

## Sunday Wrap

Greetings from my favorite café here in Berlin's Mitte,

Two topics have dominated my conversations this past week, namely the ECB's uncommitted message on Thursday and the prospect of serious gains by nationalist, hard right, parties in the ongoing European elections. I'll take them in turn:

- **I'll argue that the ECB message on Thursday was more or less as expected and sufficiently open-minded to lead to the expected further rate cuts.**
- **Most of my interlocutors argued that the projected gain for the nationalists, hard right, parties in the European elections is just another step towards their dominance of European politics in coming years. I'm not so sure. I'll argue that their appeal may soon begin to fade.**

### 1. The ECB message: Not hawkish; further rate cuts are coming.

On Thursday, the ECB delivered its fully-telegraphed 25bp rate cut. However, the slight increase in their inflation forecast for this year and next, along with a rather uncommitted message with respect to future rate decisions, were widely interpreted as hawkish.

I disagree. The revision of the inflation forecast was quite predictable and more "institutional" than real. As you know, the June and December forecasts are done by the entire eurosystem (i.e. all the national central banks in cooperation with the ECB staff), while the March and September forecasts are done by the ECB staff alone. This always produces some (undesirable) volatility in the forecasts, and generally towards the hawkish side when the eurosystem is in charge – and generally wrongly so.

And I don't share the interpretation that President Lagarde's noncommittal message implies a hawkish bias in the Governing Council's outlook for rates. Granted, she did say, "I cannot confirm that it is the dialling-back process that is underway", but her very next sentence was: "There's a strong likelihood [of this being the dialling-back process], but it will be data-dependent and what is very uncertain is the speed at which we travel and the time it'll take." So, there's a "strong likelihood" that rates will be moving lower (how could anyone have expected that she would have made that statement unconditional?), but the speed of cuts are "very uncertain." I would have preferred just "uncertain", as opposed to "very uncertain", but now we are splitting hairs.

Given (i) the inherent uncertainties in forecasting, particularly in the present aftermath of multiple shocks, (ii) the troublesome experience of recent Fed communication on their expected path of interest rate decisions, (iii) the Governing Council's own (excessive) risk aversion and (iv) the "location inside the GC of where the risk aversion is particularly extreme" (if you know what I mean), I find it easy to understand why Lagarde chose the cautious wording on Thursday.

Yet, I maintain my long-held view that the ECB overdid the tightening, most likely driven by concerns about its reputation as ferocious inflation fighters. As a result, as the declining trend in inflation and sub-par growth continue – and with their inflation fighting credentials burnished – the monetary policy easing will continue. Yes, I hear the repeated warnings about wage growth, but it really is nothing more than the desirable restoration of real income levels following the terms-of-trade shock. Moreover, as my colleague, Tullia Bucco, showed in her illustrative Chart of the Week on Friday, profit margins continue to absorb the increase in labor costs. Hence, one shouldn't be particularly concerned about wage growth in the eurozone, but more about the outlook for growth and employment – and hence undershooting of inflation. Tullia's note is here: [Chart of the Week- Eurozone: profit margins absorb increase in labor costs](#)

So, I'll happily bet my money that the ECB message on Thursday (and the balance of subsequent statements since then) will be moderated in coming months to tee up another rate cut in September – and again in December as well as through next year until we get down to 2.0%-2.5% around the end of 2025, as I have discussed in previous notes, and as forecast by my colleague, Head of UniCredit Research, Marco Valli.

## 2. The European elections: Approaching peak-time for the nationalist, hard-right, parties.

The European elections started on Thursday and run through this evening, with the final results expected to be announced before tomorrow morning. According to the latest opinion polls, the centrist coalition will maintain its majority with about 56% of the seats. Including the Green Party and other smaller pro-EU parties, the center is projected to win more than 60% of the seats. But the news will focus on the gains by the nationalist, hard right, parties, which are expected to win about 25% of the seats. Depending on how exactly the chips fall and the political leaders' preferences for alliances and principles, this means that obstructions or slowdowns in Europe's response to the rapidly changing global environment will likely become more prominent.

