

Focal Point

German election: What is at stake?

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Our *Focal Point* series explores topical issues on macro, markets and investment

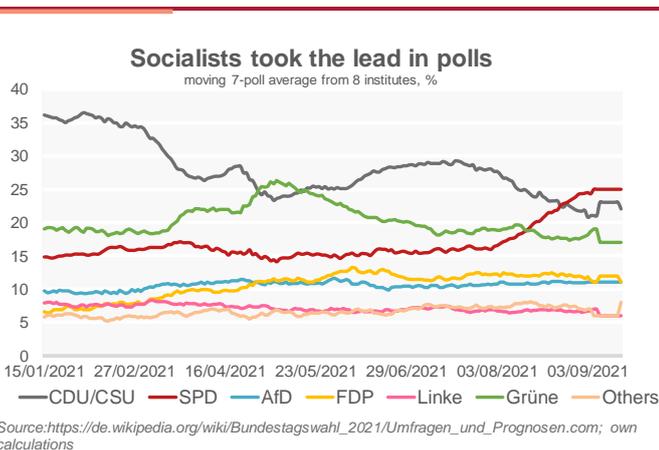
The September 26 German election will not only end the Merkel-era but also Germany's tradition of two-party coalitions. Socialists (SPD) currently lead against the conservatives (CDU/CSU) in a neck-on-neck race.

There is a wide range of possible coalitions with a centre-left (SPD, greens, liberals) or centre-right (CDU/CSU, greens, liberals) most likely to us. Polls suggest that Scholz (SPD) is more likely to become the next Chancellor than Laschet (CDU/CSU). Following cumbersome coalition negotiations a new government may still take office before year-end.

Our base case is a centre government with either the socialists or conservatives leading a coalition with the greens and liberals. All parties want to increase public investment. The greens are most ambitious suggesting a € 500 bn investment plan and we think that they can push through parts of this idea in coalition negotiations.

The left parties are open to a reform of the national and European fiscal rules. The greens and SPD are open to reform European fiscal rules in stark contrast to conservatives and liberals, which makes bolder changes quite unlikely also under a new German government.

Unless the elections result in an outright left coalition, financial market effects are likely to be muted.



On September 26th the Germans will elect a new government. Following a decade of crisis and the emergence of Covid, the next government will have to address key issues. Near term the pandemic will still stay in the focus. But medium to long term crucial topics like the insufficient stock of public infrastructure need to be addressed. The next government will also have to form a position on delicate EMU topics like a modification of the Stability and Growth Pact (SGP).

In contrast to the previous four elections Mrs Merkel (CDU) no longer candidates. This makes the election race more open as the incumbent chancellor usually gets a bonus. In

contrast, the vice-chancellor (Mr Scholz, SPD) of the current CDU/SPD coalition is the only main candidate who can benefit from his role in the current government. This together with some pitfalls of the other candidates in the election campaign contributed to a surge of the SPD in polls. In latest polls it leads against the CDU by about 5 pp. Given the usual margin of error this points to a neck-on-neck race. Moreover, according to latest polls ([Forschungsgruppe Wahlen](#)) 20% of voters are still undecided whether and if which party to vote. This gives rise to a range of different outcome

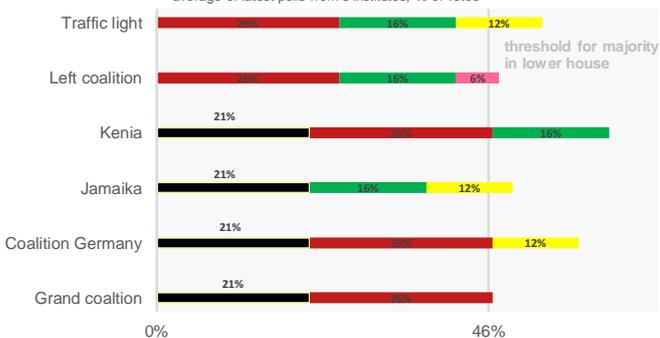
Centre-left or centre-right government most likely

With the election being only about two weeks ahead, its outcome still has the potential to surprise in any direction. However, it became clear that the tradition of two-party coalitions will end. Even in (the uncertain) case of a majority of the incumbent 'grand coalition', its relaunch is not wanted by neither of the two. After the 2017 election both were forced into this marriage of convenience when the liberals suddenly withdrew from negotiations (with the greens and conservatives).

