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German election preview

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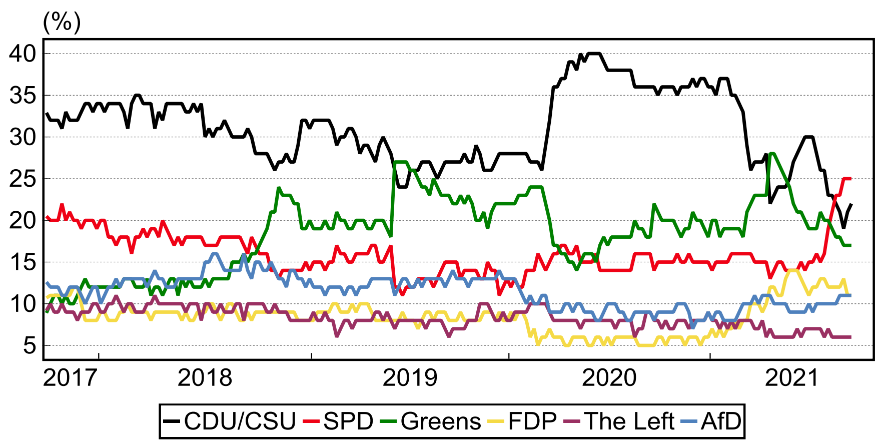
The German election on Sunday is likely to leave the door open to an array of possible governing coalitions and complicated talks are set to last for several months. While the outcome will have some implications for policy both domestically and for the EU, the chances of radical change seem low.

The race is on to succeed Angela Merkel

After four terms in office, the process to replace Angela Merkel as German Chancellor was never likely to be straightforward. Three parties have led the polls this year. With no clear frontrunner, Sunday's election is likely produce an array of possible governing coalitions.

Of the six parties set to enter the Bundestag, any of five could feature in the next German government. These are: 1) Merkel's centre-right CDU/CSU bloc, 2) the centre-left SPD, junior partner in the current grand coalition government, 3) the FDP, the business-friendly liberal party, 4) the Green party, which has become more pragmatic and centrist under its current leadership and 5) the left-wing Die Linke party. None of these parties would be willing to form a government with the far-right AfD, which is the only other party set to be represented in the Bundestag.

THREE PARTIES HAVE LED THE POLLS IN JUST THE LAST SIX MONTHS



Source: Forsa, MUFG Bank Economic Research Office

It had long seemed as though the CDU/CSU would be the senior partner again in the next German government but the party faded in the polls this year as the party's leader, Armin Laschet, had various stumbles. The Greens have also seen a fall in support as various allegations emerged about their leader, Annalena Baerbock.

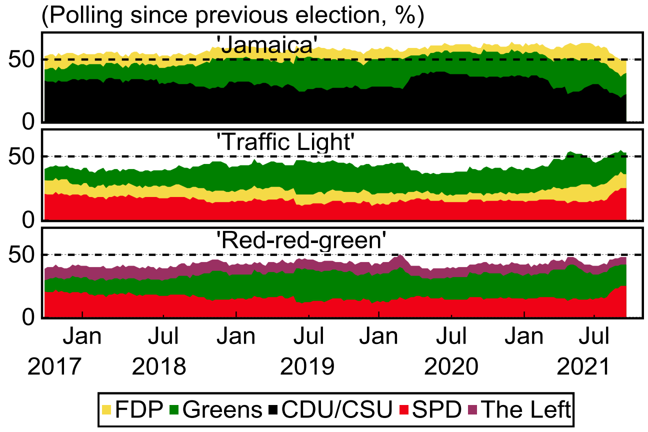
The pre-election debates have not reversed this trend. Olaf Scholz, the SPD leader, was a comfortable winner of each and his party is now the clear frontrunner in the polls. Scholz is moderate and pragmatic. He is the vice chancellor and finance minister of the current government, and the fact that he and his party are on the rise suggests that the electorate may favour continuity and stability over any new faces.

Will the FDP give the green light to the SPD?

While the numbers *might* be there for another CDU/CSU and SPD tie-up – the SPD was in a 'grand coalition' for all but four of Merkel's 16 years as Chancellor – both parties have indicated an unwillingness to see a repeat this time. Instead, with the CDU/CSU, SPD and Greens now all polling between 15% and 25%, the next German government is very likely to be a three-way coalition. This would be a novelty at a national level but is fairly common at a state level.

