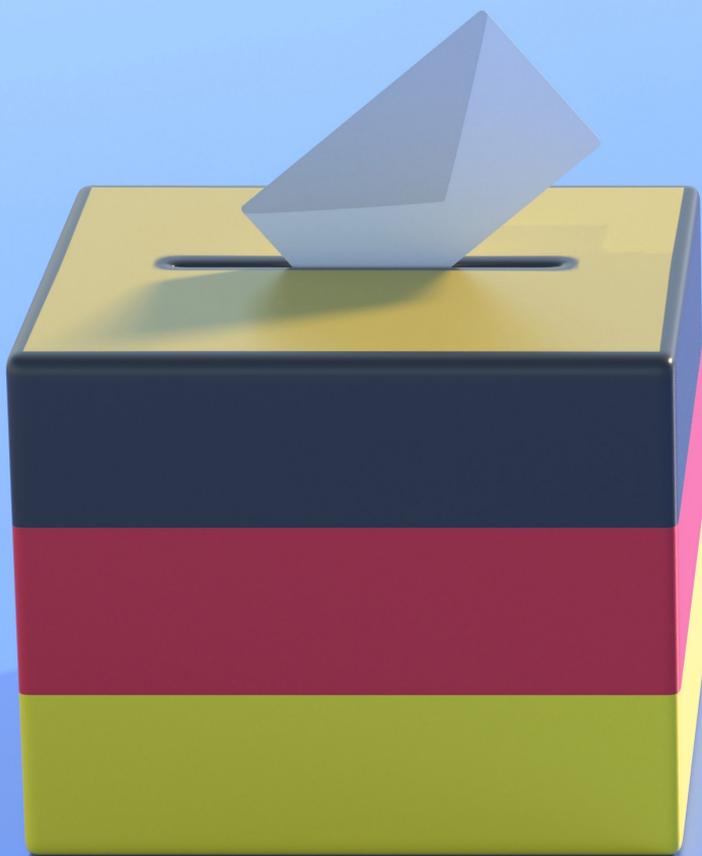


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German politics after Merkel

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GERMAN POLITICS AFTER MERKEL

The outcome of the upcoming German elections is uncertain. Many observers are concerned about who will succeed Angela Merkel after 16 years as German Chancellor and de facto leader of the European Union. In this edition of *Infocus*, GianLuigi Mandruzzato looks at the main issues at stake in the forthcoming German vote.

Less than two weeks before the German elections on 26 September, it is far from clear who will succeed Angela Merkel as Chancellor. Nevertheless, several key issues are clear. The first is that the next government will likely be supported by a three-party coalition, a first for post-war Germany. The second is that the fight against climate change and more investment in infrastructure will be at the top of the agenda, whatever the composition of the next government coalition. The third is that while there will be no drastic changes in fiscal policy and European integration, in both areas the approach of the next German government will be more proactive and flexible, which should be appreciated by the financial markets.

Who will be the next Chancellor?

The German general election on 26 September will mark the end of Merkel's Chancellorship after 16 years and the race for her successor remains wide open. The polls show the greatest support for the SPD's Olaf Scholz. The popularity of Scholz, who is Vice-Chancellor and Finance Minister in the incumbent CDU/CSU-SPD coalition government, has soared since Germany was hit by heavy flooding in mid-July (see Figure 1). As Finance Minister, Scholz has been proactive in ensuring support for people and businesses affected by the floods, demonstrating to the voters his ability to manage a crisis.

In contrast, the CDU/CSU's candidate Armin Laschet, the incumbent President of North Rhine-Westphalia, Germany's

largest and most populous Länder, was criticised for some inappropriate behaviour at a memorial for flood victims and for the slow pace of his government in North Rhine-Westphalia in distributing financial support to those affected by the floods. The decline in Laschet's popularity is seen by many as the main reason for the decline in support for the CDU/CSU.

The Green's candidate Annalena Baerbock has failed to capitalise on an event that demonstrates the urgency of the fight against climate change and has also been penalised for not having government experience.

If the polls are a good guide to the election results, Scholz is the most likely candidate to succeed Merkel as Chancellor, although this ultimately depends on the composition of the government.

