

Focal Point

Limited risks from Dutch election outcome

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- Despite some decline in the most recent opinion polls, the Eurosceptic Freedom party (PVV) – which wants to hold a referendum on Euro-membership – may become the strongest party at the Dutch general elections on March 15.
- That said, the PVV is unlikely to be part of the next Dutch government with Eurosceptic parties unlikely to secure an absolute majority of seats. Pro-European parties have ruled out to form a coalition with the PVV.
- However, the next Dutch government will involve more parties than the present coalition of just two. And this implies a lengthy process of government formation.
- Ultimately, we expect the new cabinet to basically maintain the present stance on European issues. Though, its ability to compromise on critical issues (e.g. Greece, immigration) will be constrained by the threat of PVV strengthening.
- With political risks limited and economic activity solid, we expect a stable Dutch-German sovereign bond spread.

Over the last weeks, markets have become concerned about the threat of a French President Le Pen after the second round of elections on May 7. However, already on March 15 there will be general elections in the Netherlands. The Eurosceptic Freedom Party (PVV) declared that it wants to hold a referendum on the Dutch EU membership. Looking ahead, the question is whether there is a realistic risk of a “Nexit” and how Dutch financial markets will likely behave after the election.

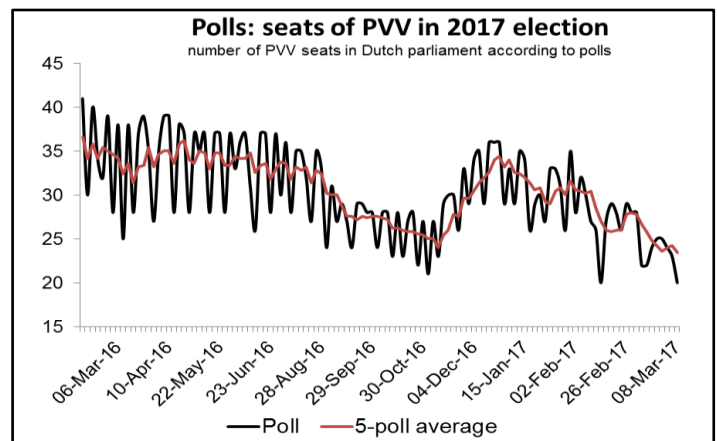
Structurally strong support for Eurosceptics

The Dutch Freedom Party (PVV, Partij voor de Vrijheid under its leader Geert Wilders) is the most Eurosceptic party in the Netherlands. It combines economic liberalism (e.g. seeks to lower taxation) with a conservative program on immigration, is hostile towards the EU and outspoken anti-Islam. Most importantly, the PVV wants to hold a referendum on EU membership in order to vote the Netherlands out of the European Union (“Nexit”).

According to polls covering the past twelve month (five-poll average), the PVV will manage to get between 17% and 25% of the seats out of the 150 in the Dutch parliament. Over the past months, the PVV has even been the strongest party in polls. That said, support for the Freedom Party also varies considerably across polls and as of late it lost some ground. One major determinant seems to be refugees. About three months after the arrival of refugees peaked at 10120 persons in October 2015, the number of seats for the PVV (according to polls) reached the record of 42. The number of asylum seekers has come down since then (to 1,830 in Aug. 2016, the latest available).

Moreover, commentators also put forward that wide-held criticism regarding US President Trump also affected PVV leader Wilders’ popularity who expressed some affinity to him. However, less than two weeks before the Election Day, the share of undecided voters remains high (close to 50%). All in all, the PVV seems set to secure more than the 15 seats it got in the 2012 election.

Apart from the PVV, there are also other Eurosceptic parties. The Socialist Party (SP) opposes what it sees as the European super-state. The Christian Union (CU) is generally skeptical about European integration. The Reformed Political Party (SGP) is a party of the Christian right and also opposes the European project. According to the latest poll, these parties would get 23 seats altogether.



