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European Sovereign Creditworthiness Might Diminish If Eurosceptics Take Power

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High unemployment and underemployment, declining real wages, credit constraints, public spending cuts, and weakening job security have fed into support for European political parties that are sceptical (at best) about the benefits of membership of the EU and the Economic and Monetary Union (EMU, or eurozone).

Opinion polls indicate that, since 2007, support in EU countries for these "Eurosceptic" parties has grown, across the political spectrum, from next to nothing to around 34% for Italian and Greek Eurosceptic parties and 28% for Spanish Eurosceptic parties. Even in Germany and the U.K., where economic performance has been better than in Europe generally, support for local Eurosceptic parties has been growing. The popularity of Eurosceptic parties has also increased because of perceptions of corruption and cronyism among the traditional political parties, particularly in Southern Europe (see table 1 for the Corruptions Perceptions Index, published by Transparency International).

Overview

- Popular support for Eurosceptic parties has risen across Europe.
- Nevertheless, Standard & Poor's Ratings Services anticipates that if such parties were elected, they would soften their Eurosceptic stance because of the risk to their economies if they lose their vital access to European Central Bank (ECB) funding.
- Standard & Poor's sovereign ratings currently assume that eurozone governments will continue to prioritize servicing their sovereign obligations over most primary spending.
- We expect that should an elected eurozone government--Eurosceptic or traditional--prove unwilling or unable to accept the eurozone's fiscal and monetary constraints, its creditworthiness would weaken, quickly and materially.

In Their Current Form, Eurosceptics' Fiscal And Structural Policies Would Be Difficult To Square With Eurozone Membership

For the purposes of this article, we consider a party to be "Eurosceptic" if it advocates:

- Exit from the eurozone.
- Exit from the EU.
- Sovereign debt restructuring or rescheduling, or the restructuring of commercial debt held by private investors.
- Repudiation or renegotiation of the Treaty on Stability, Coordination, and Governance (TSCG, or the fiscal compact), which enforces budgetary consolidation among all eurozone countries and the eight other EU member signatories.

Four European parties currently advocate some form of restructuring or forgiveness of public debt. These include Golden Dawn and Syriza in Greece, Sinn Fein in Ireland, and Podemos in Spain. All except Syriza also advocate private sector involvement, that is, the restructuring of commercial debt held by private investors.

Standard & Poor's ratings are assessments of the probability, not the advisability, of default. We currently rate all EMU members at or above 'BBB-', except for Greece, Cyprus, and Portugal. Our ratings do not address whether or not the decision to default would benefit a country's long-term growth prospects or competitiveness. Our experience with sovereign defaults since 1998 (which includes Russia, Argentina, Uruguay, Jamaica, and Venezuela) suggests that defaults do not necessarily benefit an economy's long-term performance. In addition, two eurozone members have already defaulted without materially lowering their public debt to GDP levels--Greece (twice in 2012) and Cyprus (2013).

With the exception of Alternative for Germany (Germany, founded 2013) and Podemos (Spain, founded 2014), all parties considered in this article are currently represented in their national parliaments. We have excluded parties that have the support of less than 7% of their national electorate, on the basis that these parties are unlikely to hold cabinet positions or to influence policy decisions in major European countries.

We do not include any of the several European parties which are calling for a broader renegotiation of EU treaties or an end to official financing to EMU member states. Similarly, we do not consider a party to be Eurosceptic simply because it favors a slower pace of fiscal consolidation (such as the Portuguese Socialist Party) within the framework of the TSCG.

We also omit regional separatist parties--including those in the U.K., Spain, and Belgium--from consideration in this article, though we view the risk of secession by Scotland or Catalonia as potential ratings negatives for the U.K. and Spain, respectively.

Euroscepticism Comes In Two Flavors

Eurosceptic parties fall into two distinct varieties: those that oppose the fiscal compact and advocate default (Group 1), and those that favor exit from the EU or EMU (Group 2)

Group 1: Parties focusing on anti-austerity, debt restructuring, and labor protection

This group of Eurosceptic parties is characterized by opposition to austerity and, in particular, to European fiscal treaties, including the TSCG. Although nearly all of these parties--Podemos (Spain), Syriza (Greece), and Sinn Fein (Ireland)--want to remain eurozone members, the policies they advocate--including default--are unlikely to be compatible with EMU membership, or with maintaining continuous access to ECB financing for their domestic banks or for the sovereign, via the ECB's Outright Monetary Transactions program (conditional government bond buying by the ECB, which has been somewhat superseded by this week's announcement of quantitative easing).

