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European economies: Will political risk spoil the party in 2017?

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By Coface Group Economists

The UK referendum in June, parliamentary elections in Spain in December 2015 and June 2016... The past 12 months have seen a multiplication in the number of political deadlines with unexpected outcomes and uncertain consequences in Europe. However, the political tempo is set to quicken again in the coming year, with the referendum in Italy and the presidential election in Austria on 4 December, possible parliamentary elections in Spain on 25 December (the third in just over a year!), elections in the Netherlands on 15 March, presidential and parliamentary elections in France in April, May and June, without forgetting the vote in Germany in autumn 2017.

The question induced by this faster political tempo is simple: will economic growth withstand the pace? Indeed, growth could be affected in various ways by increased political uncertainty: delayed investment and corporate spending decisions, a drop in household confidence, a downturn on equities markets and the increase in bond rates taking a toll on financing terms for economic agents, as well as a lack of reforms and a freeze on public spending in the event of a government vacuum. While it is easy to enumerate these transmission channels, it is far more difficult to quantify the impact of this political uncertainty on growth. This is what we attempt to do here.

After measuring political risk in 14 countries in western Europe by taking into account risk indicators specific to the region (rising euroscepticism, anti-immigration sentiment and a fragmentation of political scenes), we have built an econometric model aimed at measuring the impact of an increase in political uncertainty on GDP growth in five countries: Germany, the UK, France, Italy and Spain. This indicates that the increase in political risk noted since the crisis has dented growth by 0.2 points on average, the impact on investment (0.5 points) being higher than that on household consumption (0.1 points). Nevertheless, this average masks clear differences, growth in the UK (0.3 points), France (0.4) and Spain (0.3) being more affected by political risk than in Italy and Germany. In the event that these last four countries suffer a rise in political uncertainty like that seen in the UK at the time of the referendum in June, their growth would be dented by around 0.5 points on average.

Eventually, it is difficult to speak of political uncertainty without mentioning the US in these last months of 2016. Our model shows a significant impact on the US economy by a shock in political uncertainty to a similar extent of that seen with the UK referendum (1.5 points). The impact on European economies would be even worse, thereby confirming the systemic role of the US economy

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EUROPEAN ECONOMIES: WILL POLITICAL RISK SPOIL THE PARTY IN 2017?

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1 POLITICAL TEMPO ACCELERATING IN EUROPE

Political risk has been associated with emerging markets for several decades, but now it also affects western countries and especially Western Europe (as well as the US in the late stages of 2016). The first signs of this rising political risk in Europe appeared in 2011, via institutional blockages in the European Union and numerous political uncertainties within the countries suffering from the sovereign debt crisis (Greece and to a lesser extent Portugal, Ireland and Spain). These risks have again notched up a gear over the past year with two parliamentary elections in Spain and the UK referendum in June. The political tempo is set to quicken again over the next 12 months, when votes with uncertain outcomes are scheduled in four of the main eurozone countries (and even the top five, if we include the parliamentary election in the Netherlands on 15 March 2017).

On 4 December, Italy is due to hold a referendum on its constitutional reform aiming to reduce the powers of the Senate and thereby improve capacity to reform the country. After announcing that he would resign if the project is rejected, prime minister Matteo Renzi contributed to transforming this vote into a referendum for or against him. Issues related to migrants, for whom the number of arrivals has not fallen since the agreement signed with Turkey contrary to Greece *(see chart n°1)*, are playing a significant role in the campaign, as is the situation in the banking sector. Although Mr Renzi has since suggested that he could remain in place even after a defeat, voting intentions remain very mixed and the outcome uncertain, with the no vote underpinned by the 5star anti-system movement and the Northern League far-right party. In the event of defeat and the departure of the current prime minister, the short-term political future of the country would be uncertain, with possibly the formation of a technical government of national union or the organisation of fresh elections.