In Germany the parties are free to find majorities with other parties to form a government. However, informally the strongest party is the natural candidate other parties talk about the formation of a new government. There is no majority for wishful coalitions from the perspective of the two strongest parties. Neither a SPD/Green coalition (that governed 1998-2005) nor a CDU/CSU/Liberal coalition (ruling 2009-2013) are likely to get a majority of seats.

Feasible coalitions for Germany

average of latest polls from 8 institutes, % of votes



Source: <http://www.wahlrecht.de/umfragen/index.htm>

The range of coalitions is further narrowed by the fact that so far no party was willing to form a coalition with the far-right (AfD) or the far-left (Linke). However, regarding the latter that might change. Neither the Greens nor the SPD explicitly excluded this on request. And there are signs that the Linke is willing to compromise on some of its extreme positions (e.g. NATO membership, foreign army interventions). The top candidates do not seem keen on such a government but there is a minor probability, especially if negotiations with the Liberals should once again prove unsuccessful.

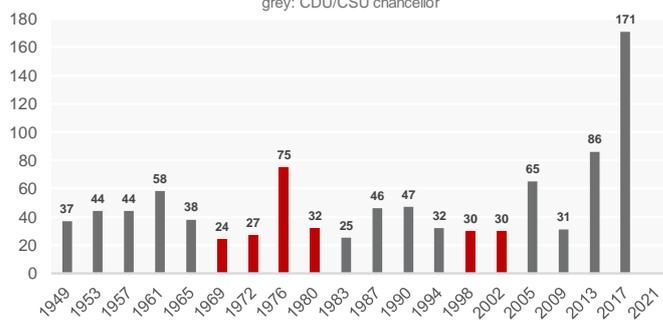
Realistically this gives rise to two key options (apart from a grand coalition), each comprising the greens and the liberals. The so called 'traffic light' (by colours of the parties) comprising the SPD, the liberals and the greens would likely result in case of the SPD becoming strongest. In the (less likely) case of the CDU/CSU becoming strongest the 'Jamaika' coalition with the conservatives and these two parties would most likely result in our view. The common denominator of both coalitions is that they are both centrist one, either leaning towards the left (traffic light) or the right (Jamaika). Risk cases are in our view – with descending probabilities – a relaunch of the grand coalition, a left coalition (SPD, greens, Linke) or a minority government.

Lengthy negotiations ahead

In any case, the much more fragmented political spectrum of parties in Germany will imply cumbersome and lengthy coalition negotiations. The historical average (since 1949) is 50 days. In contrast, the current government was formed only 171 days after the election. This had to do with the already mentioned sudden withdrawal of the liberals from the negotiations and the need to revitalize the grand coalition. From a reputational perspective that did not pay out for the liberals and we deem such an event unlikely this time. That said, three-party coalition talks will be cumbersome and could last until Christmas in our view. While this is an element of uncertainty we see the outright implications for markets as limited as by constitution the current government will stay in power until the new one is sworn-in.

Length of government formation in Germany

in days from election until swearing-in of cabinet; red: SPD chancellor, dark grey: CDU/CSU chancellor



Source: [https://de.wikipedia.org/wiki/Bundesregierung_\(Deutschland\)](https://de.wikipedia.org/wiki/Bundesregierung_(Deutschland))

Greens to foster climate change adjustment

Among the parties, the Greens are most ambitious on environmental policies. They intend to reach climate neutrality already by 2040, want to push the carbon price to at least € 60 per tonne of carbon, end the registration of new cars with a combustion engine by 2030 and seek to end coal-fired power plants already by 2030 (compared to the current plans foreseeing 2038). As the Greens will highly likely be part of the next government they will push for more ambitious climate goals in any coalition negotiation.

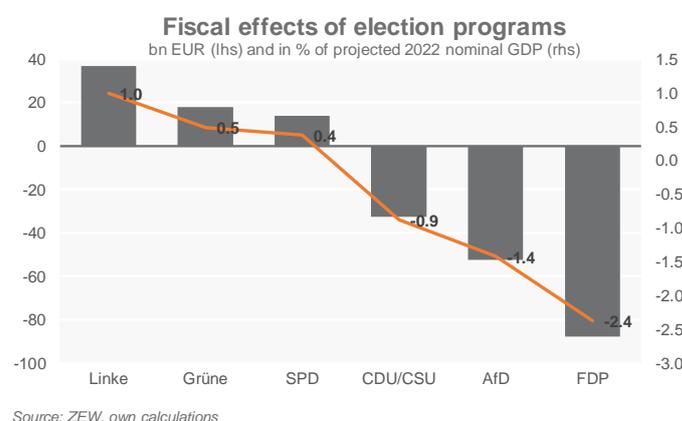
Strong infrastructure spending boost likely

