# Investment Strategy Bulletin

# German elections: the end of an era opens up a range of scenarios

**Investment Solutions**

27 August 2021

- The 26 September federal elections will change Germany's leadership after four terms of Chancellor Angela Merkel. The next government's composition is highly uncertain.
- Current polls point to a three-way coalition including both centre-left and centre-right parties, meaning any policy change will be modest.
- Nevertheless, the next government's fiscal stance should be more expansionary than pre-Covid, as all parties see the need to invest in the energy transition.
- A shift in fiscal policy will be measured rather than revolutionary: centre-right parties continue to advocate balanced budgets and resist rising debt.
- Some additional flexibility in EU fiscal matters looks possible, but bold EU fiscal rule reforms, or continuing the Recovery Fund, would face centre-right opposition.

**Germany's Chancellor, Angela Merkel, has steered her country through a series of crises over the last 15 years, from the global financial crisis to the European debt crisis and the Covid pandemic. While every other European country has regularly changed its head of government, Germany has been a notable exception. The result will set the tone for fiscal policy in both Europe's biggest economy, and across the European Union.**

In September, Germany's voters will elect a new Chancellor. Crucially, the result is likely to create a three-way coalition, as this appears the only way to achieve a governing majority in the parliament, or Bundestag.

## A fragmented electorate means a range of possible outcomes

Poll data in decent months point to a close and volatile race with the lead already swapping (see chart 1, page 2). Over the summer months, the alliance between the Christian Democratic Union (CDU) and the Christian Social Union (CSU), known as the Union Party, has been challenged by the Greens, and most recently, the Social Democratic Party (SPD). With no combination of two parties close to a majority of 50%, current polls, if accurate, point to a three-party coalition. This is especially true if we rule out the possibility of another 'grand coalition' between the CDU/CSU and the SPD, a scenario opposed by the latter.

**Box: German electoral system and the principle of proportionality**

**Each voter casts two votes:**

1. The first is a vote for a candidate in their constituency (Wahlkreise). The candidate with the most votes is directly elected to the Bundestag. The 299 constituencies each elects a representative by **majority voting**.
2. The second vote is cast for a party. This **proportional voting** process determines each party's share of seats in the Bundestag.

Parties with less than 5% of votes get no seats, except for those won in majority voting. In contrast, parties with at least 5% of votes, are awarded seats in line with their proportional share of the vote.

For example, a party winning 150 seats by majority voting and 200 seats in the proportional vote process wins an additional 50 seats. A party winning 150 seats by majority voting, but only 100 by proportional vote, would keep the 'extra' 50 seats, to respect the proportionality principle. This explains why the number of Bundestag seats can vary between 598 and 750.

Since absolute majority is rarely achieved by a single party[1], it is then up to parliament to elect the Chancellor for a four-year term through coalition negotiations.

[1] The only exception to this has been Konrad Adenauer's win in the 1957 elections that handed the CDU/CSU an absolute majority

The precise vote needed for a majority in the Bundestag is hard to establish, given the particularities of Germany's electoral system. As explained in the box on the left, the number of parliamentary seats is not fixed. Nevertheless, a total vote share of around 48% should be enough to secure a majority.

This situation leads to a wide range of possible outcomes (summarised in the Appendix), given the number of different three-way combinations that could create a Bundestag majority.

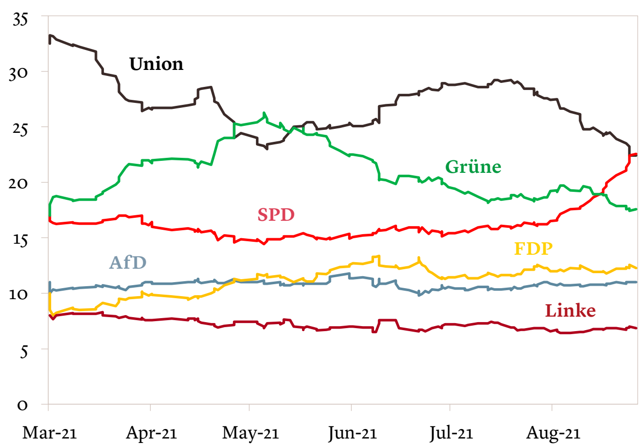
A key implication is that, despite the differences in party agendas (discussed below), we expect most of these possible outcomes to result in a significant degree of policy continuity. This is because most scenarios would include both centre-left and centre-right parties. The very process of forming a coalition inevitably requires these two sides to reach a compromise. This tends to lead to 'lowest common denominator' government coalitions, with the most ambitious items on each party's agenda likely to be dropped.