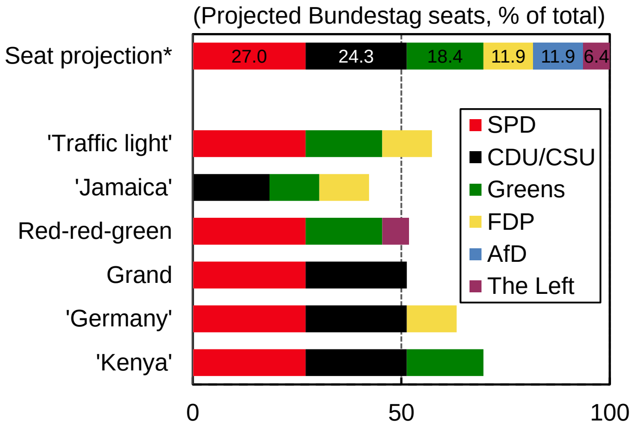
The FDP, polling around 12%, may well find themselves in the position of kingmaker after the election. After the 2017 election the party was deep in negotiations with the CDU/CSU and Greens (for the so-called 'Jamaica' coalition on account of the Yellow, Black and Green colours of the parties) before leader Christian Lindner abruptly pulled the plug on talks saying "it's better not to govern than to govern badly".

TRAFFIC LIGHT MOVES AHEAD OF JAMAICA



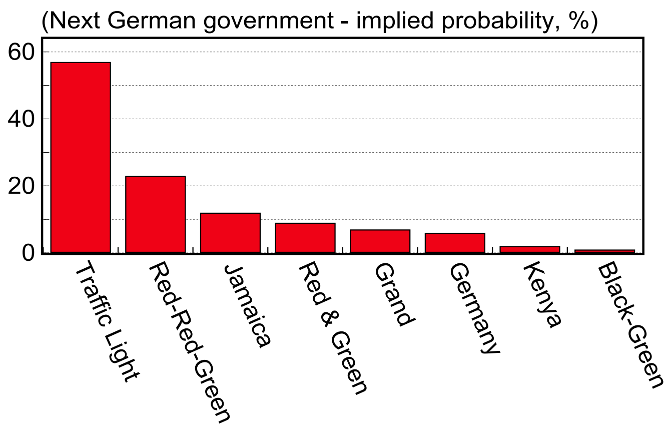
Source: Forsa, MUFG Bank Economic Research Office

SEAT PROJECTION - A RANGE OF POSSIBLE COALITIONS



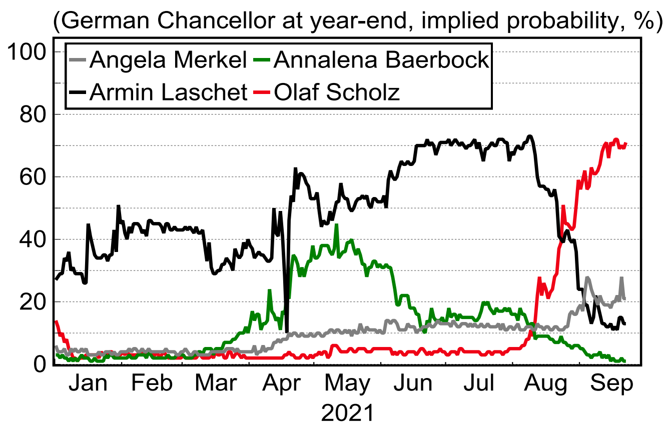
Source: Forsa (21 Sep), MUFG Bank Economic Research

A 'TRAFFIC LIGHT' COALITION NOW SEEMS MOST LIKELY



Source: PredictIt, MUFG Bank Economic Research Office

SCHOLZ HAS EMERGED AS A CLEAR FRONTRUNNER



Source: PredictIt, MUFG Bank Economic Research Office

Even if the SPD were to emerge as the largest party (as seems likely based on current polling trends), Scholz would not necessarily be the next Chancellor. Laschet and Lindner have a good relationship and the FDP is politically closer to the CDU/CSU. Despite what happened in 2017, the FDP would instinctively favour a

‘Jamaica’ arrangement if the numbers are there for it.

But the possibility of a left-wing alternative (SPD, Die Linke and the Greens – or ‘Red-Red-Green’) could prompt the FDP to make a deal with the SPD and the Greens in order to keep Die Linke out of government. This so-called Traffic Light (red, yellow, green) coalition has now emerged as the most likely after the election.