Chart n° 1
Monthly arrivals of migrants in Greece and Italy
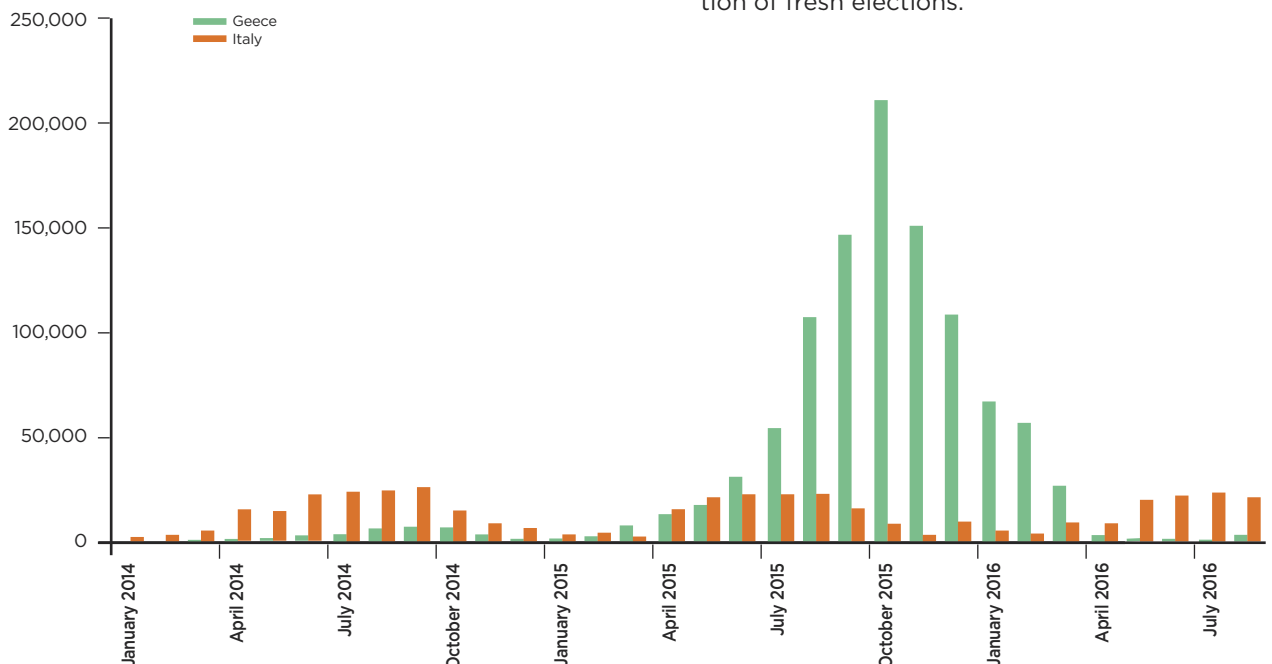
Source: UNHCR

In Spain, the risk of a third parliamentary election in just over a year, being held on 25 December, has not disappeared. Indeed, negotiations between the four main parties, which have started after the 26 June election, have so far not been more efficient than those held after the December 2015 vote. Parliament has until 31 October to elect a government, under threat of being dissolved again. The outcome of these negotiations will notably depend on the position of the PSOE left-wing party, undermined by dissensions regarding which path to follow: either to continue opposing the vote to invest a coalition government between the PP right-wing party of current prime minister Mariano Rajoy and the anti-corruption centre-right party Ciudadanos, or to abstain. However, the forced resignation of the PSOE's secretary general, Pedro Sanchez on 1 October 2016 could open the way to an improvement in negotiations with the PP. Therefore, fresh elections could weigh on corporate and household confidence (even if this has not been the case so far), especially since the non-approval of the 2017 budget before the end of the year would be synonymous with freezing a large amount of public spending at the current level.

Meanwhile, the French presidential election on 23 April and 7 May will see a showdown between the candidates of the three main parties: the right-wing Les Républicains, the left-wing Parti Social-iste and the far-right Front National party. So far, only the Front National candidate is known: Marine Le Pen is virtually certain to get to the second round of voting according to opinion polls. Les Républicains' candidate, probably former president Nicolas Sarkozy or former prime minister Alain Juppé, is to be chosen after a first vote

organized for 20 and 27 November. The winner will be the favourite to accompany Marine Le Pen and then win the election. Finally, current president François Hollande is set to announce before the end of the year whether he will stand for election and take part in the first vote organized by the Parti Socialiste on 22 and 29 January. Two of his former ministers (Arnaud Montebourg and Benoît Hamon) have already announced their participation in this first vote, whereas two others could also present themselves for the presidential election: Emmanuel Macron and Cécile Duflot (Les Verts party). One shall not forget likely candidates, who are Jean-Luc Mélenchon (far left) and François Bayrou (centre-right). In this context of multiple candidates, sources of uncertainty are numerous: who will face Marine Le Pen in the second round? If abstention is high in the second round, could she win the election? Will the party that wins the election, which ever one it is, manage to obtain a majority of seats in the National Assembly following the legislative elections in June?