There is however one such combination that would result in a marked departure from status quo: an SPD-Green-Left government, known as an 'RRG' (Red-Red-Green) coalition, which would stand for a significant increase in investment, some tax hikes, and a more favorable stance towards fiscal transfers at an EU level. This is a low-probability outcome, give that their current poll numbers only barely sum to 50%, and SPD candidate Olaf Scholz has taken a stance against governing with the Left.

The other implication is that the government formation process may prove both long and complicated. Following the

**1. Polls point to an unusually close race**

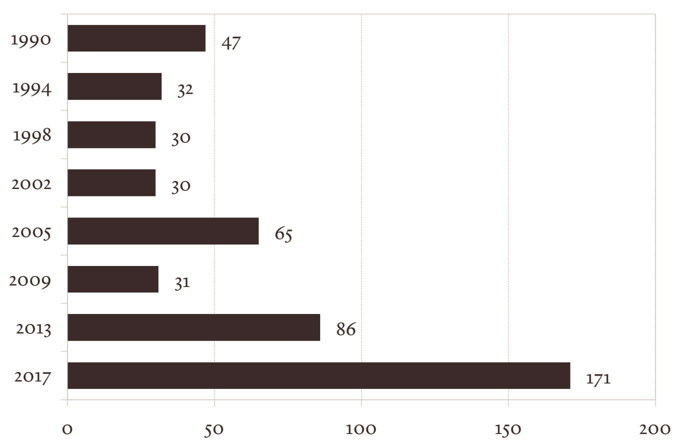
Average of last five polls, in percent




Sources: Polling companies, Wikipedia, Lombard Odier

**2. Forming a government coalition is a complicated affair**

Days between elections and government formation




Sources: Bundeswahleiter, Lombard Odier

last general election in 2017, it took almost six months for a new government to be formed. This is historically exceptional (see chart 2, page 2), but all governments for the last 30 years have been two-party coalitions, reducing the complexity of negotiations to form a government.

A three-party coalition therefore risks a protracted period of uncertainty while negotiations work through different scenarios. This may have a market impact. In the near term, the macroeconomic risk is limited, as the outgoing government will act as caretaker and continue to implement 2021's budget. However, if the talks extend beyond 2021, when the current budget expires, the government would then face important spending constraints. Nevertheless, our baseline expectation is the urgency of dealing with the pandemic should help accelerate the process of forming a multi-party government.

### A shift in fiscal stance is the key macro variable

The key areas of market interest are the fiscal plans and the approach to EU/euro area matters.

In the recent (pre-pandemic) past, Germany ran a particularly tight fiscal policy, with government budgets consistently in surplus (see chart 3). The flipside of these budget surpluses is Germany's well-known lack of public investment. The reduced fiscal impact from limited public spending can act as a drag on near-term GDP growth. More importantly, it affects the economy's long-term growth prospects as this underinvestment has allowed the quality of public infrastructure to deteriorate. This became evident during the pandemic as severe shortfalls in digital services and the education system have made the topic an electoral issue this year.

A tight fiscal stance also has acritical effect on financial markets: the limited borrowing by German government has resulted in bond scarcity, which – together with increased demands for safe assets —has contributed to the marked fall in Bund yields: 10-year yields fell below 0% in May 2019 and have remained negative ever since.