Policies proposed by Group 1 Eurosceptics include:

- Raising public spending, either by restructuring outstanding debt or by issuing more debt;
- Retracting labor market reforms implemented over the past several years;
- Nationalizing commercial banks (Syriza);
- Broadening the ECB's price stability mandate to include other macroeconomic objectives, such as full employment (Syriza and Podemos);
- Imposing interest rate caps (Podemos); and

- Opposing NATO membership (Podemos and Syriza).

We view most of the policies advocated by Group 1 parties as credit negative. The eurozone states where Group 1 Euroscepticism is on the rise already have high levels of public debt. Greece's gross general government debt at the end of 2014 was 177% of GDP; Ireland's was 119% of GDP; and Spain's was 96% of GDP. Since the onset of the global financial crisis, none of these sovereigns has been able to rebuild its fiscal buffers to face the next crisis. In our view, they have limited fiscal space to accommodate further net general government debt issuance, as proposed by the Group 1 parties.

If the proposal to unwind recent labor reforms were to pass, Greece, Spain, and Ireland would lose the considerable benefits to competitiveness they have achieved since 2010 through lower unit labor costs. This would make it more difficult for these sovereigns to export their way to stronger growth outcomes and more sustainable net external positions.

Group 1 Eurosceptics are polling the highest in those sovereigns where net external debtor positions are the most compromised: narrow net external debt in Greece is 463% of current account receipts (CARs); 279% of CARs in Spain; and 252% of CARs in Ireland. To pay down these high levels of foreign debt, governments will require years of current account surpluses or will need to convert debt into equity. Reversing labor reform would make it more difficult to generate the yearly external surpluses necessary to pay down their debt.

Group 2: Parties pushing for exit from the EU and eurozone

This group of Eurosceptic parties explicitly calls for an exit from the EU or the eurozone (see table 1) as a means of restoring sovereignty over monetary and economic policy. Within the eurozone, this group includes the National Front in France, Freedom Party of Austria (FPO), Alternative for Germany (AFD), Golden Dawn in Greece, the Party for Freedom (PVV) in The Netherlands, and Lega Nord and Movimento Cinque Stelle in Italy. Outside of the eurozone, parties that advocate leaving the EU include the U.K. Independence Party (UKIP), the Danish People's Party, and the Sweden Democrats.

Table 1

Eurosceptic Political Parties And Their Policies

Party	Country	Support in polls (%)	PDR/PSI	Leave EMU	Leave EU	Oppose fiscal compact	Oppose free labor movement within EU	Foreign-born residents (% of population)	Unemployment (%)	Corruptions Index
Freedom Party of Austria (FPÖ)	Austria	27	No	Yes	No	No	Yes	16.1	4.9	72
Danish People's Party	Denmark	12	No	---	Yes	No	Yes	9.8	6.4	92
Conservative People's Party of Estonia	Estonia	4					Yes			
Front National (FN)	France	18	No	Yes	No	Yes	Yes	11.5	10.3	69

Table 1

Eurosceptic Political Parties And Their Policies (cont.)

Alternative for Germany (AFD)	Germany	7	No	Yes	No	No	--	12.4	5.0	79
Golden Dawn	Greece	9	Yes	Yes	Yes	Yes	Yes	11.2	25.7	43
Syriza	Greece	27	Yes	No	No	Yes	No			
Sinn Féin	Ireland	21	Yes	No	No	Yes	No	16.0	10.7	74
Lega Nord	Italy	15	---	Yes	No	Yes	Yes	9.5	13.4	43
M5S	Italy	19	---	Yes	No	Yes	---			
Freedom Party (PVV)	Netherlands	10	No	Yes	---	No	Yes	11.5	6.5	83
Podemos	Spain	28	Yes	No	No	Yes	No	13.2	23.9	60
Sweden Democrats	Sweden	13	No	N/A	No	---	Yes	15.4	7.8	87
UKIP	U.K.	27	No	N/A	Yes	---	Yes	12.3	4.6	78

PDR--Public debt restructuring. PSI--Private sector involvement. EMU--European and Monetary Union.

