2 December 2021

German Politics Monitor

Traffic light is flashing green

- **Under the mantra 'daring more progress' the new government plans an ambitious investment offensive, but details are somewhat scare and financing remains the Achilles' heel of the deal.**
- **We expect Germany to maintain a clear pro-European stance, but see scope for a more critical foreign policy stance towards China, Russia and autocratic leaders in the EU.**

Daring more progress

As a first in German history, a new 'traffic-light' coalition between the Social Democrats (SPD), Greens and the liberal FDP party has taken over the government in Germany. Combining political forces on the left (SPD, the Greens) and right (FDP), we see the 'traffic-light' trio as a centrist coalition that is united in its aim of breaking with the status-quo represented by the last grand coalitions.

Previous Finance Minister Olaf Scholz will succeed Angela Merkel as chancellor and we see him as a steady hand with a measured and consensus-based leadership style in the tradition of Merkel. While clearly less experienced than his predecessor on the European political scene, Scholz has gathered credibility among European leaders for his role in the OECD accord on global minimum corporate taxes. Whether he can fill the vacuum of a strong European leader that Merkel leaves, will only be seen over time and probably not before the next crisis hits. Liberal FDP leader Christian Lindner will likely take over as Finance Minister and although more fiscally conservative than Scholz, he has shown a willingness to compromise on fiscal matters during the coalition negotiations and *highlighted* Germany's special responsibility in holding the Eurozone together and enable countries room to invest in their economies.

Under the mantra 'daring more progress' the *coalition agreement* sets out an ambitious investment offensive ranging from public sector digitalisation, broadband access to new technologies to achieve the Paris climate goals. In light of Germany's dire investments needs we view this investment focus as positive for potential growth. Reducing investment barriers stemming from an opaque public administration are key in addressing implementation bottlenecks for infrastructure projects, that are particularly prevalent at the local government level were most construction investment is realized. Debt relief for highly indebted municipalities will be an important measure to boost fiscal multiplier effects, but could prove tricky to achieve in the absence of a broad consensus in parliament to make the necessary constitutional adjustments. Favourable depreciation rules for digital and green investments in 2022 and 2023 should also foster private investments, but usage could turn out lower than expected if supply bottlenecks and semiconductor shortages persist.

The coalition agreement also envisages aggressive action on climate, with the exit from coal advanced to 2030 (instead of 2038) and a target of at least 15mio electrical vehicles on Germany's roads by 2030. Large scale adoption of renewable energy is a key focus, with the aim of renewables to account for 80% of electricity production by 2030, up from the current 65% target (and 45% share today).

Division of ministries

SPD

- Chancellery
- Interior
- Defence
- Health
- Construction
- Economic cooperation and development

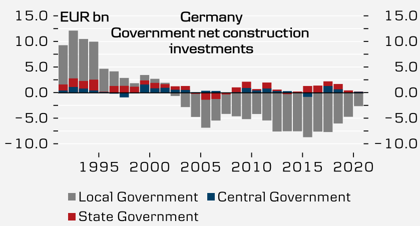
Greens

- Foreign
- Economy and climate
- Family, seniors, women and youth
- Environment, nuclear security and consumer protection
- Food and agriculture

FDP

- Finance
- Justice
- Traffic and digital
- Education and research

Local government bottlenecks impede infrastructure investments



Source: Destatis, Macrobond Financial, Danske Bank

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But also social policies have come back into focus with a commitment to stable public pensions and a 25% increase in the minimum wage to EUR 12/h (from currently EUR 9.60/h) during 2022, which should benefit especially low income households with a larger propensity to consume. Both the growing importance of carbon pricing tools and higher minimum wages should have a pro-inflationary impact in the coming years in our view, see also *Euro Area Research - Measuring the euro area inflation pulse*, 15 November.