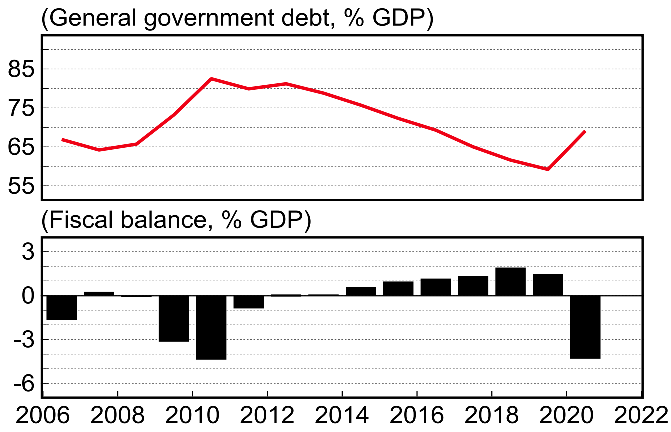
While polls and prediction markets are clearly now pointing towards a SPD-led government, there are plenty of sources of uncertainty. Postal voting opened in mid-August. The popularity of postal voting has increased over recent elections (to 29% of votes in 2017). The pandemic may have caused this to shift much higher still, which means that the final result may not reflect the recent post-debate rise in popularity for Scholz and the SPD. There is also a (very) small chance that Die Linke could receive less than 5% of the vote and win fewer than three districts, in which case it would drop out of the Bundestag under the German electoral system. This would complicate coalition talks and perhaps push the FDP towards a Jamaica deal.

The future path for fiscal policy could be the key stumbling block to any deal

There are common themes to the manifestos of all the major parties (see summary in Table 1 at the end of this report). Whatever the composition of the next coalition, we know that climate change and higher government investment spending will be priorities. The Greens are likely to be in the next government and flooding in Germany in July this year has only intensified the focus on climate change.

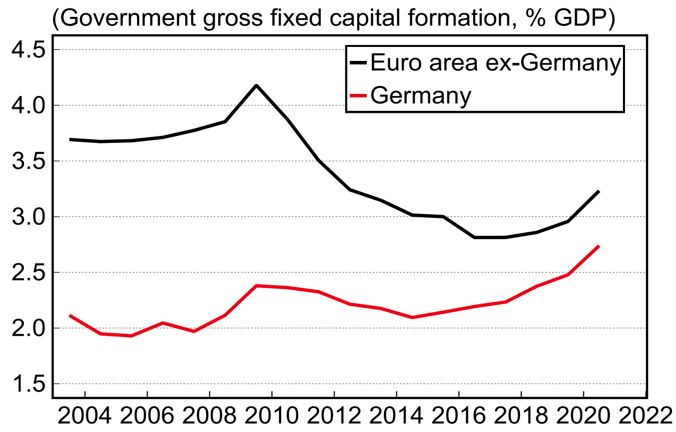
There is a broad acceptance that public investment should increase after years lagging behind the euro area average. Indeed, many observers, including MUFG, had been arguing for more fiscal support in Germany for some time. The fiscal landscape is different now that pandemic-induced emergency measures (including direct grants to businesses, expanded welfare payments and a temporary VAT cut) have pushed Germany into its first fiscal deficit in nearly a decade. A sudden return to austerity territory during the recovery phase to protect fiscal space is unlikely, however. As the Bundesbank noted in its latest monthly report, “there is…no need for Germany to pursue an overly ambitious policy in the next legislative period…the process of structural consolidation can take place gradually…”.

THE PANDEMIC LEFT ITS MARK ON PUBLIC FINANCES



Source: Bundesbank, MUFG Bank Economic Research Office

GERMANY HAS LAGGED BEHIND ON INVESTMENT



Source: OECD, MUFG Bank Economic Research Office

The pace of this fiscal consolidation will be a key issue for coalition talks. Part of the reason for underinvestment has been the ‘black zero’ constitutional debt brake in Germany which limits the federal structural budget deficit to 0.35% of GDP. The CDU/CSU, FDP and SPD all want to retain the debt brake. The SPD’s spending plans would see a slower return to a balanced budget, however. Only the Greens are advocating reforming the law, to finance their climate-related investment plans.

The debt brake rule means that even a left wing ‘red-red-green’ coalition, with a focus on social and green spending, would be unlikely to result in a sea change when it comes to fiscal policy. The debt brake is enshrined in the constitution so any changes would require support from two-thirds of the Bundestag – and the next coalition is likely to only just get over the winning line.

That said, there are some workarounds that could allow some increase in spending without any reform to the debt brake. Special vehicle funds could be tapped to increase spending without any changes to the rules, for example. The definition of unobservable figures (the output gap) could also be tweaked to give more leeway.

While there has been relatively little focus on the EU and foreign policy more broadly during the campaign (instead, the debates centred on leaders’ personal competence and crisis management), the shape of the next German government will also have implications for Europe. Again, fiscal policy will be a focus. The Stability and Growth Pact (SGP), which compels EU governments to keep public debt below 60% of GDP and deficits below 3% of GDP, has been suspended during the pandemic. It is due to be reinstated in 2023. There is likely to be disagreement on the pace of fiscal normalisation after emergency pandemic spending has seen EU27 total government debt surge from 79% of GDP in 2019 to 92% of GDP in 2020. The CDU/CSU and FDP would be keen to see these previous SGP limits reinstated as quickly as possible. Both parties are also opposed to any further joint EU debt following the pandemic-induced collective borrowing arrangement for the recovery fund. The SPD is in favour of using the recovery instruments to further the integration process, while the Greens would seek common EU fiscal goals for climate-related investment.