Policies that Group 2 have in common include:

- EU or EMU exit;
- Restrictions on immigration, including the free movement of labor within the EU;
- Relieving the national monetary authority of its legal independence, and introducing capital controls; and
- In some cases, the monetization of fiscal deficits.

We would consider nearly all of these Group 2 policies credit negative.

If a net debtor country exited the eurozone, it would, in our opinion, make sovereign default inevitable. The country's debt would become foreign currency, while the economy would be redenominated in a new, and much weaker, local currency. All other things being equal, a 50% devaluation of a country's real effective exchange rate would double general government debt to GDP overnight. Meanwhile, the country's capacity to access foreign currency would be constrained by the likely necessity of imposing capital controls, and the loss of domestic banks and corporates to foreign capital market financing. Under these circumstances, we consider a sovereign default to be a foregone conclusion.

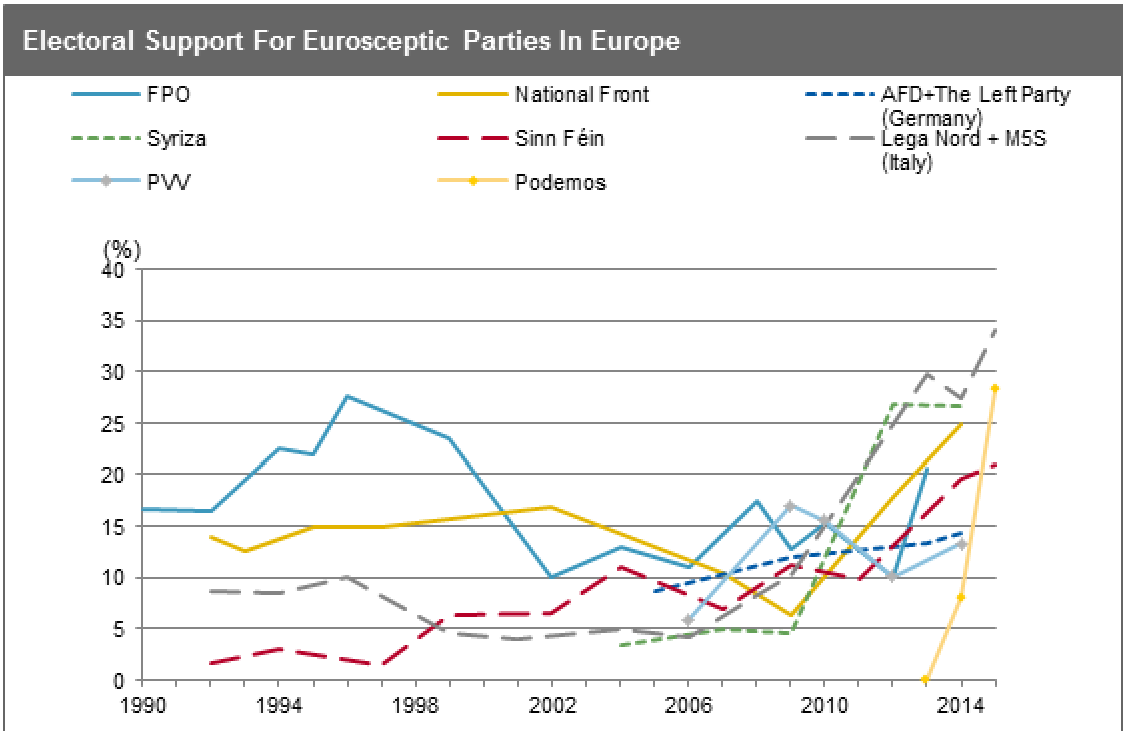
An EMU exit would also likely be preceded by substantial deposit outflows from the sovereign's banking system, which would destabilize the national banking system, a process very likely to depress economic activity, and weigh heavily on fiscal performance of the rated sovereign.

Group 2 generally also advocates reducing the free movement of labor within the EU or limiting or preventing net immigration in other ways. For most Group 2 Eurosceptic parties, popularity does not appear to be correlated with employment trends (which are positive in the U.K., Austria, Denmark, and Germany). Similarly, we see no clear relationship between support for anti-immigration parties--such as UKIP, the Danish People's Party, and the Front National--and the percentage of foreign-born nationals in the population. For example, no party has suggested limiting immigration in Ireland, even though its foreign-born population is among the highest (as a percentage of total population) in Europe.