**The general sentiment in the media and among my own interlocutors seems to be that this election will be just another step on the nationalist, far right, parties' march towards dominance of European politics which will block (much needed) further integration, if not even undo some of past years' progress.**

**I'm much more optimistic on this issue. Indeed, I suspect that we may be approaching the peak of European nationalist forces. Below, I'll summarise why - but first a little perspective to remind you of European political resilience:**

On Thursday, Europe celebrated along with its US, Canadian and other allies the 80th anniversary of D-Day. The incredible courage and sacrifice by the more than 150,000 troops who landed on the coast of Normandy made possible the peace, freedom and prosperity that Europe enjoyed during the decades following the war. Of course, the eastern parts of Europe experienced considerably less prosperity and freedom during those first post-war decades. That was the result of the Soviet Union's critical role in defeating Nazi-Germany (incidentally manned primarily with Ukrainian troops) and its subsequent control of Central and Eastern Europe.

But we Europeans never wanted a divided Europe, or one dominated by foreign powers. And you can't keep a good man down, as they say. Following uprisings in the GDR in 1953, in Hungary in 1956, and in Czechoslovakia in 1968, all of which were militarily crushed by Moscow, the Polish uprising in 1980 finally succeeded. It started with Lech Walesa's leadership of the protests at the Gdansk shipyard, which led to the partially democratic election in Poland in 1989 - the first in Central Europe after World War II. (This past Tuesday marked its 35 year anniversary. Incidentally, one of my personal highlights was a chance-meeting with Walesa years later on a flight to Warsaw. What a man!)

A few months later, in October 1989, Soviet leader, Mikhail Gorbachev, told protesting Berliners on Unter den Linden, during the 40th anniversary of the GDR, that the Soviet Union would not intervene to prop up the GDR regime, and a month later the Berlin Wall fell. I'm told by people, who supposedly know, that the two key convictions shared by presidents Xi and Putin are: One, Gorbachev made a fatal mistake when he didn't intervene militarily in Central Europe, and, two, the subsequent global dominance by the US is detrimental to their interests.

And yet, the liberal democracy and European integration, which has delivered peace, freedom and unprecedented prosperity in Europe these past decades, is no longer uniformly appreciated across Europe. It is truly mind-boggling.

But I remain a shameless believer in European political resilience and in our commitment to the values which have served us so well in the past. In 1980, Poland led the way out of Soviet dominance, but roads are rarely straight lines. So in 2015, Poland was one of the first to take society back into a period towards nationalism and hard right policies. But the majority of Poles did not want this and last year they voted a new coalition back in power with a mandate to return Poland to its European political roots.

The odds are that other countries will follow Poland's lead back towards more pro-EU policies in coming years, and that nationalist opposition parties elsewhere will see their appeal wane.

### **The following four factors will play a role:**

First, Europe's nationalist leaders gained prominence largely by pointing to foreign so-called strongmen as models for alternatives to European democracy – but the appeal of these models is clearly waning with the revelation of who they really are and what they stand for.

For example, French hard right leader, Marine le Pen, made no apologies when it was revealed years ago that her party had received huge financing from Russian banks associated with Putin (side-comment: Why does Europe even allow foreign financing of its political parties?), but her party apparently felt a need to repay the loan following Russia's invasion of Ukraine in 2022 - incidentally with public funds received as a result of its political gains, according to Politico. And Italian hard right leader, Matteo Salvini, proudly paraded in Moscow wearing a T-shirts with Putin's portrait, only to toned down his admiration for Putin these past two years. Clearly, beyond the extreme margins, association with Putin no longer sells tickets in Europe.

Donald Trump is still referred to as a model for many European leaders, including Hungarian PM Orban and Romanian nationalist leader George Simion, as well as the UK's Nigel Farage, even though it's hard to find objective indicators to suggest that his presidency was a success. And how his newfound status as a convicted felon will play in Europe remains to be seen.

More importantly, should Trump win the US election in November (God forbid), I confidently predict that this would have serious consequences for Europe and that it would undermine his status as a role model for the European hard right. Specifically: (i) Trump says he'll end financial and military aid to Ukraine. This would probably result in a Russian "take-over", or at least dominance, of Ukraine within a relatively short period of time, and lead to substantial instability in Ukraine for years to come; (ii) Trump says he'll impose tariffs on most imports, including 30% on imports from Europe. Surely, this would lead to retaliation by the EU and the risk of a rapidly descending trade order between the EU and the US. Such trade frictions would have negative implications for European growth, particularly for small open economies. How would European Trump-fans and allies explain all of this to their populations? (iii) In reaction to such Trump initiatives, the EU's major powers will push for further European integration, leaving smaller EU countries to either sign up, or be left outside. Enhanced cooperation – or integration of the willing – will prevent hold-out countries from blocking such initiatives. So, will the hard-right fold themselves into a proper European Union with all that'll entail for their narrative – or will they chose isolation and less prosperity outside?

