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German elections: Life after Merkel

Key take aways

- With Angela Merkel not running for another term, the German federal elections will result not only in a new Bundestag but also in a new Chancellor. Current polls and party-political preferences suggest that the existing CDU/CSU and SPD coalition will also not survive.
- Negotiating a coalition agreement may take some time after the election, given the often contradictory nature of parties' policy objectives. At present a CDU/CSU and Green coalition looks the most likely outcome, but there are other possibilities.
- Fixed income markets may be more sensitive to potential coalition partners' views on spending and debt, at both a national and an EU level. Coalition agreements will be important for some equities sectors, but probably less so for the equity market overall.

01 Introduction

German federal elections will be held on September 26. After 16 years at the helm, Angela Merkel is not running again: there will therefore be both a new Bundestag and a new German Chancellor.

Current opinion polls suggest that the existing coalition allies (i.e. the CDU/CSU and SPD) will not command a majority in the Bundestag. Furthermore, it seems that the CDU/CSU and SPD would not want to continue with their existing coalition anyway. This implies that a new coalition at a federal level of two or even three parties will be necessary. We discuss the possible options below.

The Bundestag elects the Chancellor (they are not elected directly) and, up to now, all the Chancellors in the history of the Federal Republic of Germany have been either from the CDU or SPD. Merkel's CDU/CSU has as its Chancellor candidate Armin Laschet, the incumbent prime minister of North Rhine-Westphalia, Germany's biggest state by population. The SPD has incumbent finance minister Olaf Scholz as its chancellor candidate. With the real possibility of a Green chancellor this time around, the Greens have nominated party co-chair Annalena Baerbock. (The term chancellor candidate does not exist in the German constitution, but has been used by the parties since the 1960s to indicate their preferred choice in the event of an election.)

Some of the potential government coalition combinations do exist on a state level but have not happened at a federal level so far. The next Bundestag will most likely comprise six parliamentary groups meaning that many coalition options are possible and negotiations could be complicated. Potential coalition partners may have no previous working relationship and their opposing positions on many issues could make agreement difficult, particularly if parties come out of the election with a similar share of the vote.

It may therefore take a while until a new government is formed after the federal election. At present, a combination of CDU/CSU and the Greens (the so-called "black-green" coalition) looks the most likely, but opinion polls are fluctuating. Some of their positions with regards to climate protection (market based or regulation), taxation or

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defense policy seem quite at odds. Involving a third party could further complicate negotiations. Four years ago, talks between CDU/CSU, Greens and FDP failed, resulting in another CDU/CSU and SPD coalition.

In this report we look into possible coalition combinations and the consequences for economic policy and financial markets.

02 Possible coalitions

Since the last federal election in 2017 the German Bundestag has comprised six parliamentary groups: the CDU/CSU, SPD, AfD, Greens, Linke and FDP. A party needs to get 5% or more of the overall vote (or three directly-elected seats) to be represented in the Bundestag: as polls stand, all these six groups will meet this threshold. The German chancellor usually comes from the party with the biggest share of votes trying to form a government.

While some coalition options are politically infeasible, there are still many possibilities. As noted above, polls suggest that a "black-green" (CDU/CSU + Greens) coalition may get the majority of seats. If needed, they may be joined by the FDP to form a so-called "Jamaica" coalition (like the Jamaican flag – black, green and the FDP's yellow). An alternative "Kenya" coalition of the CDU/CSU, SPD and Greens (black, red, green) is possible but seems unlikely as the SPD seems unwilling to support another CDU chancellorship. A "Germany" coalition (black for CDU/CSU, red for SPD and yellow for FDP) is probably more of a theoretical option than a realistic one, as would be a combination of Greens, SPD and FDP (a "Traffic Light" coalition) as the liberal FDP may find it difficult to support a more leftist government. All other options can be excluded for the time being.

Predicting coalition outcomes is difficult at this stage. Opinion polls seem to have lost some of their predictive power due to changes in the electorate's behavior, as witnessed at the last state election in Saxony-Anhalt. The popularity of new faces may also fade, as happened during the last federal election campaign to Mrs. Merkel's SPD rival, Martin Schulz.

