09 September 2021

German Politics Monitor

The tables are turning left

- **German election is shaping up to be a close call, with several 3-way coalitions in reach of a majority.**
- **We see an equally likely probability for a 'Jamaica' coalition (40%) led by the CDU/CSU and a 'traffic light' coalition (40%) led by the SPD. A 'red-red-green' coalition (20%) leaves the biggest disruption potential.**
- **Difficult and lengthy coalition negotiations loom after the election and we do not expect a new German government to be in place before the end of the year.**
- **Only a major election surprise has the potential to trigger significant market moves in our view.**

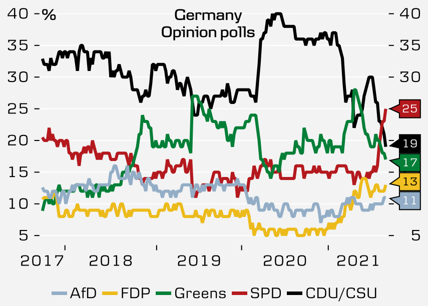
A tight race has opened up

With less than four weeks to go until the 26 September, the German election campaign is entering its hot phase. As a consequences of increased political fragmentation, Germany is likely headed for its first three party coalition since the 1950s. In *Research Germany: End of the "era Merkel" leaves German politics in unchartered territory*, 27 April, we discussed the different coalition possibilities and policies in detail (for an updated overview of the different party programmes see appendix). Lately, the steady rise in popularity of the SPD party has gained markets' attention, opening up the possibility of current Finance Minster Olaf Scholz taking over the chancellorship under either a centrist 'traffic-light' or leftish 'Red-red-green' coalition that could loosen the fiscal purse strings. A first debate between the three chancellor candidates also has bolstered Scholz' position as the favourite, while polling for the CDU/CSU has slumped below 20%, the lowest support since 1949 according to Forsa Institute.

The election is shaping up to be a close call, with several 3-way coalitions in reach of a majority (see appendix). Reflecting the tight election arithmetic we see an equally likely probability for a 'Jamaica' coalition (40%) led by the CDU/CSU and a 'traffic light' coalition (40%) led by the SPD. In or view, both centrist coalitions should not 'rock the boat' in terms of policies as left-wing or conservative tendencies will likely be moderated either by the Greens or the Liberal FDP. We would expect both coalitions to pursue a pro-European and pro-investment agenda with the potential for a more relaxed fiscal stance down the line that could boost Germany's long-term growth prospects.

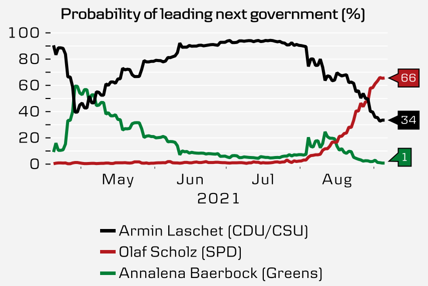
Polls have been relatively accurate in the past to predict German election outcomes. However, an added element of uncertainty this time stems from the increased share of mail voting. In 2017 nearly one third of voters voted via mail, this time it is expected that the share will rise to 40-50%. Voters already started to receive their ballots from mid-August – that has had implications on both campaigning as well as polling, as a higher share of the current polling might reflect already 'cast' votes. Furthermore, it could limit the impact of the two remaining chancellor candidate debates (on 12 and 19 September) on the election dynamics.

