

# European Economics

## The thick of it

### Research Analysts

Christel Aranda-Hassel  
 44 20 7888 1383  
[christel.aranda-hassel@credit-suisse.com](mailto:christel.aranda-hassel@credit-suisse.com)

Mirco Bulega  
 +44 20 7888 9315  
[mirco.bulega@credit-suisse.com](mailto:mirco.bulega@credit-suisse.com)

Neville Hill  
 44 20 7888 1334  
[neville.hill@credit-suisse.com](mailto:neville.hill@credit-suisse.com)

Gergely Hudecz  
 44 20 7888 7342  
[gergely.hudecz@credit-suisse.com](mailto:gergely.hudecz@credit-suisse.com)

Sonali Punhani  
 44 20 7888 4297  
[sonali.punhani@credit-suisse.com](mailto:sonali.punhani@credit-suisse.com)

Giovanni Zanni  
 +44 20 7888 6827  
[giovanni.zanni@credit-suisse.com](mailto:giovanni.zanni@credit-suisse.com)

There's no sign of the euro area economy moving out of a low gear. Survey indicators may be bottoming, but hard data suggest the recovery is still insipid. That should be reflected in Friday's GDP print, with output up just 0.1%q/q in Q3.

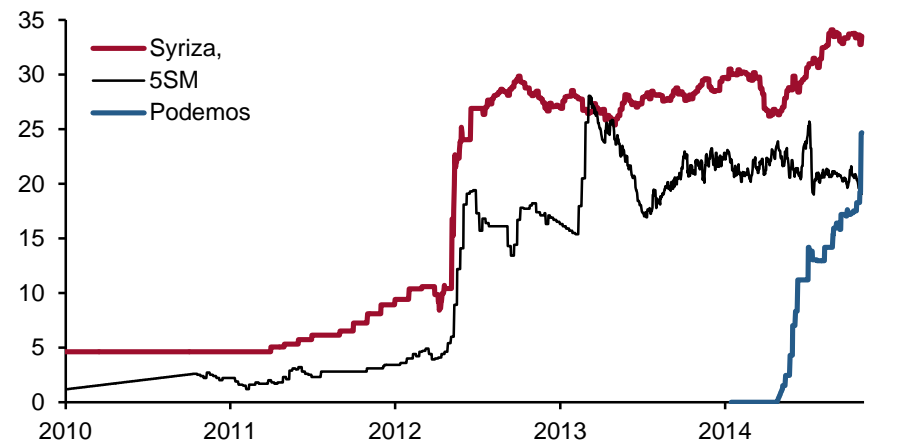
Although a policy stimulus of sorts is underway from the ECB, last week's press conference confirmed that supplementary asset purchases are unlikely until next year. And the prospect of a meaningful move to fiscal stimulus in the euro area – or some parts of it – remains slim. So although we expect growth to improve next year, a more vigorous recovery remains unlikely.

A weak, but growing economy, receiving incremental increases in monetary stimulus is unlikely to fall back into recession or generate severe financial stress. But although the European economy may not be a direct cause of financial turbulence next year, its electorates might. 2015 poses considerable political risk, with elections in the UK, Portugal and Spain, and possibly Greece.

At the least, those elections are likely to prove stress points, as we saw in Greece in 2012, Italy in 2013 and the Scottish independence referendum this year. In part that's a reflection of the diminishing support for mainstream political parties, and in turn, we think, a reflection of poor economic performance since 2008.

Inasmuch as those elections rattled markets, political "status quo" was sustained, particularly with respect to countries' relations with the EU and the euro. But the risk is that new political movements more effectively disrupt electoral outcomes to put that status quo into question.

### Exhibit 1: Support in opinion polls for Syriza, 5SM and Podemos



Source: Credit Suisse

Note: Five-poll moving average, several polls. Data prior October 2010 for 5SM and February 2011 for Syriza are estimated. Syriza was launched in 2004, 5SM in 2009, Podemos in 2014.

DISCLOSURE APPENDIX AT THE BACK OF THIS REPORT CONTAINS IMPORTANT DISCLOSURES AND ANALYST CERTIFICATIONS.

## The thick of it

Although markets remain concerned about the strength of the euro area recovery, we remain relatively unconcerned about the risks of a relapse back into recession, as we discussed last week. Indicators suggest that the euro area economy is just about growing.

And although more aggressive stimulus from the ECB would be welcome, we think easier credit conditions on the back of the conclusion to the ECB's comprehensive assessment, the credit easing measures being implemented by the ECB as well as a lower oil price and currency should mean growth is a little stronger, rather than weaker, in 2015.

But for us the bigger risk Europe poses to markets next year is not the weakness of the euro area economy per se, but the effects of its prolonged stagnation on the political process.

To practical effect, ECB President Draghi's promise to do "whatever it takes" and the creation of the OMT programme removed the prospect of market-driven redenomination risk. The prospect of intervention from the ECB clearly eased the risk that a vicious financial feedback loop could generate such severe financial and market distress that a member state would have little choice but to leave the euro.

But the ECB cannot effectively respond to a different redenomination risk – one where an electorate votes for a government led by a party prepared to aggressively confront the rules and restrictions of euro membership to the extent to which the party would not qualify for official support, be it from the ESM or the OMT. At that point its ability to remain a member of the euro area would become far more questionable.

Next year carries considerable electoral risk. As we show in Exhibit 6, there are general elections in the UK, Portugal and Spain. And it's also likely we'll see an election in Greece. There are also regional elections in Italy and Spain. Given the above, these could all present a source of turbulence for markets as they hover into view.

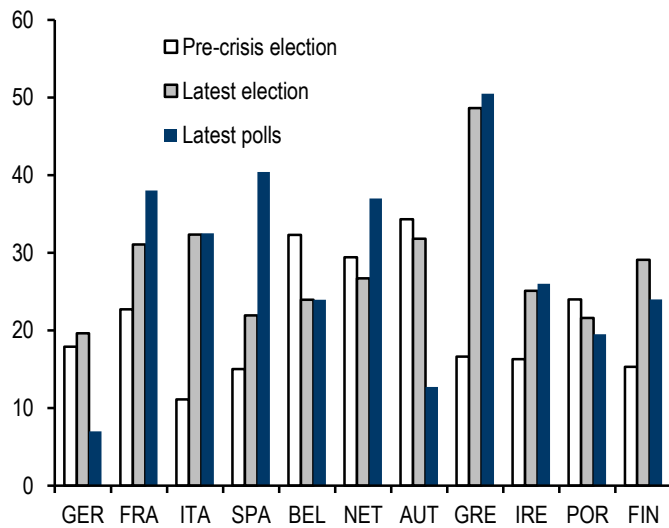
The global financial crisis of 2008-2009 and the euro area crisis of 2010-2013 have left political radicalization in their wake. That has led to a substantial decline in support for mainstream political parties and created room for new parties and movements to disrupt electoral outcomes. In the past two and a half years we have seen elections where support for radical change to the status quo was considerably higher than market participants anticipated only a few months in advance: the Greek (2012) and Italian (2013) general elections and Scotland's independence referendum (2014).