In Germany, the next parliamentary elections are to be held between 23 August and 22 October 2017. The usual parties (right CDU/CSU, centre-left SPD, liberal FDP, the green party and the far left Linke party) are set to face the new far-right AfD party (Alternative für Deutschland), whose score (currently more than 10% of voting intentions) will depend on the make-up of the traditional-party coalition. The most likely scenario remains a major coalition between the CDU/CSU and the SPD, within which Angela Merkel would remain chancellor, even though voting intentions in favour of her party have declined over the past year.

2 ECONOMIC CRISIS RHYMES WITH RISING POLITICAL RISK

Coface assessment of political risk in emerging markets...

Following the Arab spring, which showed that underlying tension in emerging countries could express itself and result in political changes and revolutions, Coface adapted its methodology of measuring political risk [1] in order to take into account this new landscape. The series of populist risings in North African countries, the Middle East and beyond appeared to be the result of socio-cultural momentum testifying to the populations' aspiration for greater justice and increased respect for individuals. Therefore, in order to measure political risk in emerging markets [2], Coface decided to use indicators

stemming from two sources of rationales. The model aims to identify, in emerging markets, the aspiration and ability of populations to rise against a system that induces political and economic frustrations. As such, indicators of pressure for change are taken into account:

• GDP per capita: the higher the level of development, the more access to essential goods (food, housing, health) is guaranteed to a sizeable share of the population; similarly, the higher the population's expectations are in terms of satisfaction of additional needs [3];

(1) Political risk can be defined as all political or administrative events and decisions, whether national or international, that can cause economic, commercial or financial losses for companies that import, export or invest abroad.
(2) Coface Country Risk Panorama 'Changes in emerging country risk" March 2013
(3) Maslow's psychological theory of needs. Abraham Maslow's hierarchy of individual needs follows the idea that these change depending on the level of satisfaction. When basic survival needs are satisfied, other needs must be satisfied too (security, belonging, esteem, self-actualisation in the order defined by Maslow).

- Unemployment: a high unemployment rate excludes people from professional insertion and social integration, thereby exacerbating frustration.
- Inflation: a high inflation rate can make access to goods difficult, especially foodstuffs.
- The GINI coefficient: an unequal distribution of income (measured by the GINI index) makes the satisfaction of certain social needs difficult, such as access to housing.

These traditional economic and social indicators are key variables. However, they do not fully exhaust the logic of this exasperation. Frustration is not just economic, but can be political:

- "Expression and responsibility": as underscored by Armatya Sen, freedom constitutes the aim of the development process. Freedom of speech, freedom of association and the existence of free media is therefore a major issue. As such, their absence is a major source of discontent.
- Corruption breeds a feeling of injustice and frustration favouring protestation.

These variables reflect economic, social, and political frustrations in a country. In a second stage, Coface measures the ability of countries to transform this pressure into change. Instruments of change are measured by the rate of higher education, the literacy rate in adults, access to internet, the proportion of young people, fertility rates, urbanisation rate and the female participation rate. Political risk therefore combines these two modules (pressure for change and instruments for change), made up of six aggregates each.

Table n° 1
Components in the Coface political risk indicator for emerging countries

	VARIABLE	SOURCE
PRESSURE	GDP per capita	IMF
	Gini	World Bank
	Inflation	IMF
	Unemployment	*Oxford Economics*
	Political freedom	World Bank
	Corruption	World Bank
INSTRUMENTS	Young people aged 20-29	UN
	Level of education	World Bank
	Female participation rate	World Bank
	Fertility rate	World Bank
	Internet access	World Bank
	Urbanisation rate	World Bank

Source: Coface

... adapted to western European countries

Under the framework of developed countries such as those that we study here [4], taking into account instruments does not seem relevant. As such, we estimate that if aspirations for change were present, populations would not encounter barriers either for expressing their exasperation, or transforming them into political change, unlike in emerging markets where the means for provoking change can be blocked by several factors. For all EU countries, the literacy rate is indeed above 95% [5]. Furthermore, a majority of households in the EU have access to the internet (81% in 2014 according to Eurostat). Except for France, with 2.01 children per woman, fertility rates in Europe are below 2 children per woman. Finally, European Union countries are all highly urbanised.