German election is shaping up to be a tight race



Source: Forsa, Macrobond Financial, Danske Bank

SPD's Olaf Scholz seen as frontrunner to take over the chancellery



Source: INWT Statistics

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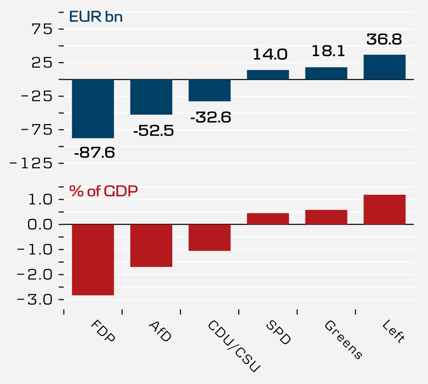
In sum, difficult and lengthy coalition negotiations will likely ensue after the election and we would be surprised to see a new German government in place before the end of the year (after the 2017 election it took 172 days). While both a 'Jamaica' or 'traffic light' coalition would not lead to dramatic policy changes in our view, markets will keep a close eye in the remaining weeks on the chances of a left-wing government taking power, as this constitutes the biggest disruption potential in our view.

Fiscal expansion: easier said than done

From history, European political events have usually affected markets either in case of a risk of EU exit or a significant impact on fiscal policies. We argue that the euro-exit risk from the German election is close to non-existent. All parties except AfD are pro-European and without a two-thirds majority vote in both Bundestag and Bundesrat, an EU-exit cannot be achieved.

The risk of significant change in fiscal attitudes only exists in case of left-wing 'red-red-green' coalition in our view (20% probability). Such a coalition would probably try to enact a sizable infrastructure/climate investment plan, combined with increases in the minimum wage, higher social benefits and tax cuts for low-income earners. That said, many of the spending measures would probably be financed via tax hikes on higher incomes and wealth, limiting the additional borrowing needs. A *study* by the German ZEW Institute on the fiscal implications of the different party programmes finds a positive budgetary impact from the envisioned measures by the Left (EUR 36.8bn, 1.2% of GDP), the Greens (EUR 18.1bn, 0.6% of GDP) and the SPD (EUR 14.0bn, 0.5% of GDP). The planned tax cuts from FDP, AfD and CDU/CSU on the other hand would worsen fiscal balances according to ZEW (see chart).

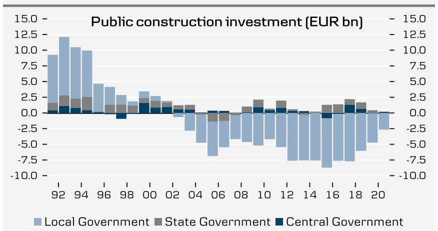
Fiscal effects of party programme measures



Source: ZEW

Another important hurdle to a sizable fiscal expansion stems from the constitutional 'debt brake' that limits the structural deficit to 0.35% of GDP (EUR 10-15bn in 'normal' economic times). This leaves little wiggle room for big unfunded tax cuts or spending measures. To overcome this difficulty, the Green party has advocated to supplement the 'debt brake' with an investment rule based on the loss of infrastructure value, but such a constitutional change would require a broad consensus in parliament (two-thirds majority) that seems difficult to achieve without the CDU/CSU on board. If the required support for 'debt brake' reform is lacking, the Greens have also mulled organising the investments via KfW or creating a federal investment fund that raises debt and is backed with equity capital from the government (see *FT story*). Our expectation would be that a 'red-red-green' coalition would try and frontload its fiscal plans as much as possible in order to still benefit from the pandemic 'escape clause' of the debt brake in 2022.

The root of Germany's infrastructure decay lies at local government level



Source: Destatis, Macrobond Financial, Danske Bank

However, infrastructure projects often take years to negotiate and implement. Labour shortages and planning approval bottlenecks add to the list of impediments, especially at the local government level where most construction investment is realised. Hence, agreeing on the financing is only one part of the puzzle. Implementing infrastructure investments on the ground is quite another. The SPD's plan for debt relief for highly indebted municipalities and digitalisation efforts to reduce investment barriers stemming from an opaque public administration could prove crucial in that respect to increase fiscal multiplier effects.