We've discussed [this issue](#) in [the past](#), but it is a problem that should persist. As Exhibit 2 shows, support for "non-mainstream" political parties has risen across Europe since the financial crisis, but all the more so in the troubled periphery, where unemployment – especially amongst young people – remains high.

The academic literature suggests that support for more radical elements is correlated more with the level of output than its growth rate. So although the euro area has moved out of (its second recent) recession, the depressed level of output, especially in the periphery, should keep politics febrile for some time.

In Spain, the creation and surge in support for the Podemos popular movement in advance of next year's election mirrors the burst in support that Syriza saw in advance of the Greek elections in 2012 and M5S saw in advance of the Italian election last year. So we think the Spanish election late next year could be the key political event next year, inasmuch as it has the capacity to generate considerable uncertainty.

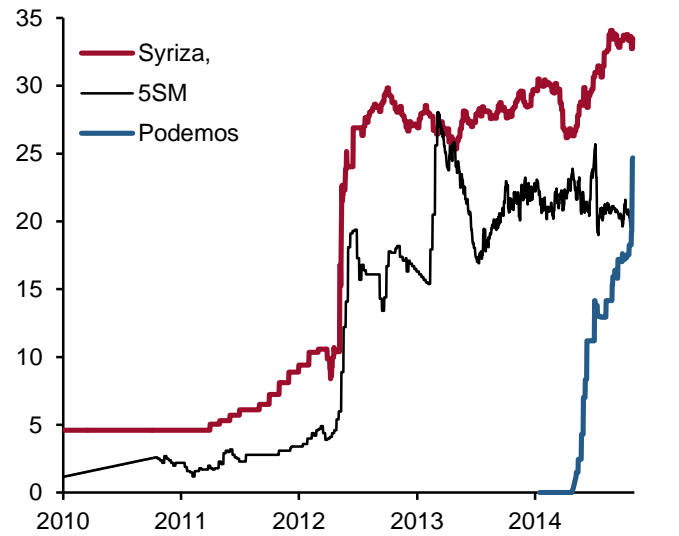
### Exhibit 2: Support for "non-mainstream" political parties still rising



Source: Credit Suisse

### Exhibit 3: ... and we've seen this movie (twice) before

Support in opinion polls for Syriza in Greece, 5SM in Italy and Podemos in Spain

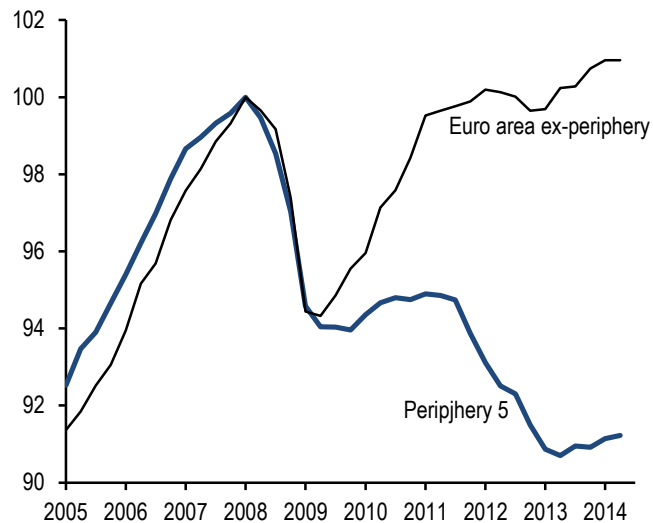


Source: Credit Suisse

Note: Five-poll moving average, several polls. Data prior October 2010 for 5SM and February 2011 for Syriza are estimated. Syriza was launched in 2004, 5SM in 2009, Podemos in 2014.

### Exhibit 4: Output depressed in the periphery

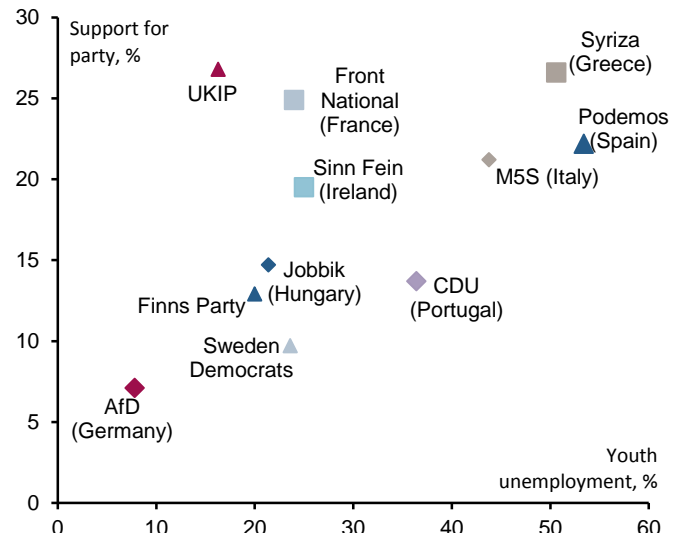
Real GDP, Q1 2008=100



Source: Credit Suisse, Eurostat

### Exhibit 5: ... youth unemployment and support for radical parties

Youth unemployment rates (%)



Source: Source: Eurostat, European Parliament, Credit Suisse

Note: AfD=Alternative for Germany, CDU=Democratic Unitarian Coalition (Portugal), Jobbik=Movement for a Better Hungary, M5S=Five Star Movement (Italy), UKIP=UK Independence Party; Party support shows the results of the EP elections in May 2014, except for Podemos where it shows the average of recent opinion polls; Youth unemployment is measured as unemployment rate among the population younger than 25 years.

But although the rise in support for "non-mainstream" political parties is a common theme across European countries, there are many particularities. We discuss those in detail in the country sections below. But these differences are important, inasmuch as they can and likely will deliver very different political outcomes.

For us, there are a couple of important factors to consider.

**Maturity.** In terms of their capacity to disrupt the political process, it seems that movements such as Syriza, M5S and Podemos are at their most potent in their infancy. Maturity seems to either move their politics closer to the political mainstream – as Syriza – or slowly erode their support – as seems to be the case with M5S. In effect, a Syriza-led government should generate less political (and financial) turbulence if it is elected next year than it would have done if it had been elected in 2012. And the loss of momentum for M5S – now polling below 20% – makes it less of a potential disruption to Italian politics. In that sense, Podemos' capacity for political turbulence will be at its greatest next year.

