

A shift in the pace, not in the path

European elections unlikely to change EU policy stance, but pace of integration will slow.

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FLASH NOTE

SUMMARY

- The incumbent grand coalition retaining a majority in Parliament is the most likely outcome of this week's European elections, although the general feeling on Sunday night will certainly be one of a symbolic victory for the far right.
- Strengthening the strategic autonomy and competitiveness of the European economy will remain at the heart of the next European Commission, but in the absence of exogenous shocks, progress on integration is likely to be limited.
- A stronger than expected rise of the far right this weekend could make it harder to find working majorities in the Parliament and even undermine the proper functioning of the EU institutions.

NO MAJOR UPHEAVAL, BUT A SYMBOLIC VICTORY FOR THE FAR-RIGHT

The European elections on 6-9 June should not be overlooked. The vote of 360 million EU citizens will determine the composition of the new European Parliament, which may not carry as much weight within the European institutions as the European Commission (the EU's executive arm) or the European Council (the meeting of heads of state and government that sets policy guidelines), but whose influence should not be underestimated. MEPs invest in and control the Commission (which is the source of all EU legislation), participate in the legislative process and vote on the European budget. The outcome of the elections on 6-9 June will therefore largely shape European policy for the next five years and the challenges facing the European Union in this period are considerable in terms of security, defence, and competitiveness.

The vote is unlikely to significantly change the current balance of power in the Parliament, according to opinion polls. Ursula von der Leyen, the outgoing EPP (centre-right) president of the Commission and candidate for a second term, has been working since 2019 with an enlarged coalition of the centre-right, the centre-

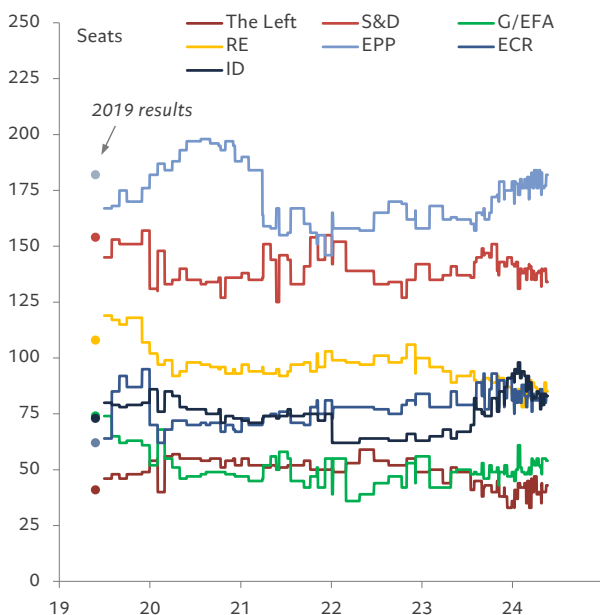
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left and the liberals. After the vote, its weight would fall from 60% to 55% of the total of 720 MEPs. The enlarged coalition would therefore retain an absolute majority, but with a reduced margin. The EPP (which has been doing well in the polls since the beginning of the year) would secure a similar number of seats as in the 2019 elections, the S&D (centre-left) a bit less. Their liberal allies Renew are projected to be the main losers in the elections, along with the Greens, the coalition’s occasional allies, especially on climate-related issues.

Against this backdrop, the most likely outcome remains that Ursula von der Leyen will be reappointed as head of the European Commission. According to the official timetable, the European Council is expected to nominate the candidate for the Presidency in June, and the Parliament is expected to invest the President at the plenary session on 16-17 September. However, the nomination process may take longer: the European Council is divided (some member states may push for alternative candidates) and securing an absolute majority in the Parliament may require lengthy negotiations, as the vote is secret, and defections are common.

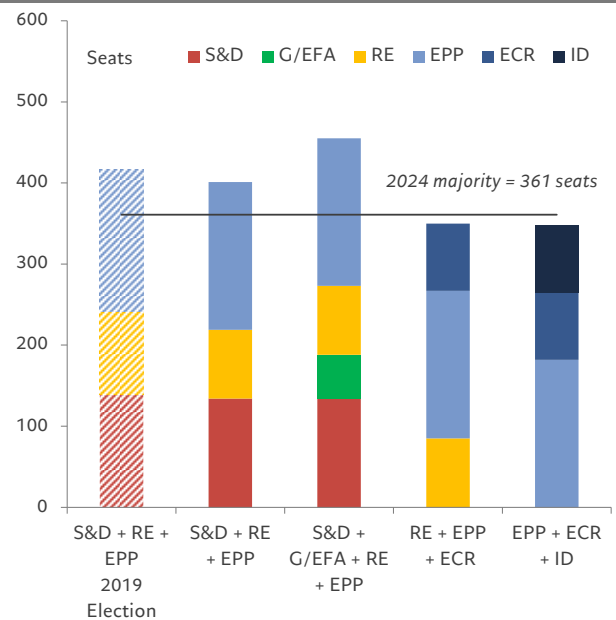
Despite the expected continuity, the Parliament is set to shift to the right, and the sense that will surely emerge on Sunday is one of a symbolic victory for the far right. Indeed, the parties of the eurosceptic and identitarian right would see the biggest increase in the number of seats, with their combined weight in the chamber rising from 17% to almost 25%. They are currently divided between the ECR (eurosceptic and anti-federalist) and the ID (eurosceptic and nationalist). United, they could form the second largest group behind the centre-right and ahead of the centre-left, an unlikely scenario but one that cannot be entirely ruled out (see below).

