Political Shakeup in Europe

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Sunday's elections in France and Greece revealed the extent of voters' anger over austerity. Moreover, they further blurred the future direction of the euro zone — or did they?

France

As widely expected, Francois Hollande bested President Nicolas Sarkozy, ending 17 years of conservative leadership. The result continues the trend set in motion last year by Ireland, Greece, and a handful of other countries whose political leaders have been ousted by increasingly restless voters as a result of the European crisis. Despite the media's tendency to paint Hollande as a raving socialist, he is actually more pro-European Union than his predecessor. His campaign policy proposals, which include a 75% tax on income over $1 million and greater government spending, are indeed disquieting to many investors. However, we expect the polarizing political rhetoric will recede and the relationship-building with Germany's Angela Merkel will begin after the Parliamentary elections on June 10 and 17. While news headlines may continue to spark volatility until mid-June, the long-term European implications of Hollande's victory are likely to be rather benign and should not alter the long-term — albeit halting — progress toward European fiscal union.

Greece

Greek voters, on the other hand, have created quite a mess. The two pro-European parties (PASOK and New Democracy) came up an agonizing two votes short of the necessary 151-vote legislative majority. At this writing, the New Democracy party, which received the largest share of votes, has just failed to form a coalition government. Now the second-place, left-wing Syriza party will try. The result will be either 1) a weak coalition that may not enact the necessary austerity measures to receive EU bailout funds, or 2) no coalition, resulting in another election. Either outcome raises the chance that Greece may eventually leave the euro zone.

Some commentators say a Greek exit ("Grexit" in Wall Street vernacular) would lead to a collapse of the euro zone. We disagree. During the past two years, the Troika (European Union, International Monetary Fund, and European Central Bank) has created new emergency procedures and engineered progress toward fiscal discipline and eventual fiscal union. In addition, the ECB has lent nearly €1 trillion to European banks, making the risk of a Lehman-style liquidity crisis negligible. As a result, the euro zone is now better able to withstand the shock of a default or exit.

If Greece were to exit, its economy would collapse, and its new currency (most likely the drachma) would sharply devalue, causing hyperinflation. Today's austerity measures would seem mild and gradual in comparison. But frustrated voters aren't always rational. Longer term, the risk is that other countries might also exit. However, we believe disastrous post-exit consequences for Greece could actually motivate countries to stay in the euro zone, bolstering their collective will to make further progress toward fiscal cooperation.

Conclusion

We believe the risk to the euro zone's survival is nowhere near the severity we saw last winter. Europe is much more stable today because of

recently implemented safety measures. France, under Hollande, may take a slightly different path than under Sarkozy, but it will likely still head toward European unity. Near-term events in Greece are likely to be cringe-worthy as politicians attempt to form a new government that tries to reconcile euro-zone membership and public anti-austerity rebellion. Whatever direction Greece ultimately takes, though, is unlikely to derail Europe's long-term progress toward more unified fiscal planning.

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