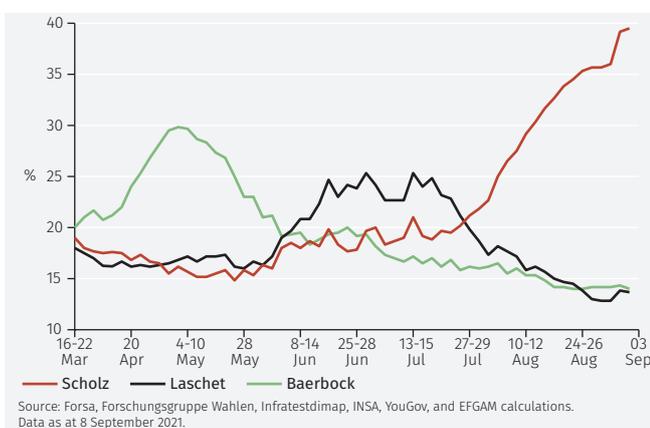
Which government coalition?

According to German Basic Law, the Chancellor is elected by the Bundestag, Germany's lower house, on the advice of the Federal President of the Republic. Members of the Bundestag are elected according to a proportional representation system with a 5% barrier. If no party obtains an absolute majority of seats, the party with the greatest support is asked to consult with the other parties to form a coalition government. However, other coalitions that would exclude the party with the most seats in the Bundestag are also possible. When a coalition controlling a majority of seats in the Bundestag is agreed, the parties report the outcome of the consultations to the President of the Republic, including the name of the Chancellor candidate, who then appears before the Bundestag to seek approval to govern.¹

With less than two weeks left before the vote, the polls (see Figure 2) suggest that:

- no party will win an absolute majority in the Bundestag, hence the next government will most likely be supported by a coalition;
- the centre-left SPD is leading and its momentum has been rising since the floods that hit Germany around mid-July;

1. Popularity of Chancellorship contenders

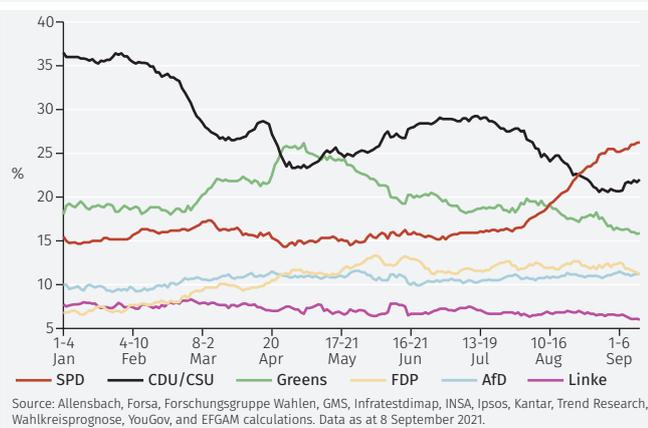


¹ Article 63, commas 3 and 4, of the German Basic Law prescribes that if the Chancellor candidate is not voted by an absolute majority of the Bundestag members, other candidates can be proposed. If within 14 days, no candidate receives an absolute majority, the Bundestag can elect a new Chancellor by a simple majority. Within seven days from the election, the Federal President may appoint the new Chancellor, allowing the formation of a minority government, or dissolve the Bundestag and call new elections within 60 days.

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- the support for Merkel's centre-right CDU/CSU has stumbled to an historical low;
- the Green party has lost support since the spring and now trails the other two major parties;
- support for the other parties that will likely enter the Bundestag has stabilised at 12% for the liberals of the FDP, at 11% for the far-right AfD, and at 7% for the leftist Die Linke.

2. Popularity of parties

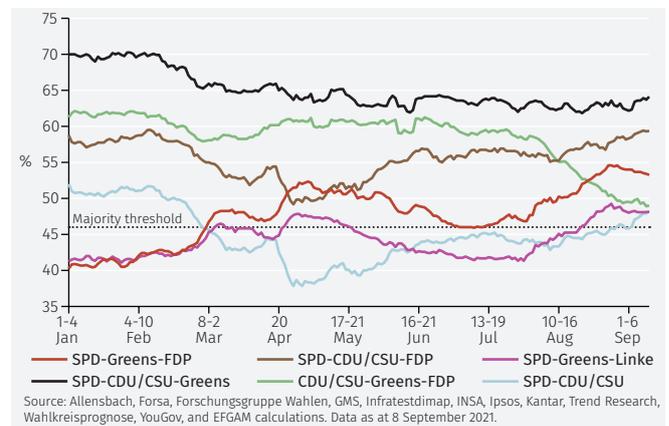


If the election result is in line with the polls, for the first time in the post-war period the government coalition could include three parties. In theory, this opens up numerous alternative formations, but only a few of them are viable because all of the four largest parties have effectively ruled out governing with either the AfD or Die Linke.