Euroscepticism Is Likely To Persist, But Its Popularity May Peak

We do not view the Eurosceptic parties' strengthening support (see chart 1) as a temporary protest vote, or an isolated response to high profile corruption cases implicating incumbent parties. Eurosceptics are advocating a major macroeconomic policy shift: A decision by any government to default on debts or devalue the currency would, without question, represent a new policy direction.

Chart 1



FPO--Freedom Party of Austria. AFD--Alternative for Germany. PVV-- Freedom Party.

Our baseline expectation remains that the established eurozone political parties--aware of the risk these parties represent to Europe's monetary, financial, and economic stability--will embrace greater flexibility on fiscal targets in return for structural reforms, while searching for other growth stimuli. We also expect the ECB's monetary stance to remain highly accommodative, as demonstrated by this week's announcement of large-scale quantitative easing.

This explains why we currently rate most eurozone sovereigns at or above 'BBB-' (Greece, Cyprus, and Portugal are rated below this level).

If Elected, We Expect A Eurosceptic Party Would Compromise

Our ratings on eurozone sovereigns incorporate our view that a eurozone exit is unlikely. Past experience suggests that, once in power, Eurosceptic parties would most probably track toward the center and become less ideological--particularly within a coalition (as was the case with Latvia's Union of Greens and Austria's Freedom Party).

Our baseline expectation is that with the possible exception of Greece's Syriza (where elections take place this Sunday), we do not think it likely that a Eurosceptic party will soon be in a position to govern as a single-party majority. Moreover, we expect that even if a Eurosceptic party were to win a general election in a larger member state, it would exert itself to maintain financial and macroeconomic stability. That would depend upon domestic banks retaining access to "lender of last resort" financing from the ECB. As a result, we anticipate that even a Eurosceptic government would likely compromise on its election promises, so that it could remain eligible for the ECB's Outright Monetary Transactions and other funding programs.

Were any Eurosceptic party to rise to power, or appear likely to gain an electoral victory, we expect the home banking system would suffer a loss of liquidity, and investments, as well as a component of consumption, would be temporarily delayed. At the time of publication, the Greek commercial banking system was already experiencing deposit outflows, while Greek retail sales in December were weaker than expected. We consider that these signs reflect disquiet about Syriza's strong polling figures ahead of the Jan. 25 parliamentary elections, and the policies that Syriza might pursue.

Traditional Parties May Borrow Eurosceptic Policies

It is also possible that established parties will mimic or accommodate Eurosceptic positions, in an attempt to remain in power. In Italy, for example, Forza Italia has suggested that Italy consider reverting to the Italian lira unless the ECB broadens its mandate beyond price stability.

In the U.K., the Conservative party has taken an ambivalent stance on the benefits to the country's services-intensive economy of the U.K.'s EU membership. We view EU membership as key to longer-term growth outcomes in the U.K., given that the EU has traditionally been the destination for more than 45% of the U.K.'s net exports of financial services. In our opinion, the U.K. would lose a portion of its inbound direct investment should it exit the EU, and such a move would have a disproportionate effect on the U.K.'s business and financial services sector, to the detriment of the sovereign rating.

How Will The Story End?

The co-dependency of European economies, particularly within the eurozone union, means that there is a real risk of contagion from a eurozone exit or a eurozone sovereign default. To fight against rising Euroscepticism, we expect eurozone governments to do more of what they have already been doing, namely:

- To interpret the TSCG more flexibly in order to allow a slower path to fiscal consolidation for EMU members that are under pressure;

- To offer to extend the maturity of official lending to program countries;
- To agree to concessional interest rates on bilateral loans to program countries; and
- To put into place new incentives for governments to implement politically contentious structural reforms, by agreeing on fiscal carve-outs for raising public capital investment (via the Juncker Plan).

There is, however, no denying that Euroscepticism is on the rise and could trigger policy shifts in individual member states. 2015 will see a busy electoral year in Europe, with six general elections scheduled (see table 2). Perhaps only when a Eurosceptic party rises to power will it become clear how far, and how cohesively, the rest of the EU will go to counter the challenge to the current ad hoc policy mix that has so far characterized much of the European response to corrosive deflation, slow growth, and high unemployment.

Table 2

Election Calendar 2015		
Estonia	March 1	Parliament
Finland	April 19	Parliament
Greece	Jan. 25	Parliament
Greece	March 12	President
Portugal	Sept. 27	Parliament
Spain	Dec. 20	Parliament
U.K.	May 7	Parliament

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