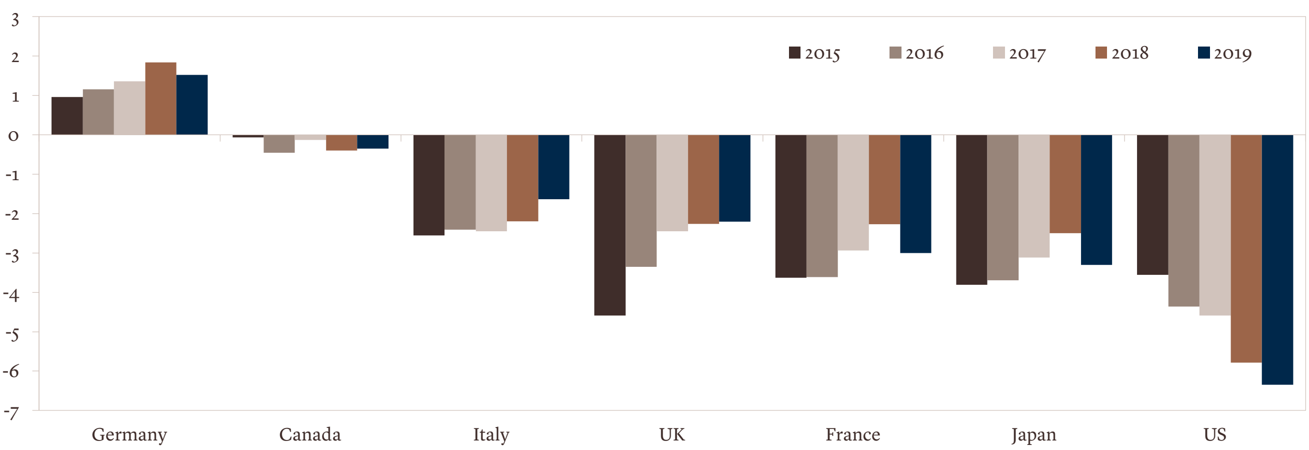
The budget surpluses are a result of policy decisions, the most important of which is the Constitutional 'debt brake'. This bans structural deficits in excess of 0.35% of GDP, and in 2009 it was enshrined in the constitution, backed by a two-thirds majority. The current government coalition went further than the constraint imposed by the debt brake, committing to the policy of 'Schwarze Null' (black zero), effectively banning fiscal deficits.

In the Covid pandemic, the debt brake was suspended until 2022, given the need for a forceful policy response to the crisis. But the political left and right differ significantly on the fiscal way forward, once the emergency is over. The centre-right parties (CDU/CSU and Free Democratic Party) argue in favour of a tight fiscal stance, specifically re-implementing the debt brake, while discussing plans to reduce the debt-to-GDP ratio and quickly repay all of the public debt from the pandemic.

The Greens support a change in Germany's constitution to remove the debt brake, permitting a significant increase in public investment, and campaign for additional investments of EUR 50 billion (or about 1.5% of GDP) per year until 2030. The

**3. Germany stands out among G7 economies for budgets consistently in surplus before the pandemic crisis**

General government net lending/borrowing, in percent of GDP




Sources: IMF, Lombard Odier

SPD, while also in favour of increasing public investment, takes a less ambitious fiscal approach, arguing that the two-thirds majority needed to change the constitution is hard to achieve.

All parties acknowledge the need to invest in relating to combat climate change, support the clean energy transition, and address the issues raised by the pandemic. But the urgency and the scope differ materially, with the Greens (and the left) looking for larger investments and a sharper reduction of carbon emissions, while the centre-right has a more gradualist approach (see Appendix).

Overall, we expect the next government to take a more expansionary fiscal stance, but the extent will depend on the composition of the coalition and the negotiations in the process of forming a coalition government. Given the opposition to reforming the debt brake by centre-right parties and their electorate, we believe that there is only a modest likelihood of a meaningful long-term shift in German fiscal policy.

## Domestic and European fiscal matters: some strong parallels

German government priorities are critical to European economic policy, as any EU-level reform efforts are highly unlikely to succeed without German support. Conversely, a German government increasing public investment at home to combat climate change, may give the momentum needed to promote similar initiatives at an EU level.

While not as strict, or strictly enforced, as Germany's debt brake, the EU's fiscal rules[2] have often added to an already contractionary fiscal mix across the euro area, contributing to sub-par growth outcomes. Their complexity has also been criticised by many observers including official institutions such as the International Monetary Fund, and the need for reform has been a matter of intense debate, pre-dating the pandemic.

Covid has raised even more questions. The crisis allowed for a suspension of fiscal rules until 2022. But what happens once the crisis is over remains an open question. A strict re-introduction of the EU fiscal rules –as advocated by the FDP – would create contractionary fiscal policy across the euro area as any country with a debt-to-GDP ratio above 60% would need to run budget surpluses to bring it back towards this threshold. That would certainly slow the economic recovery, and make the future normalisation of monetary policy by the European Central Bank (even) more challenging, if not impossible.

At the other end of the spectrum, the Greens propose a reform of the Stability and Growth Pact to protect investment, an increase in the EU budget with new revenue sources from digital and financial taxes, and support for the Recovery Fund as a permanent crisis-fighting tool.

While the fiscally conservative parties are likely to block the more ambitious parts of such an agenda, a more flexible policy may materialise, especially if the next German government is controlled by centre-left parties. This flexibility may include further suspensions in the near term to deal with the impact of the crisis, or medium-term carve-outs for expenditures to deal with much-needed investment in certain sectors.