**Electoral systems matter.** The extent to which new parties and movements can significantly alter political outcomes will depend on the electoral framework under which they operate. For example, the extent to which bonus seats are allocated to parties in countries like Greece could give a high-polling populist party a majority. Whereas the UK's first party past the post electoral system might not only mean that a high polling populist party can achieve very little representation; as it takes support from one of the main political parties it actually makes it easier for the other main party to form a government.

### **What previous experience tells us**

There is a long strand of academic literature that explores the links between economic crisis and political instability. These studies present mixed conclusions about the ultimate impact of economic crisis on politics, but we think that there a couple of tentative lessons from earlier observations which may be interesting to highlight:

- Electoral and party systems matter. Political systems with stronger democratic credentials are more likely to be resilient in the face of economic crisis.
- Affluent and established democracies are more robust. On the other hand, young and less affluent democracies are more vulnerable to economic crisis.
- The welfare state also makes a difference. Countries with stronger welfare systems are less likely to see major political realignment.
- A malfunctioning economy can aggravate existing tensions. Economic crisis is more likely to lead to political instability in a country with pre-existing cleavages.
- Voters are likely to vote based on their circumstances and punish incumbent leaders for the crisis, but this does not necessarily entail a shift to radical views.
- Finally, and perhaps most importantly, leadership can play a moderating role or can make things worse. Polarization is more likely to be driven by political elites than by the change in preferences of ordinary people. Therefore, the actions of political leaders are decisive in moderating or exacerbating the impact of the crisis. Popular radicalization is more likely to happen if voters can establish a clear and direct connection between the actions of political elites and economic hardship.

These tentative conclusions provide some comfort regarding the political outlook for Europe, in our view. European states are long-established and affluent democracies with strong welfare states. However, the implications for pre-existing cleavages are more disquieting. The examples of the Scottish and Catalan independence moves suggest that pre-existing cleavages have been amplified. Furthermore, the response from mainstream political elites to the rise of radical parties is mixed. In some countries, political leaders indeed play a moderating role. In other countries, however, we see signs that the incumbent establishment responds to demands by fringe parties, and weakens its support for European integration. Hence we see the polarization of mainstream parties as a less likely but a potentially more damaging risk.

**Exhibit 6: 2015 Election Calendar: considerable electoral risk ahead**

Date	Political events
Sun, 15-Feb 2015	Hamburg's election
Sun, 1-Mar 2015	Italian regional elections
Sun, 19-Apr 2015	Finnish Parliamentary election
Thu, 7-May 2015	United Kingdom general election
Sun, 10-May 2015	Bremen's election
May 2015	Spanish regional elections
May 2015	Dutch Senate election
Sat, 13-Jun 2015	Turkish general election
Sun, 20-Sept 2015 - Sun, 11-Oct 2015	Portuguese Legislative election
Sun, 18-Oct 2015	Swiss Federal election
Oct 2015	Polish Parliamentary and Presidential election
Sun, 20-Dec 2015	Spanish general election (date tbc)

Source: Credit Suisse

**Greece – Clear and present danger, but with less systemic implications**

The Greek government coalition – formed by the centre-right party New Democracy and the junior centre-left partner Pasok – has recently won a vote of confidence, with support from 155 MPs (out of 300). Such a vote was expected and confirms that the government has a sufficient cushion, currently, for normal parliamentary votes – but it doesn't prevent political uncertainty given the upcoming (February 2015) election of a new president of the Republic, which will require a majority of at least 180. If such a qualified majority is not found, the Constitution requires that new Parliamentary elections must be called. The current majority could possibly gather support from some of the smaller opposition parties' MPs, but as of this moment there is still no candidate and no declaration of support coming from these other oppositions.

**The chances of early elections next spring are probably higher than 50%, currently.** The “normal” election deadline would instead be 2016.

The uncertainty related to that vote, in addition to recent polls showing a further advance of the main opposition party Syriza, contributed to a sharp repricing of Greek assets in recent weeks. We had been highlighting political risk in Greece for a long while. The further rise in support for Syriza has two explanations, in our view.

Firstly, the party has moderated its tone somewhat, becoming less radical in its statements: Syriza no longer threatens to disavow the EU/IMF bailout agreements, nor does it request a default on the debt, preferring to demand a renegotiation and some kind of (official sector) debt relief.

Second, Syriza managed to polarise the political confrontation between a “new” left, Syriza, and the “old” right, New Democracy, with a progressive disappearance of the smaller opposition parties. As such, the recent rise in Syriza should not be seen as a further increase in radicalism in the country, but a conflation of different strands of radicalism into one most likely to win an election – as well as a more moderate political proposition.

While Syriza is leading in the polls, however, it still does not seem able to govern on its own (i.e., it is unlikely it will have an outright majority). As such, the problem is as much one of potentially protracted uncertainty in the formation of a government as it is on the bias of any new government (depending on who the coalition partners are): a coalition of Syriza with the new centre-left, pro-European movement, To Potami, would imply a more traditional centre-left approach than if Syriza were to side with more extreme fringe parties in Parliament, which have a more nationalist approach and are strongly opposed to the EU and the IMF.

Finally, it is worth nothing that polls are just that: traditional parties could still re-organise and present new political propositions and new people if forced into early elections.

Overall, while Syriza is growing in the polls and has significant chances of finding itself in government soon, it is also the case that it is becoming less radical. Moreover, both the macroeconomic and the funding backdrop are not at all the same than in 2012, while countries such as Ireland, Portugal and Spain have shown that there is life after a crisis and after a EU/IMF program. As such, **while we believe that an early election would be disruptive for markets, we also believe it won't lead to a systemic crisis for the euro area, as was the case back in 2012.**

**Exhibit 7: Sufficient cushion for normal votes...**

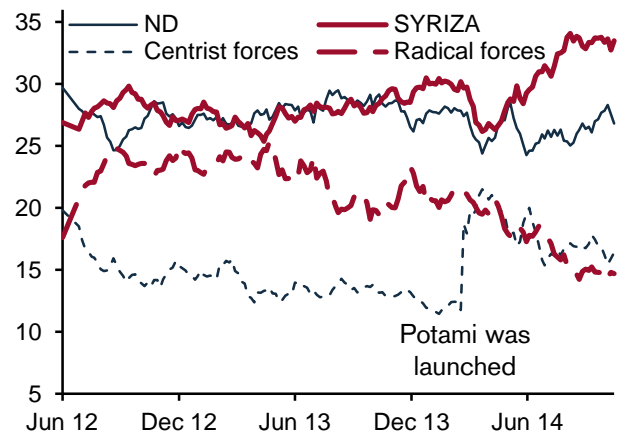
... but it doesn't prevent political uncertainty given the upcoming election of a new president of the Republic, which will require a majority of at least 180