Market reaction only upon major election surprise

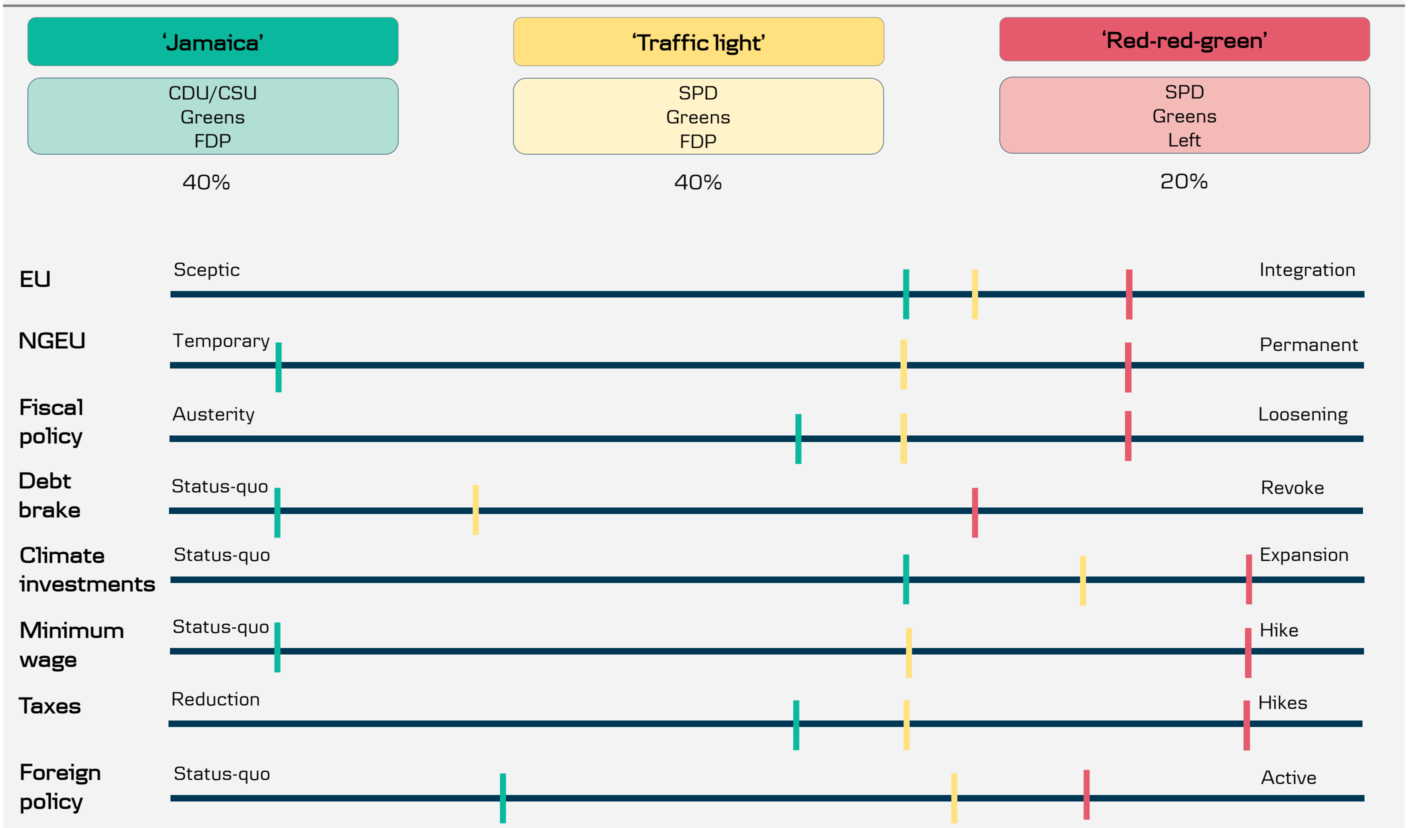
While a 'Jamaica' or 'Black-green' coalition was probably the consensus view in the market during the spring and earlier summer, the resurgence of the SPD has likely evened out market expectations between the different coalition possibilities. That means, **in our view only a major election surprise has the potential to trigger significant market moves.** Such a surprise could for example be a significant Green spending plan combined with a proposal of relaxing EU fiscal rules (Maastricht criteria), as well as a strong push for more fiscal integration/joint EU-funding (i.e. by making NGEU a permanent instrument and expanding its size).