Although negotiations for the formation of the new government will probably be long and complicated, the good news for markets is that the coalition including the SPD, the Greens, and the FDP, known as the traffic light coalition after the colours of the three parties, seems by far the most likely (see Figure 3)². One point of uncertainty relates to whether the FDP is willing to govern with the Greens. In 2017, the FDP abandoned consultations for a possible CDU/CSU-Greens-FDP coalition arguing that the Greens' positions on taxation and public spending were incompatible with its electoral base. That decision, which was followed by six months of gruelling negotiations between the CDU/CSU and the SPD to create the incumbent *Grosse Koalition*, reduced the FDP's popularity towards the 5% critical threshold. It therefore seems unlikely that the FDP will make the same choice today, at the risk of paying

an even higher price and given the increased profile of environmental issues in German politics.

3. Popularity of possible coalitions



What will be the priorities of the next government?

Agreement among the SPD, the Greens, and the FDP can be found on greater public investment in environmental policies, innovation and the improvement of infrastructure. At the same time, the presence of the FDP in government would be welcomed by the markets as a guarantee against a generalised increase in taxation and regulation, including of the labour and housing markets.

It might be more complicated to find a common denominator in the approach to the European Union. The SPD and the Greens favour greater European integration, including an increase in the EU budget and the development of fiscal solidarity instruments. In contrast, the FDP has historically held rigid positions on burden sharing within the EU and respect of fiscal sustainability criteria. The leadership of Scholz, who is a committed pro-European and an enthusiastic supporter of the Recovery and Resilience Fund as a first step towards European fiscal union, will immediately be tested in this area.

However, no drastic changes in German economic policy would be expected. Besides the broad-based composition of the next government coalition, which will most likely include parties from both political sides, the scope for major change is limited by the need to find agreement with the opposition on major issues. This is because the German Constitution grants the opposition parties a de-facto veto power on issues that also need the approval of the Bundesrat, the German Upper House whose members reflect the results of regional elections.

² Other mathematically possible coalitions are, however, hardly feasible. The Greens are unlikely to agree to be the junior partner in a coalition led by CDU/CSU and complemented by the FDP. It seems also unlikely, although not impossible, that the CDU/CSU would agree to be part of an SPD-led coalition together with the Greens. Likewise, the SPD would have little interest in enlarging the *Grosse Koalition* to the FDP since it would rather choose a more like-minded partner such as the Greens. Finally, another *Grosse Koalition* with reversed roles between SPD as leader and CDU/CSU as junior partner can no longer be excluded.

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Conclusions

With less than two weeks before the vote that will mark the end of the Merkel era, it is still uncertain who will succeed her as Chancellor. The SPD, the party of incumbent Vice-Chancellor and Finance Minister Scholz, is leading in the polls but rapid changes in voters' opinions cannot be ruled out.

If the polls are a good guide to the elections, the next German government will for the first time in the post-war period be supported by a three-party coalition. This presents the risk that the consultations for the formation of the government will once again take a long time and that government action itself will be less decisive and effective. However, the most likely coalition, led by the SPD together with the Greens and the liberals of the FDP, would easily agree on more public investment to fight climate change and improve German infrastructure. The new government is expected to be moderately more proactive on fiscal and European policies than under Chancellor Merkel, while moving in continuity with her actions. Overall, such an election outcome would likely be viewed positively by financial markets.