In terms of pressure to change, we have taken into account the unemployment rate [6] and corruption, as a source of social discontent. We have also added GDP growth as well as the annual change in the structural primary budget balance (% of GDP), which measures efforts in budgetary austerity that can be unpopular, especially since increased tax pressure is often actually concentrated on the middle class, which is the largest class and accounts for the lion's share of the electoral body. Other variables help identify pressures existing in certain European countries. These indices are measured by surveys, such as public opinion on immigration or euroscepticism. Two surveys, undertaken twice a year by Eurobarometer, deal with changes in euroscepticism and fears regarding migration. As such, we take into account the following indicators:

- The percentage of individuals within the country that answered "immigration" to the question "What are the two main sources of concern in your country".
- The percentage of people expressing a negative opinion when the question "What image of the EU do you have?" is asked.

Finally, the fragmentation of political scenes is a sign of political instability. We therefore take account of the change in the number of seats in the parliamentary majority [7] after each election. A low majority can be the sign of a large number of parties represented in the elections. The more parties there are in parliament, the more difficult it is to gain a majority and therefore implement reforms. To measure political risk, in the European case, we therefore combine eight variables. GDP growth, the unemployment rate, corruption and euroscepticism have the highest relative weights, 15%.

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(4) 14 countries: Germany, Austria, Belgium, Denmark, Spain, Finland, France, Greece, Ireland, Italy, the Netherlands, Portugal, Sweden and the UK.
(5) 2014 human development report.
(6) An alternative indicator is the unemployment rate for young people whose parents are fully aware. Note that taking this into account would not have changed the ranking presented below.
(7) Lower chamber in the case of a two-chamber parliament.

Table n° 2
Components in the Coface political risk indicator for western European countries

| VARIABLE	SOURCE
GDP growth	IMF, Coface estimates
Gini	World Bank
Unemployment	Oxford Economics
Budget balance / GDP	IMF Fiscal Monitor
Corruption	World Bank
Euroscepticism	Eurobarometer
Anti-immigration sentiment	Eurobarometer
Political fragmentation	National

Source: Coface

Chart n°2:
Coface political risk index for western European countries
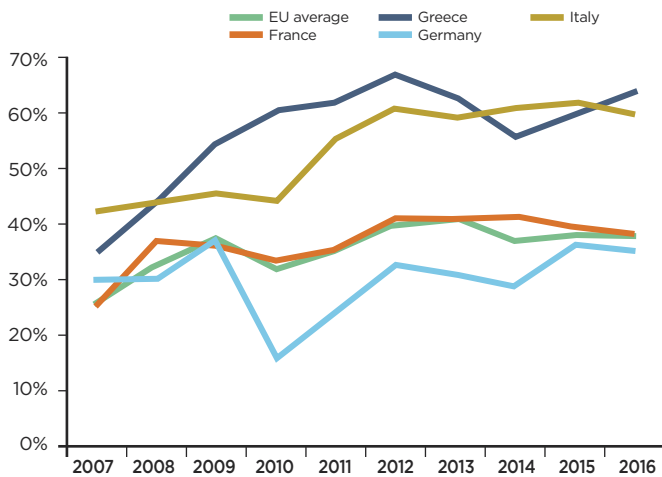
Source: Coface

Chart n° 3
Coface political risk index for western European countries
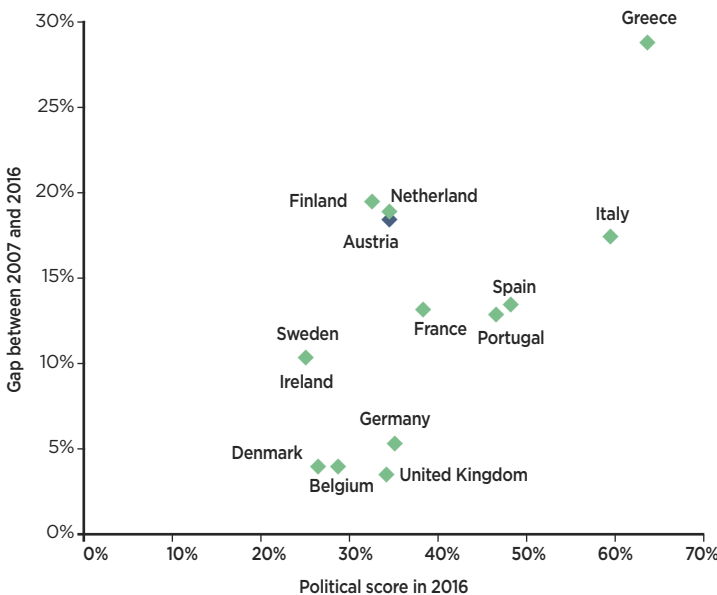
Source: Coface

Expressed on a scale of 0 to 100, this political risk index rose by 13 points on average in the countries studied between 2007 and 2016 *(see chart n°2)*. Unsurprisingly, political risk has therefore increased significantly in Europe.