Parliamentary Group	Seats
<b>N.D. (New Democracy)</b>	<b>127</b>
<b>SYRIZA (Coalition of the Radical Left)</b>	<b>71</b>
PA.SO.K. (Panhellenic Socialist Movement)	28
ANEXARTITOI ELLINES (Independent Hellenes)	13
LAIKOS SYNDESMOS - CHRYSI AVGI (People's Association – Golden Dawn)	16
DHM.AR (Democratic Left)	10
K.K.E. (Communist Party of Greece)	12
ANEXARTITOI DIMOKRATIKOI VOULEFTES	16
INDEPENDENT	7
<b>Majority: N.D. and PA.SO.K.</b>	<b>155</b>
Opposition	145
Total	300

Source: Credit Suisse, Hellenic Parliament

**Exhibit 8: Syriza on the rise... but at the expenses of radical forces**

Several polls, five-poll moving average



Source: Credit Suisse

**UK: Independence movements**

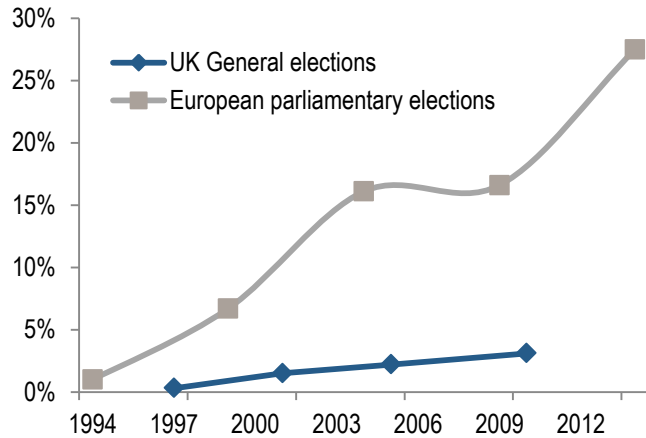
The outcome of the UK's general election, to be held in May next year, looks extremely uncertain. The 2010 election produced a rare coalition government that, contrary to expectations at the time, has lasted. However, a variety of political trends are further challenging the mainstream of politics in the UK. There are risks the election leads to a dysfunctional, weak government and/or a government that could hold a referendum on EU membership, for which there would be a clear risk of the UK leaving.

The first issue is the rise of the anti-EU populist UKIP. Its support has surged in recent years. In UK general elections, UKIP's share of the votes increased from 0.3% in 1997 to 3.1% in 2010 (with zero seats in all elections). In the European parliamentary elections, the surge has been larger from 1% of the votes (0 seats) in 1994 to 27.5% (24 seats) in 2014.

Moreover, recent opinion polls suggest that the support for UKIP has reached 14%-18%. After a defection from a member of the governing Conservative Party to UKIP and its victory in the by-election, support for UKIP rose five points at the expense of the Conservative Party, which lost two points. However this doesn't mark the peak of support for the UKIP, which reached 16% in June after the win in the European parliamentary elections and 18% after the 2013 council elections. The European parliamentary elections were the first time a party other than Labour and Conservative won the popular vote in a national election since 1906.

**Exhibit 9: UKIP since inception**

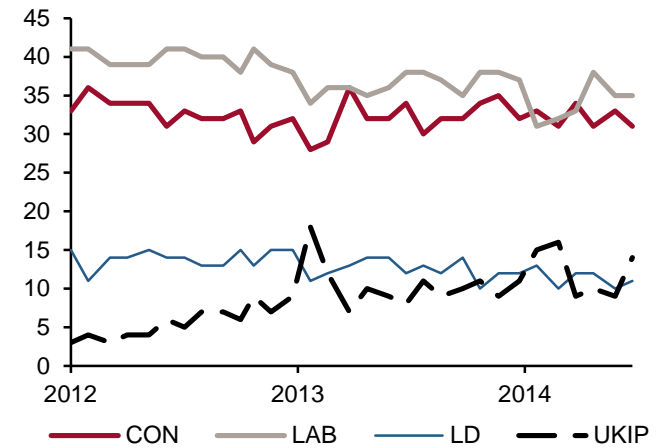
UKIP's share of total votes



Source: Credit Suisse

**Exhibit 10: ICM/Guardian opinion poll for the 2015 general elections**

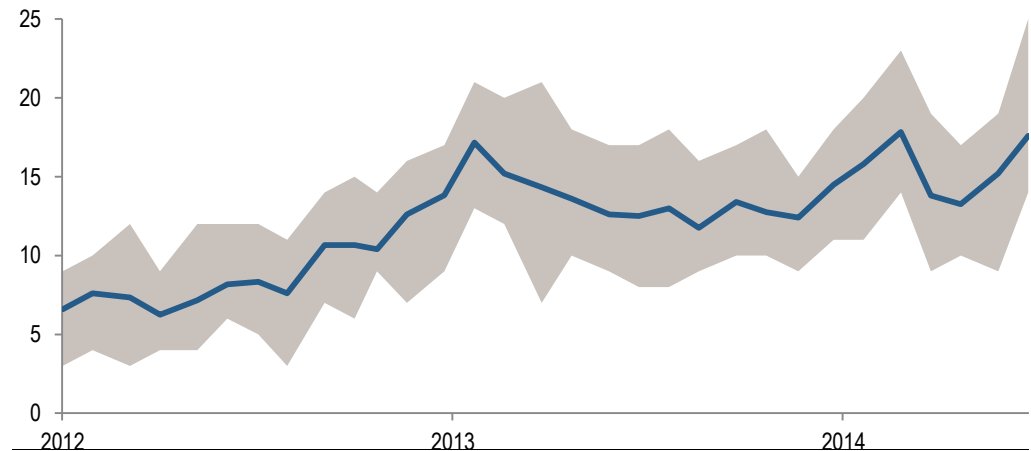
If there were to be a general election tomorrow which party do you think you would vote for? (%)



Source: Credit Suisse, UK Polling Report

**Exhibit 11: Support for UKIP in the opinion polls rising**

Share of participants who said they will vote for UKIP in the 2015 General Election (%), range in opinion polls



Source: Credit Suisse, UK Polling Report

**Consequences for the 2015 general elections:** Immigration, health and living standards are the top issues that are likely to determine the voting patterns in the 2015 UK general elections, according to a recent YouGov poll. Hence UKIP's focus on immigration explains why it is garnering more support. UKIP advocates leaving the EU and preventing free movement of labour across borders. Through its policies, it aims to ensure that immigration to the UK is controlled and access to benefits for migrants is more restricted.

In our view, the impact of UKIP in the 2015 General Election will be limited given the nature of the first past the post electoral system, which still biases outcomes in favour of the two main parties – Conservative and Labour. Indeed, inasmuch as UKIP is likely to erode the votes of the Conservatives rather than Labour, it could reduce the probability of the UK leaving the EU as it would boost the chances of Labour winning the election.

