifest across a distribution of outcomes with different risk profiles. The following section defines three alternative futures for Europe in a post-pandemic world, as shaped by domestic political developments in the largest EU countries and the different paths for the post-pandemic recovery. Although informed by background research, these narrative scenarios are, by definition, simplifications. They cannot describe exactly how the future will unfold. They cannot account for all the variables at play in the single market, from increased migration and geopolitical tensions to the rise of illiberal democracy and its fundamental challenge to European values. Nor can the scenarios fully capture the paradoxical nature of the European project. As Johns Hopkins political scientist Erik Jones argues, the forces of European integration and disintegration may co-exist, so that cooperation in the emergency response to the pandemic does not exclude divergence among member states in other respects.[55] What the following scenarios can provide, however, are the elements for "strategic foresight," as an exercise that explores possibilities and challenges preconceptions rather than making definitive predictions about what is to come.

1. **Muddling Through —** A scenario in which political developments, and the economic recovery from the global pandemic, are uneven and incongruous across the EU. The vaccination campaign is largely successful at stemming new variants of COVID-19, but local flare-ups slow the reopening of economies in a few countries and regions. The NGEU funds are released with initially positive results. Yet tensions on the European Council rise when the scrutiny of individual recipients leads to accusations of non-compliance with spending rules and reform commitments. In Italy, Mario Draghi's government launches its new fiscal program with early signs of success. But the more difficult structural changes mandated for the economy spark ire from voters and interest groups. Confidence in the government breaks down, culminating in a no-confidence vote and a premature election. The populist Northern League, M5S and FdI, secure the largest shares of the vote, but policy disagreements between the different political factions produce an unstable and ineffective coalition. Although no leader among the frugal four triggers the emergency brake in response, their collective criticisms of NGEU disbursements grow increasingly severe and betray a rising dissatisfaction among their voters with the EU's recovery program.

   Armin Laschet leads the CDU/CSU to victory in the German federal elections, with the Greens taking the second largest vote share. As a necessity, the two parties negotiate a coalition between them. Consistent with Germany's position under Angela Merkel, the new government takes a clear but measured position in support of the EU. As a change of course, it adopts a more assertive posture in relations with China and Russia. True to statements made during the campaign, Chancellor Laschet is steadfast in arguing that the NGEU should remain a one-time emergency program only, not the basis for a more permanent European borrowing scheme. His position stymies discussions of greater fiscal integration in Brussels. Yet the precedent is now set for large-scale joint debt issuance in a crisis scenario. In April 2022, French President Emmanuel Macron ekes out a razor-thin victory in a second-round vote against National Rally challenger Marine Le Pen. The LREM also loses a large share of its seats in the National Assembly. Low voter turnout, disillusionment on the political Left, and dissatisfaction with a mediocre economic recovery, are all obstacles for the incumbent. Although ultimately triumphant, Macron's political momentum is noticeably diminished. He forges a strong working relationship with Chancellor Laschet to advance ambitions for continental unity and strategic autonomy. Yet the prospects for strong Franco-German leadership within the EU have their limits.

Post-pandemic growth remains sluggish in some countries more than others as spending and reforms fail to sufficiently improve supply side factors. On the demand side, the disparities largely fall along geographic lines. While manufacturing- and export-heavy economies in the North and East perform well, many Southern European countries with large travel and tourism sectors are still adversely affected by regional epidemics and lingering consumer hesitancy. Although the pandemic recovery fund yields mixed results, digitization and the green transition remain key EU priorities of which progress continues to be made. The moves toward strategic reshoring and supply chain resiliency have some positive effect, but the benefits for the biomedical and technology industries are highly concentrated. Unprecedented public debt levels in Italy and Greece look increasingly unsustainable. The ECB adds to the strain when evidence of secular inflation forces it to more aggressively taper its QE program and raise interest rates in the second half of 2022. Fears mount over rising sovereign debt risk and instability within the Eurozone.

2. **Ever Closer Union —** A scenario in which the EU and its member states mount a coordinated and pervasive recovery from the COVID-19 pandemic. NGEU grants and loans are methodically distributed without activation of the emergency brake for alleged violations of program rules or commitments. The foremost recipients, led by PM Draghi's government in Italy, adhere to their spending plans while successfully meeting structural reform commitments. Despite its initial challenges, the EU-led vaccination program gains pace by the fall of 2021, dramatically reducing infection rates, including for the delta and other new variants, and permitting national governments to ease any remaining public health restrictions. The reopening of economies, coupled with the massive fiscal stimulus from the EU, drives inclusive growth and a steady rise in public confidence. Early successes in "building back better" help to restore popular faith in both national and European institutions. Support for centrist parties begins to rebound in France and Italy.