More precisely, Greece and Italy, which already had the highest score in 2007, are also the countries for which the score has increased the most. All of the indicators in these countries deteriorated over the period. Note for example, corruption, which was nevertheless already at the highest level of the 14 countries studied in 2007, as well as income inequality. In Greece, risk reached a peak of 67% in 2012, whereas the majority lost 20% of its seats in parliament. The lack of recovery, high unemployment, budgetary strictness imposed by international institutions, the migrant crisis and high euroscepticism (51% of Greek people have a negative opinion of the EU in 2016), are all factors explaining why the score is still above 60%. In Italy, pressure is similar; Italians stated that they were more worried about immigration than the Greeks in 2015.

Portugal *(see chart n°3)*, like Greece in 2007, shows the highest inequalities in the sample: these have not narrowed since 2007. The overall score remains fairly high given the still very high unemployment rate, which is still increasing. The election in 2015 of a left-wing coalition, partly anti-EU, testified to rising euroscepticism in the country. Whereas the economic recovery has been confirmed in Spain, inequalities, high unemployment (22% in 2015) and parliamentary instability (there is still no majority after two parliamentary elections) are slowing the decline in pressures. Political risk has also increased, in a lesser way, in France and in Germany according to this indicator, reflecting the deterioration in the economic and social environment. The population's huge concern over immigration as well as an increasingly negative opinion on the EU partly explains this trend. Unsurprisingly, these two variables were also the origin of the increasing level of risk seen in Finland (+20 points, the highest growth after Greece at 29 points), the Netherlands (+19 points) and in Austria (+18 points).

Finally, the case of the UK highlights the limits of our model, it associates the country with a fairly low level of risk, which has increased very slightly *(see chart n°3)*. Indeed, the model does not capture very well the low-skilled part of the manual labour workforce in the case of countries where unemployment remains low (4.9% in July 2016). In addition, whereas the country voted to leave the EU in June 2016, only 26% of the population has a negative opinion of the EU (vs. 32% in 2015) according to the Eurobarometer survey. In contrast, the survey shows a rise in migratory fears in 2016 [8].

(8) For 38% of the population in 2016, this is a major source of concern.

3 WHAT IMPACT DOES POLITICAL UNCERTAINTY HAVE ON GROWTH IN EUROPE?

Economic growth and political risk are interconnected. As set out in the previous part, deterioration (improvement) in economic conditions is likely to cause an increase (decrease) of political risk: a rise in unemployment, inflation or income inequalities can provoke social discontent.

Meanwhile, increased political risk can affect the economic environment. The impact of this political uncertainty on growth primarily involves two transmission channels that are likely to support each other mutually: 1) a decline on equity markets and an increase in bond rates taking a toll on financing terms for economic agents (state, companies and households) and hence their investment and spending outlook, 2) a lower level of corporate and household confidence prompting delays or cancellations in investment or spending decisions. If these last for some time, a third channel can also occur: that of budget policies. In the event of a long-lasting government vacuum, the freeze on public spending causes a negative impact on activity.

Various studies confirm these interconnections. In 2011, Aisen and Vaiga [9] concluded that a higher degree of political uncertainty (measured by the number of changes of government) is associated with lower growth in GDP per capita, after studying the statistical relationship between these two variables in 169 countries between 1960 and 2004. These results confirm those of Alesina (1996) [10] according to which GDP growth in 113 countries between 1950 and 1982 was significantly lower when the likelihood of the collapse of a government was high.

However, recent events in Europe only seem to partially confirm the theory. For example, the Spanish economy does not seem to be penalized by the lack of government since end-2015 if we look at growth figures for the first semester of 2016. The same was also true of Belgium in 2013-2014. In the UK, the economic consequences of uncertainty caused by the 23 June vote are visible, but not as bad as expected (see Coface Q3 2016 Country Risk Barometer Panorama).