Outlook – coalition talks likely to extend Merkel’s long goodbye

Angela Merkel represented stability for Germany and the political landscape was always likely to be in flux once she stood down as Chancellor. There have been swings in the polls as election day approaches but no party has emerged as a clearly dominant force. The favourite to succeed Merkel is current vice chancellor Scholz whose party have served in coalition with the CDU/CSU for most of the past 16 years. Our reading of this is that the electorate is open to a different governing party but beyond that does not have much appetite for fundamental change.

A likely three-way coalition will necessitate politically tricky concessions (pre-election red lines often soften once the result has been announced) and reduces the risk of any dramatic policy changes. Whatever the outcome, we expect an increase in government funded infrastructure investment and modernisation projects. In our view, a fiscal rethink would be good for Germany and could be positive for longer-term potential growth. Over the short-term we wouldn’t expect much of an impact as infrastructure changes typically have long lead-in times and current labour shortages in the construction industry could hamper the start of any more ‘shovel-ready’ projects. The most ‘extreme’ coalition possibility is the red-red-green deal featuring Die Linke. Such a government would look to increase social spending, but the scope to loosen the purse strings would be limited. The CDU/CSU and FDP would have a blocking minority in the Bundestag and would prevent any changes to the constitutional debt brake.

The process of coalition talks is likely to take months, which would extend what has already been a long goodbye for Angela Merkel after she announced in 2018 that she would not seek re-election. She will remain as Chancellor until the Bundestag approves a new government. If Merkel remains in the post beyond 16 December she will become Germany’s longest-serving chancellor, breaking the record of predecessor Helmut Kohl.

TABLE 1: KEY POLICIES AT A GLANCE

	CDU/CSU	SPD	Greens	FDP
Fiscal policy	A return to a balanced budget as soon as possible. Reinstatement of the debt brake. Higher R&D spending.	Maintain the debt brake but seek a continuation of higher investment spending after the pandemic.	Reform to debt brake to allow for greater investment. Higher public investment over the medium- to long-term.	Debt brake to be reinstated. Public debt should quickly return to 60% of GDP. Government spending to focus on investment.
Taxes and income	Steady reduction in tax burden for low-to-middle earners. Tax increases have been ruled out. No wealth tax.	Some relief for low-to-middle earners. Reinstate wealth tax. Introduce a financial transaction tax. Increase in minimum wage to 12 EUR per hour. Return to a longer period of eligibility for unemployment benefits.	Higher taxes on high earners with the top rate increasing from 42 to 48%. In favour of a wealth tax. A digital tax on tech companies. Increase in social aid and increase in minimum wage to 12 EUR per hour.	Reduction in tax burden for firms and high earners. No wealth tax.
Europe	Opposed to any more joint EU borrowing. Maastricht debt limits should be reinstated. Completion of banking union.	The recovery instruments should be used to advance the integration process, with a common investment policy and steps towards a fiscal union.	Common EU fiscal policy goals. The ECB should focus on growth and employment as well as price stability. Completion of banking union. Establishment of a European Monetary Fund.	No more joint EU borrowing. Opposed to any EU-wide taxes. In favour of EU-wide defence coordination.
Climate change	In favour of climate protection and sustainable growth. Carbon neutrality by 2045.	Carbon neutrality by 2045 (with energy generation to be carbon neutral by 2040). Expansion of renewable energy and electric transport. Support for citizens affected by the energy transition.	Carbon neutrality within twenty years. Rapid increase in carbon prices. Phasing out of coal-powered energy and emissions-generating vehicles by 2030. Expand rail travel. Disbursement of government energy revenues to citizens.	Carbon neutrality by 2050 Expand the EU ETS and increase incentives for private investment in renewable energy.
Foreign policy	Committed to NATO and 2% of GDP spending on defence. Dialogue with Russia and China. Pro-EU defence cooperation.	In favour of EU defence union. Opposed to NATO 2% of GDP defence spending target. Open to constructive dialogue with Russia and China.	Pro-EU defence cooperation. Reform of NATO, opposed to the 2% GDP defence expenditure target. A tougher stance towards Russia and China. Reform of WTO.	Committed to NATO and 2% of GDP spending on defence.
Other	Reduction in bureaucracy, digital infrastructure investment. Expanded house building (1.5m apartments by 2025)	Greater R&D spending. Rent increases to be limited to inflation in areas with housing shortages.	Introduction of rent controls including commercial properties.	Increase in house-building and tax breaks for home purchases. Privatisation of state-owned companies. Expanded funding for start-ups. Reduction in bureaucracy.

Source: Party manifestos, MUFG Bank Economic Research Office

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