The other issue is the increase in support for the Scottish Nationalist Party, following this year's referendum on independence. One unexpected outcome has been that support for the opposition Labour party – which held 41 of 59 Scottish seats in the last election – has shifted dramatically to the SNP. The latest IPSOS poll (30 October) shows that 52% of Scottish voters would vote SNP and 23% would vote Labour, giving SNP a 29-point lead over Scottish Labour. This implies that SNP could win around 54 Westminster seats, compared to 6 currently, leaving Scottish Labour with just 4 from its current 41.

Inasmuch as the Labour Party has a small lead over the governing Conservative Party in UK opinion polls, the loss of these Scottish Labour seats could make it difficult for Labour to win an overall majority in the General Election, raising the prospect of either a broad multi-party (and consequently, unstable) coalition or a minority government.

Consequently, the outcome of the UK election in May is hard to predict. Most likely is a Labour government with either a small majority or in coalition with one or two other parties. Markets may question how sustainable, and how market-friendly such a government may be. Especially as there will need to be considerable further fiscal tightening in the next Parliament.

But it is also possible that the Conservative party could form a government in a similar way. If that's the case, then an "in-out" referendum on EU membership in 2017 would become possible, posing the clear risk that the UK leaves the EU. That's unlikely to be a prospect that is positive for UK assets.

### **Spain – Yes, we can**

Fiscal austerity, painful structural reforms and the resulting high unemployment are having a political cost in Spain at both national and regional level. At a national level a new populist party created at the start of the year, Podemos (which translates to "we can"), has capitalized on corruption scandals, reform fatigue and the growing disenchantment with the political elite. Campaigning on a series of populist proposals but also the right to re-structure Spain's debt, the new party is a challenge to Spain's traditional two-party system ahead of next year's autumn general election. The political risk could materialise earlier than that, with regional elections (in 13 out of 17 regions) taking place in May<sup>1</sup>.

Opinion polls have shown a sharp rise in support for Podemos in recent weeks, and currently suggest that the party could get up to 28% of the vote. At a regional level, fiscal austerity has also been at the root of the more secessionist fervour in Catalonia. In the run-up to the autumn election political risk and challenges to the Spanish reform programme are thus likely to increase.

Spain has been the euro area poster child of structural reforms and has started to see benefits on the economic recovery front. But this is highly unlikely to return the majority centre-right government back to power with an absolute majority. The cost of fiscal austerity and reforms is evident in the labour market. Although off the more than 26% peak, at nearly 24% Spain's unemployment rate remains staggeringly high, resulting in plenty of disenfranchised voters who feel drawn to more populist proposals.

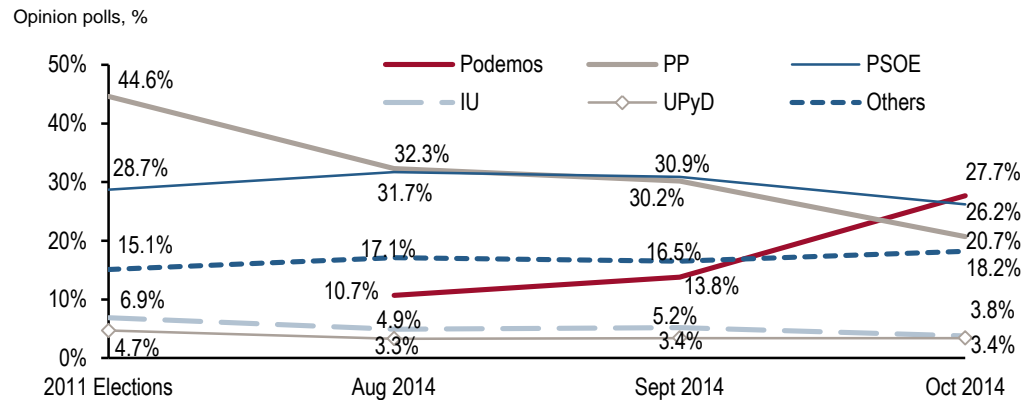
The surprise, and in sharp contrast to other periphery countries, is how long it has taken for a protest party to formally emerge in Spain. Spain's protests under the banner of 'indignados' or the angry ones at the height of reforms and benefit cuts only morphed into the new left-wing Podemos party early this year. Only a few months after being founded the party performed strongly in the May European Parliament, coming in fourth in electoral preferences. With 8% of the vote Podemos secured five seats at the European Parliament and has gone from strength to strength since then. The most recent opinion poll showed it overtaking the two established centre-right and centre-left parties.

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<sup>1</sup> Although Podemos probably won't participate in those regional contests, it could nonetheless provide indications on the change in political support for the main parties.



**Exhibit 12: Redrafting Spain's political landscape**



Source: Metroscopia for El Pais, Credit Suisse

With one year to go it is too early to forecast the outcome of the 2015 parliamentary election but current polls point to a hung parliament. This could result in an unprecedented grand-coalition of Spain's traditional centre-right and centre-left parties as they ally in an effort to keep the more radical element out. From a regional perspective, especially when it comes to the demands of Catalonia, this might not be a bad outcome. The centre-left is more open towards economic devolution and this would take the edge off the pro-independence movements.

But in one year Podemos might also tone down some of the more radical stances in a bid to become a more reliable government partner, in particular for the centre-left Socialists. Some of this seems to be underway. At the end of October Podemos' leader, Pablo Iglesias, signaled his desire for the party to occupy the political centre-ground in order to secure winning the election. This in turn is likely to force a re-think in the centre-right. So far the incumbent, PM Rajoy, has been fairly sanguine about the rise of Podemos, believing that the party poses more of a problem to the centre-left.

**A clearer Podemos party programme is emerging after the party held a citizens' assembly last month.** The assembly, in which participants could vote for favoured resolutions resulted in the party adopting the five most popular ones. These are: improving education and public healthcare (the party is committed to keeping both free), fixed living allowance for all citizens, reducing the retirement age to 60, anti-corruption measures, the right to housing and auditing and re-structuring Spain's debt. But this latter resolution is already a toned down version of the party's stance ahead of the May European Parliament election when it championed default. Now the aim is to promote an organized restructuring of peripheral European debt – a proposition markets would still find difficult to digest!

Podemos' aim of moving toward the centre-ground, trying to get support not only from blue-collar workers but also SMEs, will be an increasing headache for Spain's traditional parties, which are likely to continue seeing voter defection.

While too early to foresee the result of the parliamentary election, the one conclusion that can be safely drawn at this juncture is that challenges of this more militant, populist party may make it harder to push additional structural reforms through. And depending on whether Podemos becomes part of a government coalition, it also increases the risk that some reforms, such as the pension reform, get rolled back.

**Portugal – Socialists: outright majority?**

Parliamentary elections will be held between Sunday, 20 September 2015 and Sunday, 11 October 2015. The official date will be announced no later than mid-August, at least two months before the election.