To get a better picture, we set out to quantify the consequences of rising political risk. However, the indicator presented in the previous section cannot be used under the framework of an econometric model since its frequency is annual. In order to measure political instability, we therefore used the EPU index (Economic Policy Uncertainty) developed by Baker, Bloom and Davis, and built on the basis of the number of key-words, defining uncertainty, found in the press of the country studied. It relates three different fields: the economy, politics and uncertainty that are themselves subdivided into different categories such as public spending, financial regulations and interior security [11].

Box n°1

Statistical model measuring the impact of political uncertainty on economic activity.

Our model is made up of two variables: the measure of political uncertainty (EPU, Economic Policy Uncertainty, developed by Baker, Bloom and Davis [12], associated respectively with GDP growth, growth in household consumption and that in investment measured by the gross fixed capital formation [13]. All the variables are seasonally adjusted, quarterly and available between Q2 2001 and Q2 2016 (61 observations). We focus on five countries in western Europe (France, Germany, Italy, Spain and the UK) and the US *(see box n°2 page 9)*.

Macroeconomic variables are expressed in quarterly variation with the null hypothesis of non-stationarity rejected for all series except for Spanish GDP. However, this series becomes stationary if we take into account the period from Q1 2008 to Q2 2016. We therefore focus on this period for Spain. The EPU variable is an index that has been log-linearized and we have

(9) Aisen A. and Vaiga F. (2011), "How Does Political Instability Affect Economic Growth?", Working Paper no. WP/11/12 of the International Monetary Fund.
(10) Alesina, A. and Perotti, R. (1996), "Income distribution, political instability, and investment", European Economic Review 40, 1203-1228.
(11) The VIX index measuring implied volatility on the S&P500 equity markets index could also have been used. Its results are similar to those of the EPU (see Ferrara and Guérin, 2016).
(12) "Measuring Economic Policy Uncertainty", Scott R. Baker, Nicholas Bloom, and Steven J. Davis, NBER Working Paper No. 21633, October 2015.
(13) Source: Eurostat.

derived the first difference of this log-linearization. In order to study the impact of uncertainty on GDP growth, we use autoregressive vectoral models (VAR(p)), with p being the number of lags chosen. In order to specify the optimal number of lags, we have based ourselves on standard information criteria (AIC, BIC, Schwarz) and we select the optimal specification for each variable by minimizing these criteria. Depending on the country considered, the number of lags varies depending on the robustness of the model's specification. Similarly, the presence of a constant depends on its significance in the model. In order to avoid multi-collinearity problems, we estimate investment, consumption and GDP separately. We therefore aim to estimate the following model for $i = 1,\ldots, 6$ country, with EPU - political uncertainty, GDP - growth in GDP, conso, which is that in household spending and invest, which is that in investment:

$$conso_t^i = \beta + \sum_{k=1}^{\rho} \alpha_k \Delta\ln\left(EPU_{t\text{-}k}^i\right) + \sum_{k=1}^{\rho} \beta_k conso_{t\text{-}k}^i + \epsilon_t^i$$

$$invest_t^i = \sigma + \sum_{l=1}^{\rho} \alpha_l \Delta\ln\left(EPU_{t\text{-}l}^i\right) + \sum_{l=1}^{\rho} \gamma_l invest_{t\text{-}l}^i + \epsilon_t^i$$

$$GDP_t^i = \rho + \sum_{m=1}^{\rho} \alpha_m \Delta\ln\left(EPU_{t\text{-}m}^i\right) + \sum_{m=1}^{\rho} \delta_m GDP_{t\text{-}m}^i + \epsilon_t^i$$

After estimating our equations, we simulate a shock on political uncertainty and observe its impact on GDP growth, household spending and then investment. We use a Cholesky decomposition, which helps us in modelizing an orthogonal impulse response function represented in cumulative form.

Since the 2008 crisis, political uncertainty has increased significantly *(see chart n°4)*. The EPU index gained 117 points between 2005-2006 and 2011-2012. France and the UK are the countries where it rose the most (respectively 177 and 190 points). In Italy and Spain, the increase "only" reaches 63 and 69 points. Finally, Germany is in an intermediary position (+98 points).

In this context, we have measured the impact of this increase in political uncertainty since 2008 on economic activity in Europe by using the autoregressive vector model *(see box n° 1 page 6 and 7)*. We have firstly measured the impact of a 100-point increase in the EPU index on GDP, consumer spending and investment, that is to say an identical shock for all countries.