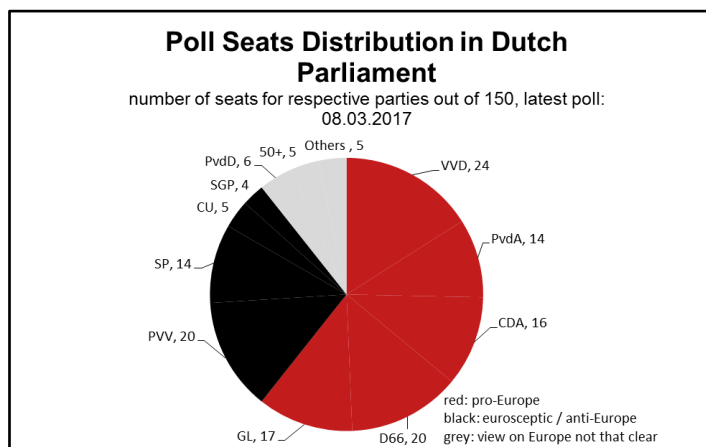
Moreover, there are other parties like the PvdD (a center-left to left-wing animal rights party) and the 50+ (a pensioners' party) which are neither explicitly Eurosceptic nor Euro-friendly.

Lengthy government formation process ahead

A Eurosceptic Dutch government is still unlikely for the following reasons: First, in polls the pro-European parties always secured a majority of seats in the Dutch parliament over the last twelve months.

Second, Euroscepticism is not the only topic. Concerning other political issues the Eurosceptic parties differ considerably, ranging from the extreme right to the extreme left.

Third, note that the Constitution stipulates no strict procedures for forming governments and the leaders of the pro-European parties have ruled out a coalition with the PVV. Hence, even if the PVV becomes the strongest party in the March election, it does not automatically have the mandate to initiate the government formation process. The first step is for an "informateur" to investigate which political parties could form a coalition. The role is often filled by a retired states person of some stature, often a former government minister or party leader. The informateur then draws up a final report, including the draft coalition agreement and recommending a government "formateur", who will probably become the new prime minister. Then the formateur seeks ministers and state secretaries for the new government. The formateur aims to form a new government as soon as possible, as the caretaker government may deal only with ongoing matters and cannot initiate new policies.



Therefore, a pro-European government is the by far most likely outcome. That said, government formation will not be easy either. The current government consists of a coalition of two parties, the Conservatives (VVD) and the Social Democrats (PvdA). The new Dutch government will likely have to be backed by up to six parties, depending on the final election result. This will complicate the process of government formation considerably. Historically, this process can last from a number of weeks to more than six months. In the current situation this process could be even longer.

Next Dutch government will be aware of PVV

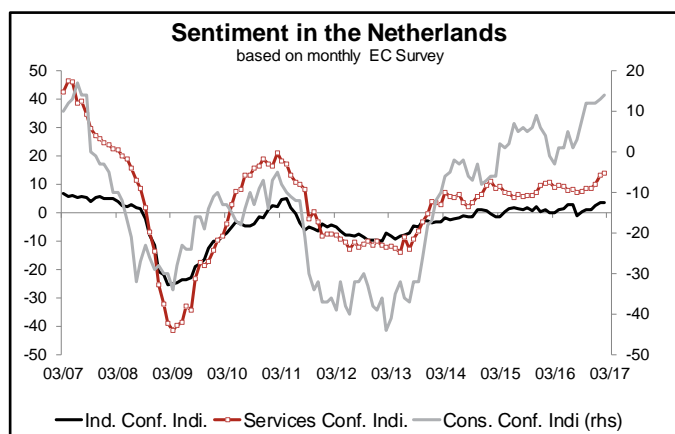
With another pro-European government likely taking over in 2017, the risk of a referendum on EU membership will be off the table for the time being. Under the current legislation there only exists the possibility of an advisory refer-

endum. Citizens can request a referendum only on laws and treaties that have been approved in parliament but not yet enacted into law. Hence, the risk of a formally only advisory but politically binding "Nexit" referendum, similar to the one witnessed in the UK last year, is low in our view.