The insufficient stock of German infrastructure is a long pending issue. It is a factor contributing to [Germany's fading shine](#) if not tackled. Estimates of the infrastructure gap are in the € 450 bn to € 500 bn range. All parties want to address the topic of public investment, albeit to a varying degree. The conservatives are least decisive on numbers and want to focus on digitalization and the modernization of the administration. In contrast, the Greens target additional public investments of € 500 bn over the next ten years. Technically it shall be run by means of an Special Purpose Vehicle off the budget. The Green's infrastructure plans get public support by [various institutes](#). There is common agreement that the currently low interest rates should be used to invest in future activity. We deem it likely that this idea (though likely scaled down) will make it into any coalition agreement comprising the Greens.

The SPD wants to maintain a € 50 bn public investment spending per year, in line with the current government's [investment plan](#) until 2025 according to the 2022 budget draft. The Liberals agree on the need of increased investment spending but want to focus on mobilizing private investment.

Hence, while infrastructure spending will likely be augmented in any case, **the most decisive increase of public investment spending is to be expected from the centre-left coalition.**

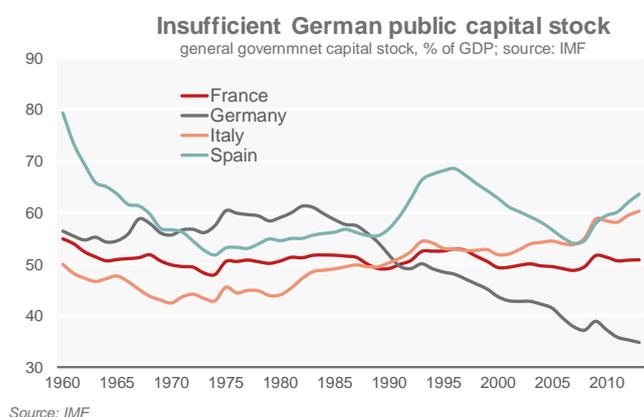
aggressive on the wealth tax. We think that **tax cuts are only realistic in case of a centre-right coalition but that in case of a (more probable) centre-left coalition the immediate net effect on the budget balance could be neutral to slightly negative** (a little bit of wealth tax in exchange for some reduction of the solidarity surcharge).



Centre-left government likely open to SGP reform

The need for elevated public investment spending amid a Covid-induced rise of public debt in an environment of low interest rates has brought the fiscal rules under discussion again. Conservatives and the Liberals intend to maintain it and to return to a balanced budget as soon as possible. This concerns the German debt brake as well as the SGP. In contrast, the Greens and the SPD want to reform the SGP. Regarding the national debt brake the Greens are most ambitious as they intend to exempt investment and focus on the interest burden instead of the debt level.

Hence a **centre-left government would be more open towards a change of the fiscal rules than centre-right one**. However, we would caution to expect too much enthusiasm about adjustment or watering down of the European fiscal rules as the SPD candidate and current finance minister is rather conservative while the liberals would also object strongly. Given many other conflicting subjects, both SPD and Greens will likely prioritize other topics (social justice, climate) in coalition talks.



Tax hikes (SPD, Greens) vs tax cuts (cons., FDP)

There are striking differences on taxation among the relevant parties. The election programs for the conservatives and the Liberals foresee significant tax cuts (mainly by a complete scrap of the solidarity surcharge). In contrast, the SPD and the Greens intend to reduce taxes only for lower incomes while increasing taxes for upper incomes and introduce a wealth tax. Therefore, the immediate budgetary effects are positive in this case (see graph below). In case of the left's (*Linke*) plans becoming true the budget would even improve by € 37 bn, mainly because it intends to be much more

Muted financial market impact from centre-coalitions

We expect only a muted financial market impact from the German election outcome. Over the past weeks markets had to familiarize themselves already with the idea of a SPD chancellor. The need to form a coalition likely containing Greens and Liberals reduces the risk of strong market-averse measures. Moreover, markets will be aware of the fact that most of the laws will have to be agreed by the lower (*Bundestag*) as well as upper (*Bundesrat*) house so that there is an indirect need to compromise with the opposition usually governing in some regions (*Länder*).

An outright negative effect on financial markets seems only likely in case of a left government. Such a coalitions' strong desire to tax wealth would probably leave its mark. Another risk case would be the failure of both kinds of three-party coalition negotiations. At the same time the current grand coalition partners could be unwilling or unable the country for four further years. In such a case a minority government could need to formed in Germany for the first time. This would contribute to uncertainty and hence drag on markets.

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