The possibility of a snap election is now slight; however, it cannot be fully excluded. The governing centre-right coalition, Social Democratic Party and Popular Party, has a solid parliamentary majority, with more than 130 MPs out of 230 seats.

**Exhibit 13: Relatively solid parliamentary majority**

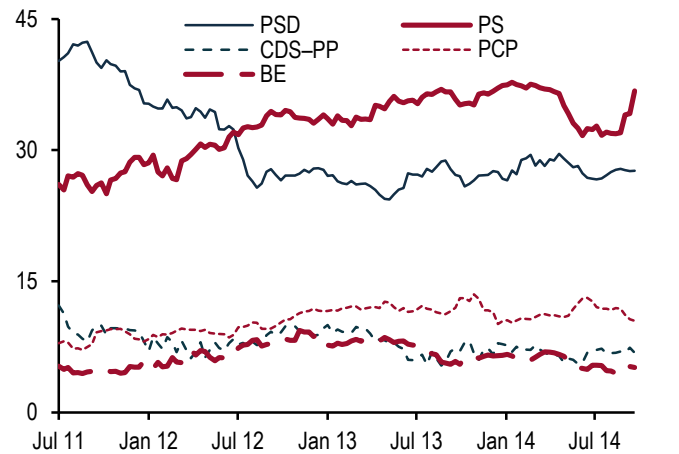
The possibility of a snap election is slight

Parliamentary Group	Seats
Social Democratic Party (PSD)	108
People's Party (CDS-PP)	24
Socialist Party (PS)	74
Communist Party (PCP)	14
Left Bloc (BE)	8
The Greens (PEV)	2
<b>Majority: PSD and CDS-PP</b>	<b>132</b>
Opposition	98
<b>Total</b>	<b>230</b>

Source: Credit Suisse, Assembleia da República

**Exhibit 14: Costa's effect – Socialists on the rise**

Several polls, five-poll moving average



Source: Credit Suisse

Despite this solid parliamentary majority, Coelho's Social Democratic party lost the lead in the polls since Mid-2012 in favour of the Socialist party. The gap has widened in the past few months on the back of Coelho's illegal payment allegation. However, the Socialist party's margin of victory in European Parliament elections was less than expected and slowed its momentum. This election outcome, therefore, weakened Seguro's Socialist party leadership. The uncharismatic party leader was defeated in a primary election (held on 28 September) by António Costa, Lisbon's popular mayor, prevailing with a solid majority (67.9% vs. 31.7%). The latter was therefore elected as the Socialist Prime Minister candidate.

Since the start of Coelho's Government in 2011, the Socialist party has criticized the troika-led reforms and "German diktats". The government coalition regained public support thanks to the clean exit from the bailout on May 17th. However, Coelho's investigation clearly does not bode well for the current government coalition and has outweighed the good news coming from the bailout exit.

The economy has returned to a positive quarterly growth path since Q2 2013 and the unemployment rate keeps falling by almost 4pp from its peak of 17.5 at the beginning of 2013, but it will take some time before people reap the real benefits of it. In our view, if the improvement in the labour market continues in the next 12 months, we may see the 12-point-wide difference between PSD and PS narrow, but it is unlikely to reverse. On the other hand, we see two major hurdles for the government: the former is the Constitutional Court, which may force the government to take alternative measures, and the latter is Coelho's investigation.

While the Socialists have been criticising the EU/IMF programme, we don't expect them to renege materially on the decisions taken by the current administration: it is worth reminding ourselves that the initial bailout programme was signed by the Socialist party as well at the time.

The Socialists are unlikely to win by an outright majority and will have to ally with at least one of the two parties in the current government coalition (Social Democratic Party or Popular Party). In that case, the President of the Republic will play a more active role, whose elections are due in January 2016.

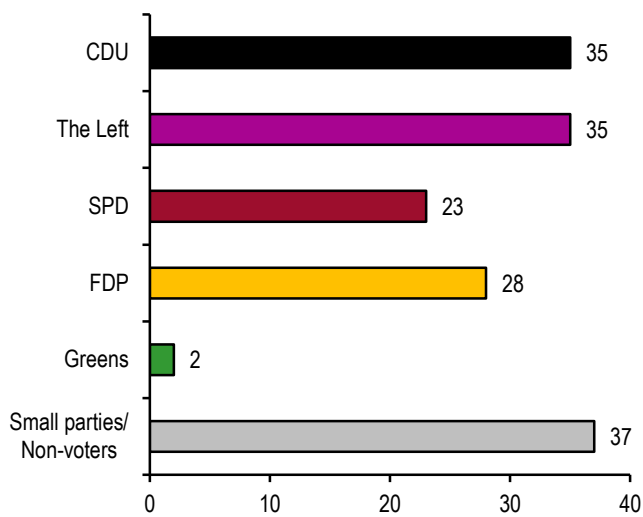
### Germany – Merkel's headache, the AfD

**Merkel cannot continue ignoring the AfD.** Since being founded 18 months ago the party challenged her support for euro area bailouts and ECB policies, especially the OMT. But keeping the party at arm's length hoping it would fade has not worked. After failing to clear the 5% parliamentary threshold at last year's federal election, the party has won representation at the European Parliament and has entered state parliaments for the first time this autumn. National opinion polls currently see the AfD getting 8% of the vote; it entered the parliaments of the eastern German states of Saxony, Thuringia and Brandenburg with 9.7%, 10.6% and 12.2% of the vote respectively.

**For the AfD the key is now to gain seats in the west** and this puts the elections of Hamburg and Bremen, two of Germany's three city states, in focus next spring. For Merkel the pressure coming from her own party, the centre-right CDU, to acknowledge the AfD and start reaching out will only increase further if the AfD manages to gain seats in the city states.

**Exhibit 15: Voter migration to AfD in Brandenburg and Thuringia**

In 1000s



Source: infratest dimap, Credit Suisse

**Exhibit 16: German election timetable**

2015		
15th February	Hamburg	state election
10th May	Bremen	state election
2016		
Spring	Saxony-Anhalt	state election
Spring	Baden-Württemberg	state election
Spring	Rhineland-Palatinate	state election
Autumn	Berlin	state election
Autumn	Mecklenburg-Western Pomerania	state election
2017		
Spring	North Rhine-Westphalia	state election
Spring	Saarland	state election
Summer	Schleswig-Holstein	state election
Autumn	all states	Federal plmt.

Source: Bundeswahlleiter, Credit Suisse

**The AfD was set up as an anti-euro party, although it is not against the EU.** But after failing to gain federal representation and in the run-up to this year's autumn state elections it broadened its message, focusing on areas that appeal to traditional, conservative voters such as policing, immigration and education.