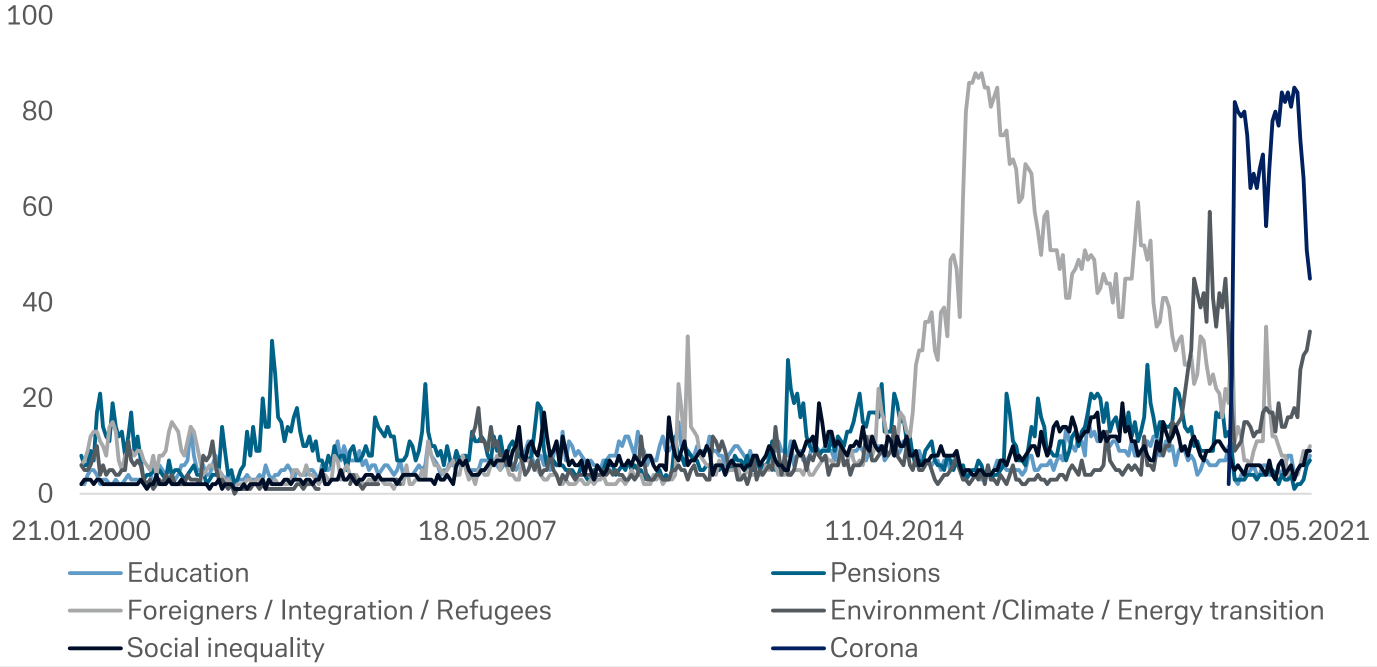
What is also important, as coalition negotiations get under way after the election, will be the parties' share of the popular vote. The Greens were part of a "red-green" coalition under Chancellor Schröder from 1998-2005. What has changed since then is their possible share of the vote. These days they are hovering around 20% in the polls (having been as high as 25% some weeks ago), whereas back then they were below 10%. A greater voting share may help them push through more of their election programme, were they to be part of the new government.

Figure 1: Results of Bundestag elections in the past 30 years (in %)

Year	CDU/ CSU	SPD	FDP	Bundis 90/Die Grunen	Die Linke	AfD	Others
2017	32,9	20,5	10,7	8,9	9,2	12,6	5,0
2013	41,5	25,7	4,8	8,4	8,6		11,0
2009	33,8	23,0	14,6	10,7	11,9		6,0
2005	35,2	34,2	9,8	8,1	8,7		4,0
2002	38,5	38,5	7,4	8,6	4,0		3,0
1998	35,2	40,9	6,2	6,7	5,1		5,9
1994	41,5	36,4	6,9	7,3	4,4		3,5

Source: Bundestag.de, Deutsche Bank AG. Data as of July 15, 2021.