Chart n° 4
EPU political uncertainty index

Source: Economic Policy Uncertainty
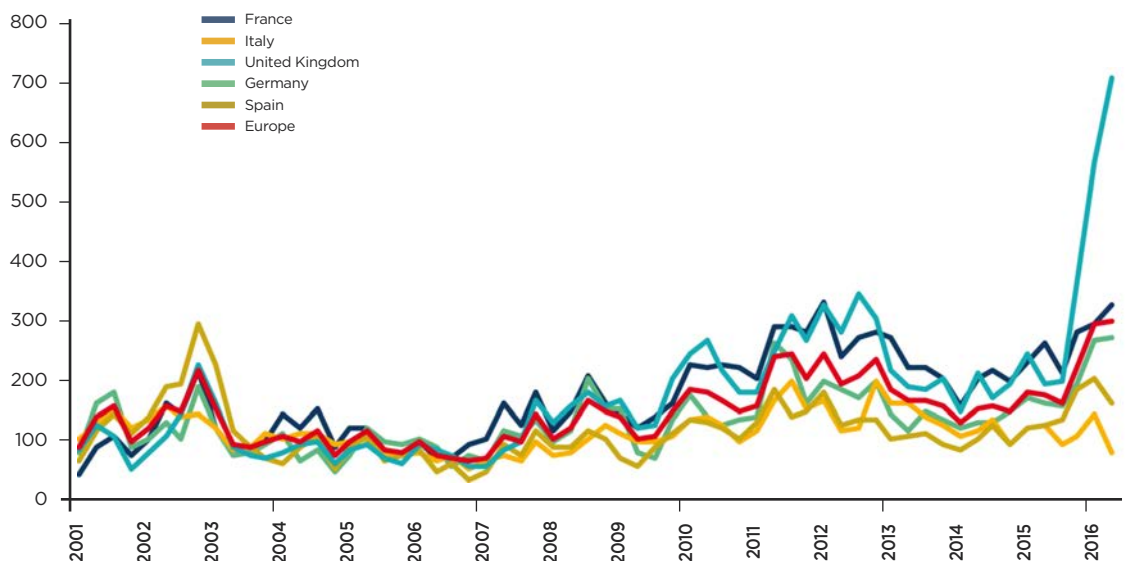
GDP would decrease by almost 0.2% on average in Europe, with all of the impact being felt in the year following the shock *(see chart n°5)*. In detail, investment spending (-0.5%, *see chart n°7)* would fall further than household consumption (-0.1%, *see chart n°6)*, in a sign that corporate confidence is more sensitive to political uncertainty than household confidence. The ensuing delays in company investment decisions therefore has a higher impact on growth than that caused by a decline in household confidence (even taking into account the relative weight of household consumption and investment in GDP [14]). Spain is the country where growth is the most affected by this uniform political shock. It is followed by France, the UK and Germany.

This ranking is modified when we apply not the same shock to the five countries, but that effectively observed in the post-crisis period. France therefore stands out as the country that has suffered the most from political risk (-0.4 points), followed by the UK and Spain (-0.3 points each). Italy closes the market, with a virtually zero impact. A possible explanation for this is an addictive effect: having witnessed numerous governments toppling and early elections over several decades, Italian economic agents are used to unexpected political change. This seems to be even more true for Italian companies than for households, with investment spending being less penalized than household consumption (contrary to other European countries).

Chart n° 5
Cumulative impact on GDP of a shock on the EPU index
(+100 points)
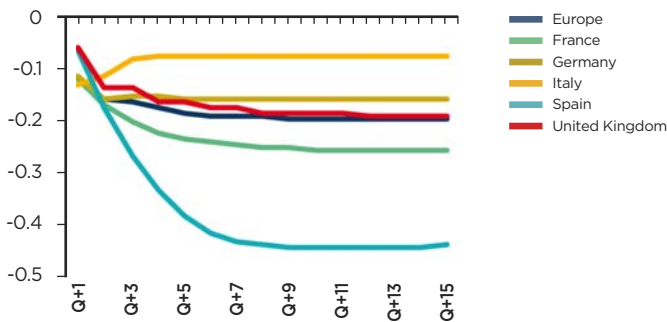
Source: Coface

Chart n° 6
Cumulative impact on household consumption of a shock on the EPU index
(+100 points)