If Trump doesn't win in November, I see a major risk of a period of civil unrest in the US. Whatever the exact form, imagines from the US of anything resembling the January 6 attack will not appeal to any Europeans beyond a irrelevantly small group of crazies.

Second, nationalist, hard right, parties are more protest movements than genuine political forces with a coherent vision of the future. As a result, these movements jump from one key objection to the next because either their constituencies lose interest in the first topic or the mainstream political parties (partly) adapt the vote-winning policy stance. At the end, they risk running out topics to protest again. For example, most of the Western European hard right parties, including in Germany, France and Italy, started as protest-parties against the euro, but as the population embraced the common currency, the topic lost appeal. Then the 2015 immigration crisis offered them a new lifeline, but as the refugees became somewhat integrated and the main parties toughened their stance on immigration that topic too became less appealing as a unique hard right selling point – although it certainly still has political milage. Then we had Covid and the anti-vax conspiracy madness, but that too is fading. Then came the effects of climate change policies on key constituencies, most prominently the farmers – still rumbling on, for sure. I predict many of these policies will be rolled back, which will help take the sting out of the protests and the hard right – at immense cost to future generations.

Third, where nationalist hard-right parties have been tested in power, they have failed when the consequences of their policies have been allowed to show. This has been on full display in the UK. Since the Brexit referendum, the UK has suffered unprecedented political chaos, and an economy which has lost about 4% relative to the most likely counterfactual. On July 4, the population will – according to all opinion polls – deliver a massive blow to the party that gave them Brexit and has ruled since. (Some political analysts have upgraded that prediction of the blow from "massive" to "fatal" following the news last week that Nigel Farage will run for Parliament as instated leader of his Reform Party).

It is noticeable that none of the hard-right nationalist leaders in Central Europe have called for an exit from the EU in spite of campaigning explicitly, or via their controlled media, on strong EU-sceptical platforms. The simple reason is that they receive approximately 3% of GDP every year in grants from Brussels – and their business sector is deeply integrated in the Western European value chains, taking advantage of the Single Market. Moreover, as we saw during Chinese President Xi's recent visit to Hungary, Central Europe's unrestricted access to the European market serves as a major attraction for Chinese (and other foreign) investments in their individual countries. As a result, the effect on any of the Central European economies were they to leave the EU, would be multiple times greater than what the UK has suffered. And that in itself would, no doubt, have significant political ramifications.

So, instead of calling for an exit from the EU (given the money involved, who would?) nationalist hard-right Central European leaders claim that they'll change the EU from within. I predict with great certainty that they'll not succeed. Indeed, I am not even sure they want to succeed. Surely, if their nationalist soulmates in the major Western European countries were to gain power, those nationalist leaders in Western Europe would almost certainly cut the EU's generous financing of Central Europe.

In other words, Central European nationalist hard right leaders are playing a high-wire game, the success of which is dependent not only on their hard right friends among the EU's pay-masters not gaining actual power, but also on the present political center in Europe not pulling the plug on the huge financing of Central Europe, and their unrestricted access to Western European markets. Hearing President Macron during his recent state visit to Germany call on Europe to "wake up" to "the ill winds" that now blow in Europe, I am not so sure that the Central European high-wire act will remain successful for long – and rightly so.

Fourth, it is my assumption that Europe will – long overdue – move to block (or at least reduce) foreign interference in our democracies, particularly as it relates to elections. Specifically, foreign financing of political campaigns ought to be outlawed, as it is in e.g. the US and many other countries. In addition, a significant step-up to prevent illegal interference by foreign powers via hacking and spreading of fake stories is already under way. I'm pretty confident that such efforts will intensify during the next couple of years – and hopefully prove successful.

To be sure, the outcome of this year's election to the European Parliament will increase the risk of disruptions to the critically important European integration process. But if the forces of the center put their relatively smaller differences aside, they'll still command a sizable majority to make the necessary reforms to cement European sovereignty via a deepening of EU integration and hence put Europe back on a growth trajectory. The alternative - to become prawns in the dangerous game between the US and China, with Russia playing hostile spoiler games – can never be a desirable outcome.

Later this week I'm off to Dubrovnik for the Croatian National Bank's 30th annual Dubrovnik Economic Conference, a true highlight of the year – and not only because of the location! As a result, I won't be able to write the Sunday Wrap next weekend as I'll be making my way back from Dubrovnik to Berlin.

And now I'm off to an afternoon in this gorgeous weather under my favorite tree in my favorite Biergarten ....

Best,

Erik

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