Figure 2: Areas of concern for the German electorate (in %)



Source: Forschungsgruppe Wahlen, Deutsche Bank AG. Data as of June 25, 2021.

03 Key policy topics and differences

During the 2017 federal election, and its aftermath, migration was the dominant topic for the German electorate. Environmental and climate change topics were prominent in 2019 before being displaced by coronavirus in 2020 and 2021. Climate change nonetheless remains the second most important topic for electors (Figure 2) and is therefore likely to play a prominent role in the upcoming election campaign.

Climate politics is at the centre of the Greens' election manifesto. Given that CO2 reduction targets are now agreed to, this focus is less unique than it was in the past. (Following a recent ruling of the German Constitutional Court, Germany is now aiming for a 65% reduction in CO2 emissions by 2030, compared to 1990, and net zero CO2 emissions by 2045.) Other parties also address environmental concerns in their election programmes. Note also that the European Union itself has recently launched its "Fit for 55" climate package recently aiming at 55% CO2 reduction by 2030 and zero emissions by 2050.

As regards other issues, the Greens remain enthusiastic about more European integration, and on reducing social inequality e.g. via a higher minimum wage. They have limited faith in market mechanisms and regulation is seen as a way to achieve some objectives. Their fiscal policy proposals include a reform of the "debt brake" (German's balanced budgets requirement), and higher taxes for top earners and for the wealthy. The reduction of environmentally-harmful subsidies is also proposed as one way to improve the fiscal situation.

The CDU/CSU puts a great weight on economic policy and foreign affairs in its election manifesto. On the environmental front, they propose some market-based instruments such as CO2 emission trading and tax deductions for investments in climate-friendly technologies. Increases in taxes are ruled out and they hold out the hope of some modest tax reductions. The CDU/CSU also want the Next Generation EU fund to be a one-off event and (unlike the Greens) are not in favour of further EU fiscal integration. They want a re-imposition of the currently-suspended rules of the EU Stability and Growth Pact.

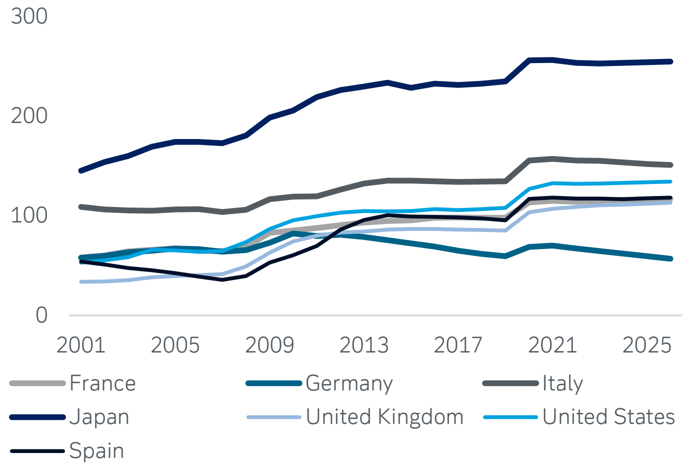
CDU/CSU positions on many topics are close to those of the economically-liberal FDP, in particular on economic affairs and market-based instruments for the fight against climate change. The FDP wants to reduce corporate taxes but they could be willing to compromise. At the beginning of their election manifesto they make clear that they want to win enough votes that no government can be formed without them. In this context it is worth remembering that the FDP was criticised for withdrawing from negotiations for a "Jamaica" coalition in 2017.

SPD positions are in many senses closer to the Greens and include a strong focus on climate change with more regulation and higher taxes for the wealthy but also on European integration. The SPD stresses humanitarian topics such as inequality and refugee policies as part of its generally left-leaning policy agenda.

In the most likely scenario of a "black-green" coalition government (CDU/CSU and the Greens), neither side will be able to implement all of its ideas. (As noted above, much could depend on the Greens' share of the popular vote: if they get 20% of the vote, they will be more able to implement important parts of their election manifesto.) If the FDP joins coalition negotiations (for a "Jamaica" coalition) the contrast between the more market-based FDP and CDU/CSU and the more regulation-based Greens may be an obstacle. A "traffic light" coalition (FDP, SPD, Greens) would also face difficulties.