Source: Coface

Chart n° 8
Cumulative impact on GDP of a shock on the EPU index seen between 2005-2006 and 2011-2012

Source: Coface

Chart n° 7
Cumulative impact on investment of a shock on the EPU index
(+100 points)
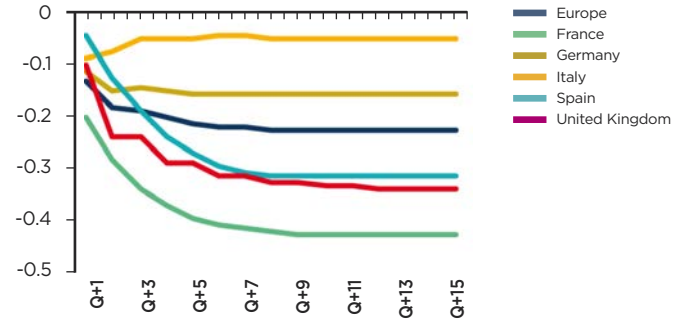
Source: Coface

Chart n° 9
Cumulative impact on GDP of a Brexit shock on the EPU index
(+340 points)
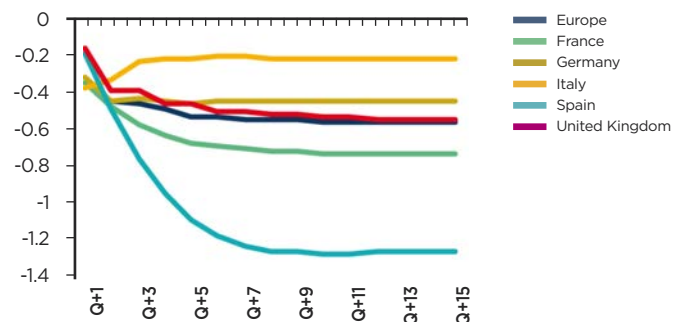
Source: Coface

(14) Investment spending in Europe totals 19.8% of GDP whereas consumption accounts for 53.4% of GDP. Taking into account these weightings, investment spending nevertheless remains the largest contributor to the overall shock on growth, accounting for 51% of the shock, vs. 21% for consumer spending.

After having measured the impact on economic activity of the political shock observed since the Lehman Brothers crisis, we question ourselves about an eventual major shock in coming months. More precisely, the aim is to quantify the impact on activity in France, Germany, Italy and Spain of a shock of a similar extent to that seen in the UK since the beginning of 2016 due to the referendum on Brexit *(see chart n°9 page 8)*. This extensive Brexit scenario would notably be relevant if sources of potential risk to come between now and the end of 2017 (Italian referendum, political blockage in Spain, elections in France and Germany, see first part) were to actually occur. In order to modelize our Brexit type scenario, the amplitude of the uncertainty shock is set as being the increase in the EPU index in the UK during this short period, namely 340 points between Q1 and Q3 2016 [15].

What do the results show? Firstly, UK growth will lose 0.5 points in one year due to the uncertainty caused by the referendum *(see chart n°9)*. Then, the Spanish economy would unsurprisingly be the most affected by a political shock of a similar extent as the UK referendum, since the model is linear. Its growth would be dented by around 1.2 points after one year. The effect would be around 0.4-0.5 points for Germany in the event of a rise in risk next autumn. Italian growth would only lose 0.2 points according to the model, for example, if the outcome of the referendum on 4 December were to generate renewed uncertainty. Finally, French growth would lose around 0.7 points, which would imply a hike of around 1.2% in national company insolvencies [16].

Box n°2

The possible election of Donald Trump, a risk for European economies?

Using the same methodology, we try to assess the impact of an increase in political uncertainty in the US, similar to that observed in the UK, since the beginning of the year on US growth, but also on European economies. For instance, this is likely to occur in the event of a victory by Donald Trump over Hillary Clinton on 8 November.

Accordingly to this scenario, US growth would lose 1.5 points in one year. The impact of this shock would be worse for European economies (-2 points of growth after a year), France, where it would be slightly over one point and Germany, being two exceptions. Apparently more surprising, these results confirm the systemic role of the US economy already observed after the Lehman crisis. Although the crisis originated in the US, GDP growth in the country only dropped by 2.8% in 2009, far lower than the 4.5% decline seen in the eurozone [17].

Chart n° 10
Response function of GDP growth following an uncertainty shock caused by the election of D. Trump

Source: Coface

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