The eastern German state elections this autumn showed that **the AfD is not only a problem for Merkel's CDU but for most of Germany's other parties** with the exception of the Greens. Voter migration to the AfD was broad based in the autumn state elections, with both Merkel's CDU and The Left party losing the same amount of supporters to the AfD. The number of voters deserting Merkel's grand-coalition partner, the SDP, was closely behind and a large chunk also came from Merkel's former coalition partner, the liberal FDP. The implosion of the latter, closely identified with Germany's SMEs, has provided fertile ground for the AfD, which is also managing to attract a large number of previous non-voters.

The 2017 federal election is still far away but ever since an internal strategy paper was leaked it is an open secret that **CDU politicians are calling for Merkel to stop ignoring the party**. This becomes particularly relevant after the SPD decided to negotiate a left-party-led red-red-green coalition of The Left, SPD and Greens in Thuringia. Although the SPD is still ruling out such an alliance at the federal level, the precedent is being set and increases the pressure on the CDU to look for alliances elsewhere. While Merkel and her Minister of Finance, Schäuble, are still ruling out cooperation with the AfD, the latter is trying to ensure support from the upcoming CDU generation as it broadens its base. And CDU politicians are openly calling not only to acknowledge the party but also to formulate CDU policies to tackle the challenge this party is raising.

**For Merkel this means that backing from her rank and file to support the euro area project in future wanes.** As compared to Berlin's tacit endorsement of the OMT at the time, endorsement of fiscal help for the periphery and indeed, QE, is much less likely going forward if the opinions of the AfD start to matter more and more.

### Italy – Re-centring the political debate

The economic crisis and political scandals led to the rise of the Five Star Movement (M5S<sup>2</sup>). The maximum support for the Movement was reached during the peak-crisis years – in 2012-2013. In the February 2013 elections, in particular, the Movement obtained 25% of the popular vote, a much higher figure than expected by opinion pollsters. Despite the continuous economic difficulties of the countries – Italy is still in a recession this year – the unwillingness to compromise and to join a government coalition with the center-left Democratic Party (PD) after the election led to a slow but steady erosion of support in the polls. The European Parliamentary Elections this year showed a fall in support to 21%, and polls are suggesting something just below the 20% line currently.

Meanwhile, the elections in 2013 and then the arrival of Matteo Renzi at the head of the PD lead to a rejuvenation and a change in the main Italian political party. As such, and paradoxically to some extent, **the first reaction of the electorate towards a radical, "anti-parties" movement turned into support for an "uber-centrist" reinvention of the traditional centre-left party.**

The lesson from Italy is that traditional parties have a chance, if they are able to transform themselves profoundly. That being said, the political situation in Italy has not fully stabilised yet, and further innovations are possible. New general elections in the coming months are unlikely but cannot be excluded. Indeed, the current Italian political system allows for some inherent political uncertainty and instability: a government is often at risk of being voted down by junior coalition members or other "rogue" MPs within the main coalition party. Moreover, the likely stepping down of the President of the Republic in the coming months represents further event risk, given the usual difficulty in finding a broadly accepted candidate and the political tensions it always implies.

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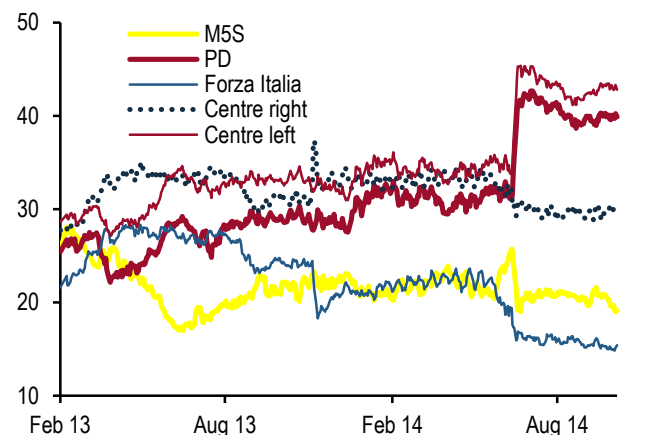
<sup>2</sup> M5S is a "green" party, is strongly against corruption, prefers direct democracy where possible. It is also very negative on the euro, and appears as anti-immigration.

**Exhibit 17: Narrow majority in the Senate**

Parliamentary Group	Seats
Partito Democratico (Democratic Party)	109
Nuovo Centrodestra (Alfano's New Centre Right)	31
Per le Autonomie (For the Autonomies)	13
Per l'Italia (For Italy)	10
Scelta Civica per l'Italia (Civic Choice)	7
<b>Majority</b>	<b>170</b>

Source: Credit Suisse, Senato della Repubblica

**Exhibit 18: Slow but steady erosion of M5S support, centre left well ahead of the centre right**



Source: Credit Suisse

**Early elections would probably lead to a reinforcement of the current Renzi leadership**, but other options – e.g., a resurgence in support for the M5S – cannot be completely discarded at this stage. To be fair, the latest innovation in Italian politics seems to be a progressive “normalisation” of the M5S movement, more open to compromise sensibly with Renzi’s party on a number of issues.

An opportunity for calling early elections could be the results of the regional elections that are taking place between November this year and the spring of 2015: a strong showing of the PD could prompt Renzi to go to the polls to boost the presence of the PD in Parliament and also to reinforce his leadership and control within the party. This might lead to some limited market volatility, that shouldn’t last long, in our view.

An interesting historical precedent in Italy is also that of the Northern League. The latter was, in the 1980s and 1990s, a radical, even separatist, movement. It, however, became “mainstream” when it shared government responsibilities within the centre-right coalition led by Mr. Berlusconi. As such, radical parties can also be contained not by shrinking their base but by having them become more like traditional parties. That said, the latest “turn” of the Northern League is that it wants to become a national party, against Europe and the euro. This new incarnation of the party is gaining some traction, with the NL now at close to 10% of preferences in some polls, although we don’t think it has a strong potential for a wider base, given its inability to attract voters in most parts of Italy due to their regionalist background.

**France**

While polls and recent European elections show a clear rise in the nationalist Front National party, the risk of early elections seems limited, given the nature of the French political system. After some opaqueness in his approach, President Hollande clarified his strategy earlier this year and with a new PM and a new Economy Minister, the French government appears more determined than at the beginning of its mandate to pursue needed reforms. The institutional framework in France makes it quite difficult for a majority to be changed before the natural timing of the following general elections, and as such we believe that the drive to reform the country should remain present and supported until then, in 2017. Given the low popularity of the present administration, though, and the rise in nationalism, the uncertainty on the path of reform could resurface just before, around and after the election period.