The Greens are very likely to be part of the new government in one of the coalitions mentioned before. However, coalition would mean compromise with either CDU/CSU and/or FDP. As both of these emphasize the stability of public finances, the need for return to the Stability and Growth pact, the one-off character of the NGEU and the importance of adherence to the debt brake, a significant change in Germany's overall fiscal position seems unlikely. Germany managed to reduce debt levels the global financial crisis (GFC) and this seems also likely post COVID-19 crisis subsides – making Germany as a notable exception amongst the largest western economies (see Figure 3).

Figure 3: Debt/GDP levels (IMF forecasts for 2021 and beyond)



Source: IMF, Deutsche Bank AG. Data as of April 2021.

04 Capital market implications

Coalition agreements on spending are however likely to have the most immediate impact on capital markets. Two separate issues add to the challenges here: first, extra spending to deal with environmental issues and, second, the impact of pan-EU spending in response to the coronavirus pandemic. On the first issue, for example, the Greens' manifesto foresees additional spending of EUR50bn per year for this decade for public investments. On the second issue, the CDU/CSU and FDP argue that the Next Generation EU fund (the EU's main coronavirus spending vehicle) and its corollary of EU common debt should be a one-off effort. They also want a return to the pre-pandemic rules of the EU stability and growth pact.

The impact of these two issues – environmental and EU pandemic-response spending – could be most evident for the fixed income markets.

More (debt-financed) spending implies that government bond supply must increase strongly. More spending, via adding to economic momentum, could also reinforce inflationary pressures meaning that the German economy starts to overheat. (There are echoes of the discussion currently taking place in the U.S. around the Biden administration's spending plans.) Growth momentum and higher debt supply would, ceteris paribus, suggest rising German yields in the medium to longer term.

There is also a concern that, from a fixed income investor's perspective, discussions around the Next Generation EU fund to turn it into a permanent fiscal fixture could change perceptions around German government bonds as a potential alternative may arise. This development would be least imaginable in a coalition with FDP participation.

The impact of the various possible election outcomes on equities might be less profound. The Greens' participation in a coalition and their focus on climate topics and corresponding spending would support certain areas, e.g. clean energy or infrastructure. Higher taxes and higher minimum wages, also key points in the SPD manifesto, would tend to reduce profit margins.

But, as many exchange-listed German large cap companies have substantial foreign revenues and also production located abroad to meet foreign demand, the effect on corporate earnings might be muted, but note planned global corporate tax reforms.

05 Conclusion

The federal election in September will bring change to Germany. On the basis of current polling (which may change, or prove wrong) the next chancellor will probably be Armin Laschet (CDU) but the potential government coalition is far from certain. Most likely the Greens will join the CDU/CSU in a "black-green" coalition but a "Jamaica" coalition with Greens and FDP is possible.

Any coalition will need to reconcile its members' often contradictory policy objectives. Climate change is on political agendas of all the parties that could be involved in coalition talks, but with different proposed solutions. With regards to economic policy we would still expect a focus on debt reduction in the coalitions suggested above, given it is a key priority for CDU/CSU and FDP. In return, the Greens may be allowed to push through more regulation on climate matters.

From a capital markets perspective, spending and debt will remain key issues. Spending pressures will come from two sources: spending to counter the effects of climate change, and increased national and pan-EU spending to deal with the effects of the coronavirus pandemic. Increased national debt issuance will have an impact on German bund yields. European debt issuance could also have a profound impact on perceptions around German yields. These will be important issues for the next German federal government, whatever its complexion.

Glossary

AfD (Alternative for Germany) is a right-wing populist German political party.

The CDU/CSU is an alliance of two German centre-right political parties, the Christian Democratic Union and the Bavarian Christian Social Union.

Die Linke (the Left) is a left-wing German political party.

The FDP (Free Democratic Party) is a German liberal centre-right political party.

The global financial crisis (GFC) is the financial crisis that started in 2007/2008 and lead to a recession in many major economies, originating from an asset bubble in the U.S. mortgage market.

The Next Generation EU (NGEU) stands for European Union recovery package to support member states hit by the COVID-19 pandemic.

The SPD is a centre-left German political party, currently forming a coalition government with the CDU/CSU.

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