In this case, we would expect the **Bund ASW-spread to tighten**, as the market would expect higher German budget deficits (more issuance of German government bonds) as well as more joint EU-funding. Gradual "tapering" from the ECB and the seasonal tightening in November/December would also speak in favour of a tighter Bund ASW-spread, which currently stands at 37.6 bp.

In FX markets, there is room for such a potential surprise to trigger a **rally in EUR/USD**, especially now where market participants seem to have shifted their attention towards the dollar. If so, focus would be on the degree of EU collaboration for increased spending (aka 'fiscal regime shift') as well as the actual details of the Green spending plans.

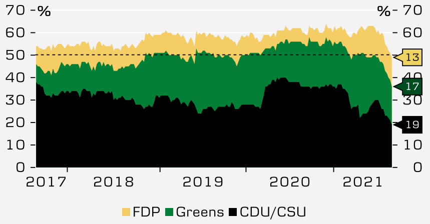
An election surprise could also impact the inflation market. If increased Green spending is perceived as inflationary, we see a case for **higher break-even inflation** (i.e. buying 10Y linkers versus nominal).

German coalition possibilities and policies



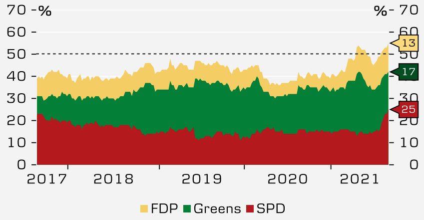
Source: Danske Bank

'Jamaica' coalition



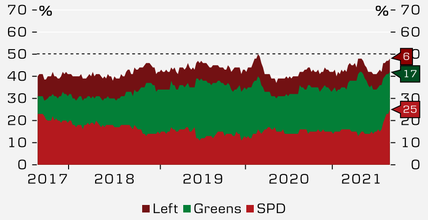
Source: Forsa, Macrobond Financial, Danske Bank

'Traffic light' coalition



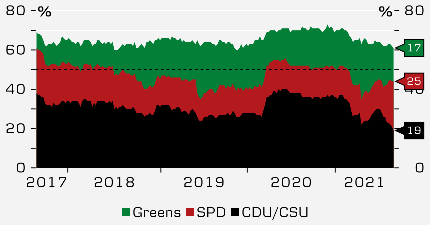
Source: Forsa, Macrobond Financial, Danske Bank

'Red-red-green' coalition



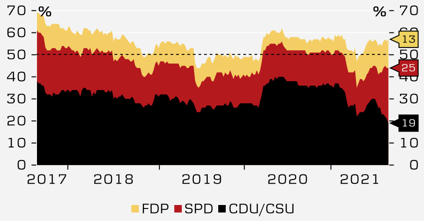
Source: Forsa, Macrobond Financial, Danske Bank

'Kenya' coalition



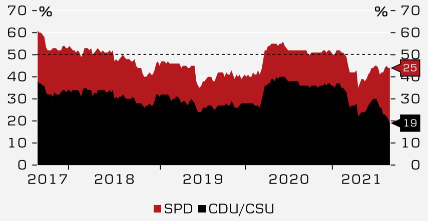
Source: Forsa, Macrobond Financial, Danske Bank

'Germany' coalition



Source: Forsa, Macrobond Financial, Danske Bank

'Grand coalition'