EU elections: seat projections since 2019



Source: Politico Poll of polls, Europe Elecs, Pictet Wealth Management, as of 04.06.2024

EU elections: projections of possible coalitions



Source: Politico Poll of polls, Europe Elecs, Pictet Wealth Management, as of 04.06.2024

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THE NEW COMMISSION: CONTINUING THE EU'S STRATEGIC PIVOT

Against a background of successive exogenous shocks, the outgoing Von der Leyen Commission contributed to significant progress in European integration. On the macroeconomic front, it helped to strengthen European budgetary policy by creating additional pockets for the pooling of resources (e.g., €650 billion for Next Generation EU, €100 billion for SURE¹) to complement the existing stabilisation mechanisms inherited from the euro area crisis and to finance the recovery in the difficult context of the pandemic, particularly in the priority areas of green and digital transitions.

More recently, the EU's agenda has been refocused on competitiveness and strengthening strategic autonomy. This agenda would be pursued by a Commission backed by an enlarged grand coalition. This pivot has taken place against a global backdrop of heightened geopolitical tensions and the widespread adoption of non-cooperative industrial policies by competing powers, with their emphasis on public subsidies (e.g., Inflation Reduction Act in the United States, massive subsidies to electric vehicles in China).

On strategic autonomy, the priorities are likely to be greater coordination on defence issues, continued support for Ukraine and the enlargement policy (nine countries are currently candidates). On trade, the Commission is also expected to flex its muscles on perceived unfair trade practices, probably in the form of an anti-subsidy tariff on Chinese imports of electric vehicles in the short run. On competitiveness, the focus will be on deepening the single market. A consensus seems to be emerging in favour of a new push towards a capital markets union, in line with the recommendations of the recent Letta report. The Draghi report, to be published in June, is also likely to revive the debate on a European industrial policy.

LITTLE PROGRESS IN THE ABSENCE OF EXOGENOUS SHOCKS

However, there is a risk that, in the absence of major exogenous shocks, these ambitions will not lead to much progress in terms of integration. First, defence is a Member State competence. Most of the increase in military spending will take place at this level rather than at the supranational level, facilitated by the exception clauses in the new EU fiscal rules. Supranational initiatives will certainly be limited to creating synergies between defence industry players or, at best, to creating a European champion in this field. This is the purpose of the Commission's proposal for a €1.5 billion European Defence Industry Programme (EDIP) and the €8 billion extension of EIB financing to the defence sector. Today, the EU faces an estimated shortfall of almost €60 billion compared to NATO targets.

Second, we see two main obstacles to the implementation of the kind of industrial policy that the Draghi report is likely to advocate. First, the EU competition policy is hardly compatible with the interventionism and dirigisme that could result from an industrial policy. Second, even if this first obstacle is overcome, member states will remain deeply divided over its financing. The Draghi report, although not yet finalised, already mentions the need to invest €500 billion a year. But governments

¹ The Support to mitigate Unemployment Risks in an Emergency (SURE) was the EU programme aiming at financing the member states' temporary short-term employment schemes during the pandemic.

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with a conservative fiscal stance have until now formally ruled out any extension of the Next Generation EU underlying facility beyond 2026 to finance other joint spending.

Furthermore, the shift to the right in Parliament is likely to lead to some backtracking on some policies. This is possible on Green Deal measures, especially in the wake of the farmers' movement that took place a few months ago. Similar developments would not be surprising on the migration front, despite the significant demographic challenge facing the EU as its working-age population ages.

As recent history has shown, exogenous shocks have often triggered periods of acceleration in European integration. **Three main contingencies could force European policymakers to be more ambitious in defence and industrial policy, and to pool budget resources further:** a US withdrawal from NATO if Donald Trump is re-elected; a turn in the war in Ukraine in favour of Russia or an extension of the conflict to other European states; a new trade war specifically targeting European exports if Donald Trump is re-elected. **But if these contingencies acted as catalysts to expand common resources, they would also have a negative impact on growth prospects.**

WHAT CAN GO WRONG?

The main risk to the baseline scenario of a policy continuity is that the far right makes greater gains than the polls predict. This would further reduce the incumbent coalition's majority, or even deprive it of a majority altogether. In this case, Ursula von der Leyen (if she is still the EPP candidate in such a scenario) would try to expand the grand coalition with the Greens. But it remains to be seen whether the Greens would be willing to concede some flexibility on the Green Deal and all the related legislation. In any case, an expanded grand coalition would be fragile and working majorities harder to get.

Alternatively, the presidential candidate could negotiate with certain parties on the far right. Ursula von der Leyen has declared herself open to negotiations with Giorgia Meloni's Fratelli d'Italia, which currently sits in the ECR. A cooperation would be possible, especially given the voting patterns in the Parliament where MEPs do not necessarily follow their group's voting instructions. But in doing so, Ursula von der Leyen risks alienating her centre-left allies. Such a scenario would likely weaken the Commission's base and lead to significant backtracking on some policies (e.g., green transition, migration policy and enlargement).

The tail risk would be the combination of a stronger-than-expected rise of the far-right parties and their union in a single parliamentary group. There are deep divisions between these parties, particularly over membership of the single currency, their position on Russia and the European budget. But cooperation between Marine Le Pen and Giorgia Meloni, whose MEPs sit in the ID and ECR respectively, could be a catalyst for a greater union of the far right. With a blocking minority in the Parliament, the group could negotiate the rollback of some policies, seriously hamper the smooth functioning of the EU institutions, and significantly slow down the EU's response to any major exogenous shock, for example on the geopolitical front.

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