The future of the Recovery Fund will demand a longer discussion – and its outcome will depend on whether the funds, just starting to be disbursed across the EU, are spent effectively. But even if the September elections do not provide a definitive answer, we will be watching this closely given its critical role in the EU's financial architecture.

It is worth highlighting, however, that German political-party differences on European issues are primarily a matter of degree rather than approach. Building and preserving the European project has been a key German policy in the postwar era, and we believe this will continue: all the major party candidates are deeply committed to the EU and the euro. Unlike elections in other EU countries, where the tail risk of a Eurosceptic win can worry markets, such a scenario looks extremely unlikely in the German elections.

*Bill Papadakis, Macro Strategist*

### Timeline

- 29 August: TV debate
- 12 September: TV debate
- 23 September: final debate
- 26 September: election date

2 The fiscal rules were enshrined in the founding documents of the European Monetary Union. The 1992 Maastricht Treaty requires members to keep public debt below 60% and public deficits below 3% of GDP. In 1997 the Stability and Growth Pact (SGP) provided the associated enforcement mechanisms.

# Appendix

## Table 1: Summary of key agenda items by party

| Party | Taxes & Fiscal | Public Investment | Climate | Europe | Industrial & trade policy |
|---|---|---|---|---|---|
| CDU/CSU | • No change to constitutional debt brake<br>• No wealth tax<br>• Tax cuts for low and middle incomes | • Improve traffic connection with eastern neighbors<br>• EUR 500mn for healthcare<br>• EUR 15bn until 2025 for tel. networks | • 2045 – climate neutral<br>• Widen emissions certificate trading (ETS) | • No eurozone debt mutualisation<br>• NextGenEU is welcome, but a one-off | • Less bureaucracy<br>• Sovereignty offensive for pharma industry |
| FDP | • Repay pandemic's gov. debt asap<br>• Cap corporate taxation at 25% | • Public infrastructure investment<br>• EUR 2.5bn per year extra in education<br>• Future fund for start-up | • Limit global warming to 1.5 degrees<br>• 2050 - Climate neutral<br>• Widen emissions certificate trading (ETS) | • Full reinstatement of the stability pact<br>• NextGenEU is welcome, but a one-off | • More free trade agreement, including trans-atlantic |
| SPD | • No austerity after the crisis<br>• 1% wealth tax on very large wealth<br>• Financial transaction tax | • Government as "strategic investor<br>• Investment in public transport, digital schools, healthcare | • Limit global warming to 2 degrees<br>• 2050 - Climate neutral<br>• 2038 end of coal power | • Expand EU-wide public investment initiatives | • Focus on re-onshoring pharmaceuticals production<br>• Battery technology |
| Grüne | • Exempt public investment from constitutional debt brake<br>• 45% income tax > EUR 100k<br>• Abolish 25% capital gains tax | • EUR 50bn per year additional public investment until 2030<br>• More culture spending | • Limit global warming to 1.5 degrees<br>• Emission-free cars only from 2030<br>• Raise CO2 price in 2023 | • European fiscal policy to complement monetary policy<br>• Reduce intra Eurozone imbalances | • Battery technology<br>• Foster semi-conductors industry |
| Linke | • Abolish debt brake<br>• Wealth tax up to 5% on net asset > EUR 1 mios<br>• Raise tax free allowance to EUR 14K | • EUR 20bn per year "transformation fund", EUR 10bn for social housing, EUR 38bn for public transport | • 100% renewable energy by 2030 | • EUR 1-2 trillion debt-funded EU investment program<br>• Strengthen fiscal supervision | • Nationalise all health care providers<br>• Nationalise energy grid. |

Sources: parties manifestos

## Table 2: Possible coalition scenarios*

| Combined vote share in polls | | Fiscal stance: Taxes | Fiscal stance: New spending | Climate transition investments | EU / Euro area issues: EU Budget | EU / Euro area issues: EU Federalism |
|---|---|---|---|---|---|---|
| 53% | Jamaica<br>CDU/CSU-Greens-FDP | - | = | + | - | + |
| 52% | Traffic Light<br>SPD-FDP-Greens | + | + | ++ | =+ | + |
| 62% | Kenya<br>CDU/CSU-Greens-SPD | + | + | ++ | =+ | = |
| 57% | Germany<br>CDU/CSU-SPD-FDP | - | = | + | - | = |
| 45% | R2G<br>SPD-Left-Greens | ++ | ++ | ++ | ++ | + |

[2] all parties have ruled out the possibility of forming a coalition with the Eurosceptic AfD

Source: Lombard Odier

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