Source: Forsa, Macrobond Financial, Danske Bank

Overview of party programmes

	CDU/CSU	SPD	Greens	FDP	The Left	AfD
Economic policy	• Reduce bureaucracy • Climate protection through innovation and new technologies • Support German Mittelstand and car industry	• Investments of €50bn/year (infrastructure, digitalisation, climate) • Long-term industrial strategy in line with EU Green New Deal • National minimum wage of €12/hour • 'Greening' of capital markets (more green bond issuance)	• Investments of €50bn/year (infrastructure, digitalisation, climate) • CO_2 price raised to 60€/tonne in 2023 • Exit from coal-fired power by 2030 • National minimum wage of €12/hour • 'Greening' of capital markets	• Support German Mittelstand • Reduce bureaucracy and role of the state after pandemic • Improve environment for private investments • Spend 1% of VAT revenues on education • Create ministry for digital transformation	• Minimum wage of EUR13/hour and 30h/4-day work week • Minimum pension/basic income of €1200 and lowering retirement age to 65 • More public investments (€120 bn per year) • Strengthen union bargaining • Rent cap and more social housing	• Stricter immigration and refugee policy • More protectionism • Support German Mittelstand and car industry • Investments in technology and education through 'Blue Deal' • Reduce bureaucracy
Fiscal policy	• No tax increases • Corporate tax of 25% • Return to balanced budget and debt brake	• Lower taxes for low and middle income earners, higher taxes on high income earners and wealth • No balanced budget policy (but conform with debt brake) • Debt relief for highly indebted municipalities • Financial transaction tax, EU-wide digital tax and carbon border adjustment	• Lower taxes for low and middle income earners, higher taxes on high income earners and wealth • Reform debt brake to allow for investments • European-wide corporate tax of 25%	• Corporate tax of 25% • Reduce income taxes • Return to EU budget rules and debt brake	• Lower taxes for low and middle income earners, higher taxes on high income earners and wealth • Introduce a digital tax • Eliminate debt brake	• Fiscal conservatism • End CO_2 price

Source: Party programmes, Danske Bank

Overview of party programmes (continued)

	CDU/CSU	SPD	Greens	FDP	The Left	AfD
Europe	• Pro-EU stance • Maintain close Franco-German ties • Support EU Green Deal • Return to EU fiscal rules • NGEU is temporary, oppose debt mutualisation • Complete banking union after risk reduction • ECB independence	• Pro EU integration (make NGEU permanent) • Transform ESM into European Monetary Fund • EU minimum wage • Complete banking union	• Pro-EU stance • Bigger EU budget and new EU own resources (digital and plastics tax) • Strengthen NGEU and make it permanent • Transform ESM into European Monetary Fund	• Pro-EU stance, strengthen strategic autonomy and defence • Extend EU-ETS to all transport sectors • EU-wide competition rules • NGEU is temporary	• Anti-austerity stance • European investment plan • Common EU debt instruments • Make ECB democratically accountable and allow monetary financing	• EU/euro exit • No common EU debt and taxes • End ECB's low interest policy and Target2 balances • Opposes EU Green Deal
Foreign policy	• Pro multilateralism and NATO • Strengthen ties with US, dialogue with Russia, Turkey and China • Maintain good ties with Poland • Pro FTAs • EU seat in UN Security Council • Strengthen EU defence cooperation	• Establish EU foreign minister and strengthen defence union • Pro multilateralism and NATO • Cooperation and dialogue with US, Russia and China	• Higher contributions to UN and WHO • Gender equality at multilateral negotiations • Closer cooperation of EU foreign and defence policy • Critical stance towards Russia, Turkey and China • Object Nord Stream 2 pipeline	• Reform WTO and strengthen global trade • Multilateralism • Pro-NATO • Critical stance towards Russia, resume dialog with China • Transatlantic FTA • Reform UN	• Anti-military stance, critical of NATO • Against EU defence union • Cut defence spending by 10% • Pro-Russian stance • Against FTAs	• Stronger ties with Russia, China and UK • More defence spending • Against FTAs and Paris climate agreement

Source: Party programmes, Danske Bank

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This research report has been prepared by Danske Bank A/S ('Danske Bank'). The authors of this research report are Aila Mihr, Senior Analyst, Jens Peter Sørensen, Chief Analyst, and Lars Sparresø Lykke Merklin, Senior Analyst.

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Report completed: 8 September 2021, 16:42 CET

Report first disseminated: 9 September 2021, 06:00 CET