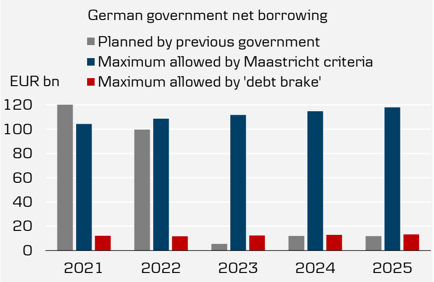
Financing ambitious investment plans remains the Achilles' heel of the deal. Under pressure from the Liberals, the coalition will again have to comply with the constitutional 'debt brake' by 2023, which limits the structural deficit to 0.35% of GDP (and government net borrowing to EUR 10-15bn per year in 'normal' economic times). At the same time, the coalition is also ruling out tax increases (both income, corporation and VAT). This leaves a question mark how investments of some EUR50bn per year (1.5% of GDP, as envisioned by the Greens) will be financed. The plan of finding additional budgetary leeway by eliminating 'unnecessary and climate-damaging' subsidies and expenditures rings hollow. Instead, a range of complex tools will likely be required to work around the debt brake rules, including increased off-budgetary borrowing via state-owned institutions such as *Kreditanstalt für Wiederaufbau* (*KfW*), *Deutsche Bahn* and *Bundesanstalt für Immobilienaufgaben (BIMA)*, extending debt repayments until 2058 and tweaks to structural budget calculations. Increased green bond issuance is thereby a clear focus. By making use of the still unused debt authorization in this year's budget, the parties also seek to inject EUR50bn into the energy and climate fund to finance investments in the coming years. A supplementary budget for 2022 could follow early next year, while a 2023 budget draft is expected in June.

We expect the future German government to maintain a clear pro-European stance. The completion of the European banking union is still the aim and in a change from the past, the new government signals willingness to participate in a common European deposit insurance system (EDIS) after further risk reduction has been achieved. On the topic of EU fiscal rules reform, the coalition agreement remains vague, but mentions that the stability and growth pact (SGP) rules could be developed further to secure growth, safeguard debt sustainability and foster green investment. We see Germany's FDP-led finance ministry open to discussions to simply existing rules (as suggested by *Bundesbank*) and allow for necessary investments, but sceptical of a significant watering down of current limits.

On foreign policy, we see scope for the new government under influence from the Greens to take a more critical stance towards China and autocratic leaders in the EU (like Hungary and Poland) compared to the Merkel area. The coalition agreement does not explicitly mention North Stream 2, but we would not be surprised for an Annalena Baerbock-led foreign ministry to adopt a more critical language towards Russia, raising the risk of diplomatic spats and retaliatory measures in the energy domain.

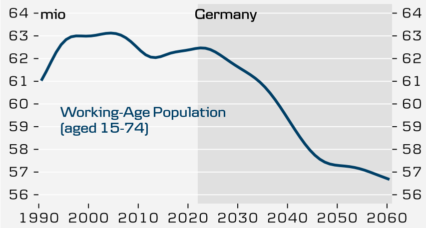
Overall, we think the traffic light government constitutes a welcome break with the status-quo from the past in German politics. The emphasis on investments and digitalisation bode well for potential growth, amid Germany's infrastructure decay. Social policies that focus on strengthening domestic demand, reducing income inequalities and ease restrictions on labour immigration from outside the EU are welcome in light of a shrinking working age population. Time will tell whether the coalition can live up to its ambitious goal. Bottlenecks in the construction sector and public administration could still delay infrastructure investments, as could resurfacing disagreements on financing especially been the FDP-led finance ministry and Greens-led economy and climate ministry. Unforeseen events will also continue to test the parties' resolve to overcome divisions and stick to their reform agenda, be it from a fourth Covid-19 wave, a fresh EU-migrant crisis or public opposition to rising costs for consumers from the green transition.