## **Finland**

Parliamentary elections are due on 19 April 2015. The incumbent coalition government is led by the centrist National Coalition Party, which has a strongly pro-European stance. However, recent opinion polls suggest that the Centre Party, which has a euro-skeptic faction, stands a better chance to become the strongest party in the next parliament. We do not think that the Centre Party overall would adopt a radical attitude towards the EU, but we see considerable risk of less unequivocal support deepening European integration. In the meantime, the radical Finns Party is likely to retain a significant presence in the new parliament, although its public support seems to have weakened from around 19% in 2011 to about 16%, according to recent opinion polls.

## **Poland**

Parliamentary and presidential elections are due in 2015. The incumbent Civic Platform (PO) and opposition Law and Justice (PiS) are neck-and-neck in the opinion polls, each having around 33% of public support. PO has a clearly pro-EU stance, which was rewarded by its leader's appointment as the President of the European Council in 2014. Furthermore, PO is likely to campaign for the introduction of the euro in Poland, which is conceivable over the next electoral cycle, in our view. On the other hand, however, PiS has a more euro-sceptic stance and is unlikely to support the deepening of Poland's European integration. Recent opinion polls suggest that neither party is likely to secure an absolute majority, but PO seems to have more options to form a coalition.

## GLOBAL FIXED INCOME AND ECONOMICS RESEARCH

**Ric Deverell**  
 Global Head of Fixed Income and Economics Research  
 +1 212 538 8964  
 ric.deverell@credit-suisse.com

### GLOBAL ECONOMICS AND STRATEGY

**James Sweeney, Chief Economist**  
 Co-Head of Global Economics and Strategy  
 +1 212 538 4648  
 james.sweeney@credit-suisse.com

**Neville Hill**  
 Co-Head of Global Economics and Strategy  
 +44 20 7888 1334  
 neville.hill@credit-suisse.com

### GLOBAL STRATEGY AND ECONOMICS

**Matthias Klein**  
 +44 207 883 8189  
 matthias.klein@credit-suisse.com

**Wenzhe Zhao**  
 +1 212 325 1798  
 wenzhe.zhao@credit-suisse.com

**Axel Lang**  
 +1 212 538 4530  
 axel.lang@credit-suisse.com

**Jeremy Schwartz**  
 +1 212 538 6419  
 jeremy.schwartz@credit-suisse.com

### US ECONOMICS

**James Sweeney**  
 Head of US Economics  
 +1 212 538 4648  
 james.sweeney@credit-suisse.com

**Jay Feldman**  
 +1 212 325 7634  
 jay.feldman@credit-suisse.com

**Dana Saporta**  
 +1 212 538 3163  
 dana.saporta@credit-suisse.com

**Xiao Cui**  
 +1 212 538 2511  
 xiao.cui@credit-suisse.com

### LATIN AMERICA (LATAM) ECONOMICS

**Alonso Cervera**  
 Head of Latam Economics  
 +52 55 5283 3845  
 alonso.cervera@credit-suisse.com  
 Mexico, Chile

**Casey Reckman**  
 +1 212 325 5570  
 casey.reckman@credit-suisse.com  
 Argentina, Venezuela

**Daniel Chodos**  
 +1 212 325 7708  
 daniel.chodos@credit-suisse.com  
 Latam Strategy

**Juan Lorenzo Maldonado**  
 +1 212 325 4245  
 juanlorenzo.maldonado@credit-suisse.com  
 Colombia, Ecuador, Peru

**Alberto J. Rojas**  
 +1 212 538 4125  
 alberto.rojas@credit-suisse.com

### BRAZIL ECONOMICS

**Nilson Teixeira**  
 Head of Brazil Economics  
 +55 11 3701 6288  
 nilson.teixeira@credit-suisse.com

**Daniel Lavarda**  
 +55 11 3701 6352  
 daniel.lavarda@credit-suisse.com

**Iana Ferrao**  
 +55 11 3701 6345  
 iana.ferrao@credit-suisse.com

**Leonardo Fonseca**  
 +55 11 3701 6348  
 leonardo.fonseca@credit-suisse.com

**Paulo Coutinho**  
 +55 11 3701-6353  
 paulo.coutinho@credit-suisse.com

### EUROPEAN ECONOMICS

**Neville Hill**  
 Head of European Economics  
 +44 20 7888 1334  
 neville.hill@credit-suisse.com

**Christel Aranda-Hassel**  
 +44 20 7888 1383  
 christel.aranda-hassel@credit-suisse.com

**Giovanni Zanni**  
 +44 20 7888 6827  
 giovanni.zanni@credit-suisse.com

**Gergely Hudecz**  
 +44 20 7888 3742  
 gergely.hudecz@credit-suisse.com

**Sonali Punhani**  
 +44 20 7883 4297  
 sonali.punhani@credit-suisse.com

**Mirco Bulega**  
 +44 20 7883 9315  
 mirco.bulega@credit-suisse.com

### EASTERN EUROPE, MIDDLE EAST AND AFRICA (EEMEA) ECONOMICS

**Berna Bayazitoglu**  
 Head of EEMEA Economics  
 +44 20 7883 3431  
 berna.bayazitoglu@credit-suisse.com  
 Turkey

**Carlos Teixeira**  
 +27 11 012 8054  
 carlos.teixeira@credit-suisse.com  
 South Africa

**Gergely Hudecz**  
 +44 20 7888 3742  
 gergely.hudecz@credit-suisse.com  
 Czech Republic, Hungary, Poland

**Alexey Pogorelov**  
 +7 495 967 8772  
 alexey.pogorelov@credit-suisse.com  
 Russia, Ukraine, Kazakhstan

**Nimrod Mevorach**  
 +44 20 7888 1257  
 nimrod.mevorach@credit-suisse.com  
 EEMEA Strategy, Israel

### JAPAN ECONOMICS

**Hiromichi Shirakawa**  
 Head of Japan Economics  
 +81 3 4550 7117  
 hiromichi.shirakawa@credit-suisse.com

**Takashi Shiono**  
 +81 3 4550 7189  
 takashi.shiono@credit-suisse.com

### NON-JAPAN ASIA (NJA) ECONOMICS

**Dong Tao**  
 Head of NJA Economics  
 +852 2101 7469  
 dong.tao@credit-suisse.com  
 China

**Deepali Bhargava**  
 +65 6212 5699  
 deepali.bhargava@credit-suisse.com  
 India

**Dr. Santitarn Sathirathai**  
 +65 6212 5675  
 santitarn.sathirathai@credit-suisse.com  
 Regional, India, Indonesia, Thailand

**Michael Wan**  
 +65 6212 3418  
 michael.wan@credit-suisse.com  
 Singapore, Malaysia, Philippines

**Christiaan Tuntono**  
 +852 2101 7409  
 christiaan.tuntono@credit-suisse.com  
 Hong Kong, Korea, Taiwan

**Weishen Deng**  
 +852 2101 7162  
 weishen.deng@credit-suisse.com  
 China

## Disclosure Appendix

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