However, this does not mean that Euroscepticism will not affect Dutch policies over the coming years. Given the large share of Eurosceptic people in the Netherlands, any government will take into account the consequences of actions on the support of its political competitors. Therefore, the new government will likely take a constructive but critical stance on European issues. This concerns topics like immigration and refugees in the first place. But it will also come to the fore regarding questions of further deepening of European integration. Quite interestingly, at the Davos meeting Prime Minister Rutte declared the target of an "ever closer union" dead. Hence, it will likely be very hard to push through a further deepening of European integration, especially when it involves transfers, when the discussion of the post-Brexit shape of the EU starts. We also think that for these primarily domestic reasons the Netherlands will continue to see only limited leeway for compromise on distressed economies, like Greece.

Stable Dutch-German bond spread expected

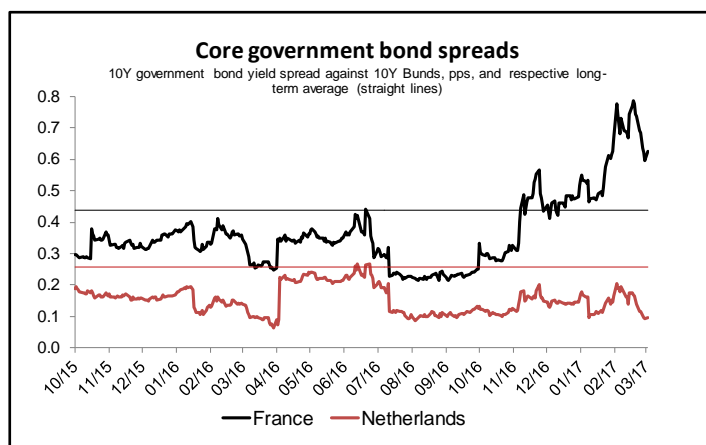
Economically, the Netherlands are doing fine. They largely digested the fallout from the busting of the housing market bubble and embarked on a growth trajectory again. In 2016, GDP expanded by 1.6% with housing investment having been a major driver. Looking ahead, the domestically-driven recovery will likely continue in 2017 and 2018. However, the Brexit fallout, especially the depreciation of the GBP, will dampen activity. The Netherlands are very exposed to the UK via trade. In 2015, the share of exports to the UK in the Dutch GDP was 7% against an average of 2.6% for the euro area as a whole. Also, higher inflation (annual average from 0.1% yoy in 2016 to around 1% in 2017/18) will weigh on consumption. Still, we look for growth of around 1 ¾ % over the 2017/18 period.



Over the coming years, the situation of public finances will likely improve further. According to EC estimates, the deficit fell to 0.8% of GDP in 2016 and is expected to recede to become almost balanced (0.1%) in 2018. Likewise, the debt-to-GDP ratio is forecast to decline from 63.0% in 2016 to 59.3% in 2018. If that was the case, the Netherlands would be the only medium-sized economy fulfilling the debt criterion of the Fiscal Compact (together with Estonia, Latvia, Lithuania, Luxembourg and Slovakia).

Dutch government debt is rated AAA with stable outlook by all rating agencies and also by our internal rating model. Therefore, and taking into account the outlook for the Dutch economy, we see sovereign debt backed by sound fundamentals.

Against this backdrop it did not come as a surprise that the Dutch-German 10-year government bond spread remained broadly stable over the past months. It even remained below the long-term average which we also attribute to the effect of ECB government bond purchases. However, the key message from the bond market is that it has never attached a sufficiently high probability to the risk of a Euro-sceptic government and a “Nexit” referendum. Moreover, in the extreme case of a “Nexit”, the reintroduced gulden may not even be subject to depreciation pressures against the euro, given the country’s sound fundamentals and its current account surplus of 8.5% of GDP in 2016. This is a major difference to France, where markets still see the risk of Le Pen becoming France’s next president. Looking towards the Dutch Election Day, we do not expect a significant bond market movement. Dutch government bonds will rather be guided by fundamentals like ECB monetary policy expectations, the activity outlook and Dutch public finances than by a reassessment of the political situation.



Imprint

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