Constitutional 'debt brake' limits spending



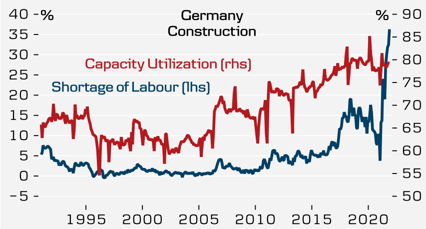
Source: BMF, BMWi, Bundesbank, Danske Bank

Germany's work force is shrinking



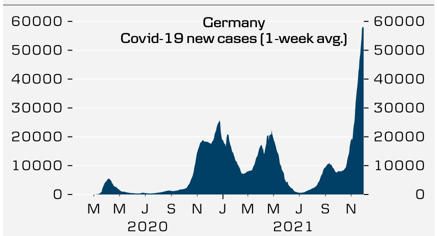
Source: OECD, Macrobond Financial, Danske Bank

Construction bottlenecks could delay infrastructure investments



Source: Ifo, EU Commission, Macrobond Financial, Danske Bank

Government is battling a fourth Covid-19 wave



Source: WHO, Macrobond Financial, Danske Bank

Policy goals of Germany's new traffic-light coalition

Cllimate policy	• Meeting the Paris climate targets is 'highest priority' • Exit from coal achieved 'ideally' by 2030 (from 2038 previously) • Minimum EU-ETS CO_2 price of €60/tonne • Renewables to make up 80% of electricity mix by 2030 (up from current 65 target) • 2% of the surface area earmarked for wind energy and solar panels to be stalled on most roofs • Planning procedures for renewables projects to be speeded up, red tape removed • At least 15mio electric cars on German roads by 2030 • Develop an industrial strategy linked to the European Green Deal • Avoid carbon leakage through EU-wide carbon border adjustment mechanism (CBAM) and making importers pay through 'Carbon Contracts for Difference' • Create an 'international climate club with a common minimum CO_2 price and a common CO_2 border adjustment' • New ministry for economy and climate protection • Minimum quotas for climate-friendly products in public procurement
Fiscal policy	• Constitutional debt brake (currently suspended) to be reinstated in 2023 (but not the 'Schwarze Null' balanced budget policy) • Debt relief for highly indebted municipalities • State-owned KfW bank to promote investment in green and digital transformation • Super depreciation allowance for green and digital investments in 2022 and 2023 • Giving state-owned companies such as Deutsche Bahn and and Bundesanstalt für Immobilienaufgaben more options to mobilise investment
Social policy	• Increase in the minimum wage from EUR 9.60/h to EUR 12/h • Stable public pensions at 48% of average salaries and no increase in retirement age • 'Basic income' for children and citizen income (Bürgergeld) to replace Hartz IV/Grundsicherung • Abolition of the renewable energy levy on electricity • Refugees will be allowed to bring their relatives to Germany • Housing: target to build 400,000 flats a year, 100,000 of them subsidised by the state; tougher rent controls, particularly in big cities with high demand; rent increases capped at 11% over 3 years (previously 15 per cent); creation of a ministry for construction • Lowering voting age from 18 to 16 years
Foreign policy	• China: Multiple-track approach - co-operate wherever possible, insist on a level playing field and develop a German strategy for China that is aligned with EU's own policy towards China, as well as in co-ordination with the US and other like-minded partners • Russia: relations are 'deep and multi-faceted', desire to co-operate on climate, health and hydrogen, but has to be counterweighed against the interests of European neighbours, especially in central and eastern Europe. No explicit critical references to North Stream 2. • Commitment to NATO and 2% of GDP defence spending goal
EU policy	• Complete EU banking union, including a European reinsurance system for national deposit guarantee schemes 'where contributions are strictly differentiated based on risk', but 'a full communitarisation of the deposit guarantee systems in Europe is not the goal' • NGEU is limited in time and size; recovery plans only approved for countries where 'preconditions such as an independent judiciary are met' • EU fiscal rules reform: make rules simpler and more transparent, but also strengthen implementation • Greens will nominate the next German EU commissioner • Strengthen EU parliament and qualified majority voting in EU Council • Use conference on the future of Europe for reforms with the goal of establishing a federal European state

Source: Coalition agreement of SPD, Greens and FDP

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The author of this research report is Aila Mihr, Senior Analyst.

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