Annalena Baerbock overcomes stumbles mid-campaign to lead the Greens to an upset victory in the German federal elections. In line with the EU's spending priorities, the new governing coalition in Berlin pushes for even greater investments in sustainable and digital infrastructure, financed in part through more deficits, public-private partnerships and green bond issuance. Competing with proclamations from the Biden Administration, Baerbock pledges to make Germany and the EU the definitive leaders in the race to net-zero. Support for French President Emmanuel Macron marginally recovers in the polls with the economic upturn. He manages to secure a narrow but definitive victory in the second-round run-off elections against Marine Le Pen. The rehabilitation of the EU's image, given the turnaround in vaccinations and fiscal stimulus, proves an anti-populist challenge for which the National Rally had no real counter.

With his new mandate, President Macron partners with the likeminded Chancellor Baerbock to continue in his push for European solidarity and a reinvigorated, but inclusive form of globalism. Brussels does prioritize issues of supply chain resiliency in critical sectors like medical equipment, pharmaceuticals and semiconductors. But in their actions and rhetoric, European leaders resist a downward spiral into more severe forms of trade protectionism. The doors to FDI remain largely open and secure. The early successes of the NGEU lubricate discussions of more significant fiscal powers for the EU. After some debate, leaders agree to further consultations on a permanent common debt instrument. Financial markets are bolstered on promises that these "Eurobonds" will serve as the most compelling risk-free alternative to U.S. treasuries. Market expectations of new joint debt arrangements also lower the cost of borrowing for countries like Italy and Greece, where emergency pandemic spending has compounded what were already tenuous debt burdens. These states are granted further leeway when the EU extends its fiscal exemptions under the escape clause of the SGP beyond 2023, while the terms of the pact itself come under renegotiation. The rise in inflation measured throughout 2021 ultimately proves transitory, as a global reopening helps to reconcile demand/supply imbalances. Pressure eases on the ECB to raise interest rates, lowering the risks to highly-leveraged state, commercial and household borrowers. Governments in Southern Europe continue emergency spending lines to accelerate a regional recovery, much of which depends on a rebound in the improving, but still beleaguered, tourism sector.

3. **Fury and Fragmentation —** A scenario in which the backlash against neglected economic disparities post-pandemic, and the criteria for the recovery fund, nurture far-right populism in recipient nations. Voters in some of the largest economies elect nationalist governments that threaten EU solidarity and the single market. The COVID-19 vaccination campaign accelerates over the course of 2021, but immunization levels are not sufficient to prevent the spread of infectious variants, forcing new shutdowns in many countries. In Italy, the reform efforts of PM Draghi falter under pressure from the combined weight of anti-establishment parties, including the M5S, Northern League and FdI. Members of the frugal four group of states invoke the escape clause of the NGEU. Euroscepticism rises in the Netherlands and Germany over perceptions of enduring fiscal imprudence in Italy. The German federal election results produce a fiscally hawkish, CDU-led coalition, excluding the Greens. The new government strikes a hard line in favour of the prompt reimposition of EU spending rules under the SGP. Meanwhile, Marine Le Pen exploits divisions among left-wing parties, defections from Emmanuel Macron's LREM, and general voter apathy, to squeeze out a surprise victory in the second round of the French presidential elections. Siding with illiberal governments in Hungary and Poland, Le Pen challenges Brussels on issues like human rights, migration and foreign policy.

   The widening of political divides on the European Council narrows the bandwidth for greater fiscal union. Attempts to cement a permanent joint borrowing scheme falter when confronted by renewed German opposition, and hopes for a single, EU safe asset are left unfulfilled. Disagreements over the commitments to structural reform impair payments under the NGEU scheme and dull the expected benefits to economic growth. Planned infrastructure projects lose out on public financing, and thus, fail to present new investment opportunities for alternative asset managers. Yet the EU's leadership and focus on climate change and digital policy still drive regulatory changes and carbon reduction. The cost of borrowing on financial markets increases for Italy, Spain, Greece, and other countries with high public debt levels. Added pandemic expenditures in these states threaten the financial stability of the Euro zone.

   Support for protectionism and supply chain self-sufficiency increase across the political spectrum and the EU in the wake of pandemic disruptions. Rhetorical appeals to economic nationalism are especially pronounced where far-right leaders hold office. Yet the local political risks to foreign investors are not necessarily greater in these markets. Populist governments in France and Italy curb their hostility toward private FDI where it outwardly contributes to domestic economic growth. Foreign businesses still face reputational risks in these markets, however, when clients perceive even tacit associations with far-right, xenophobic and anti-globalist policies that flout ESG commitments.

CONCLUSION

The EU is both a political and economic union which brings together a diverse community of states. It is a supranational organization that at times struggles with the dichotomy of too much and not enough integration. Debates over the nature and extent of political and macroeconomic union in the EU have marked the past ten years and endure through the current moment. The great financial crisis and sovereign debt crisis enflamed internal tensions with the bloc. The global pandemic could prove a similar moment of disruption. As explored in this paper, recent and future power shifts at the national level may both influence and prove reactive to the EU's pandemic recovery, and influence the Union's trajectory over the near to medium-term. Canadian FIs should recurrently assess the potential outcomes for the single market, and their consequences for operations and portfolios.

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