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APPENDIX

Key points in main parties' manifestos

| | SPD | CDU/CSU | Greens | FDP |
|----------------------------|--|---|--|--|
| General orientation | Investment in the green transition and infrastructure funded by higher taxes. More European integration including a common fiscal policy. | Moderate tax cuts and return to fiscal prudence. Green transition driven by market-based instruments. Increased European integration but no common fiscal policy. | Push for green and social policies funded by higher taxation. More European integration, including an increased EU budget. | Tax cuts and return to fiscal prudence. Green transition driven by market-based instruments. Return to Maastricht criteria for eurozone members. |
| Climate | Carbon neutral by 2045. Enhanced CO2 emission trading scheme. 100% electricity generated from renewable sources by 2030. Exit from coal at the latest by 2038. Accelerate the penetration of EV. 130 kmh speed limit on motorways. | Carbon neutral by 2045. Enhanced CO2 emission trading scheme. Accelerated shift to renewable sources of energy. Exit from coal on schedule by 2038. No speed limit on motorways. | Cut CO2 emissions by 70% by 2030. Government to support costs of transition in industry. Increase CO2 emission tax to EUR60/ton by 2023. 100% electricity generated from renewable sources and exit from coal by 2030. New cars to be emission free by 2030. 130 kmh speed limit on motorways. | Enhanced CO2 emission trading scheme. No speed limit on motorways. |
| Fiscal policy and taxation | No "black zero" for the budget and exploit flexibility in the "debt brake" rules. Minimum of EUR50bn of public investment per year. Tax rate for incomes >EUR250k to rise to 48% from 45% and introduce a 1% wealth tax. Taxation of capital income at normal rate instead of 25%. Support EU financial transactions tax and a more comprehensive taxation of digital platforms. | Return to "black zero" for the budget but exploit flexibility in the "debt brake" rules to fund investment. Moderate tax cuts if allowed by budget conditions. Adjust tax brackets to inflation. End solidarity surcharge applied to incomes >EUR73k. Simplify the corporate tax code capping taxes on retained profits at 25%. Reduced red tape and accelerated depreciation allowance to support investment and digitalisation. Payroll taxes <40% of salary. Support a more comprehensive taxation of digital platforms. | No "black zero" for the budget. Ease the "debt brake" rules in the Basic Law to run small deficits and fund investment. Increased public investment by EUR50bn per year partially financed by reduced subsidies to brown industries. Raise tax rates by 3 percentage points for incomes >EUR100k and >EUR250k to 45% and 48% respectively and introduce a 1% wealth tax. Taxation of capital income at normal rate instead of 25%. 25% minimum corporate tax rate. Support EU financial transactions tax and a more comprehensive taxation of digital platforms. | Return to "black zero" for the budget and end of escape clause in the "debt brake". Income tax cuts and adjustment of tax brackets to inflation. End solidarity surcharge applied to incomes >EUR73k. Simplify the corporate tax code cutting the effective tax rate to 25%. Payroll taxes <40% of salary. Support a more comprehensive taxation of digital platforms. |
| European Union | Achieve a full fiscal and economic union, including a common investment policy. Complete the banking union including the common deposit insurance scheme. Aim for EU unemployment insurance and minimum wage. | Revamp common fiscal rules without easing them and keeping sanction on non-compliant countries. Complete the banking union without the common deposit insurance scheme. | Make the Recovery Fund a permanent facility and turn the ESM into a European Monetary Fund. Complete the banking union including the common deposit insurance scheme. Aim for EU unemployment insurance. Transfers more powers from national Parliaments to the EU Parliament. | Tougher sanctions on countries non-compliant with Maastricht rules. Turn the ESSM into a European Monetary Fund with stricter criteria for extending financial support. Supports an EU constitution and European army. |

Cont.

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| | SPD | CDU/CSU | Greens | FDP |
|------------------------|--|---|--|---|
| Job market and welfare | <p>Raise minimum wage to EUR12 from EUR9.5 per hour by 2022.</p> <p>Increased unemployment benefits with less penalties for job refusals.</p> <p>Raise federal subsidies to keep public pensions at 48% of salary.</p> <p>Transform private health insurance schemes into a public scheme.</p> <p>Increase digitalisation in the provision of healthcare services.</p> | <p>Increase flexibility of job market with weekly cap on working hours.</p> <p>Launch of funded pension scheme to complement public pay-as-you-go system and reform the private pension system.</p> <p>Increase digitalisation in the provision of healthcare services.</p> | <p>Raise minimum wage to EUR12 from EUR9.5 per hour and increase flexibility of working hours.</p> <p>Increased unemployment benefits with less penalties for job refusals.</p> <p>Raise federal subsidies to keep public pensions at 48% of salary.</p> <p>Transform private health insurance schemes into a public scheme.</p> <p>Increase digitalisation in the provision of healthcare services.</p> | <p>Increase flexibility of job market with weekly cap on working hours.</p> <p>Launch of funded pension scheme to complement public pay-as-you-go system and reform the private pension system.</p> <p>Increase digitalisation in the provision of healthcare services.</p> |
| Housing | <p>Temporary suspension of rents in hotspots.</p> <p>Rent increases of no more than the inflation rate.</p> <p>Build 100k social houses per annum.</p> | <p>Reduce red tape to build more houses.</p> <p>Enhance depreciation allowance to increase supply of housing for rent.</p> | <p>Cap on rents of existing houses and tighter limits on rent increases in hotspots.</p> <p>Rent increases of at most 2.5% per annum.</p> <p>Build 1 million social houses in 10 years.</p> | <p>Remove caps on rents.</p> <p>Reduce red tape to build more houses.</p> <p>Enhanced depreciation allowance.</p> |

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