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German elections: The post-Merkel era

A guide to German elections and coalition negotiations

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Key points

- Germany will vote on 26 September to elect representatives to the Bundestag – the federal parliament
- Pre-election polls suggest no single party will achieve an outright majority and that a three-party coalition is likely to be necessary
- The current polls show the SPD, led by Finance Minister Olaf Scholz, leading at 25%, ahead of the CDU/CSU (22%), the Greens (15%), the centre-right and liberal FDP at 12%, and the Left party (6.5%)
- We currently consider a 'traffic light' coalition, with the SPD, Greens and FDP as kingmaker, as the most likely outcome, albeit that such a coalition would struggle to form a coherent economic and social agenda
- There are still uncertainties around margin polls, undecided and tactical votes so other coalitions have been explored. The Left coalition, swapping the FDP for the Left party, would be a breakthrough scenario
- The race to the Chancellery is at least as important as coalitions. We believe a Scholz Chancellery would adopt a more proactive stance at the European Union level

The end of an era

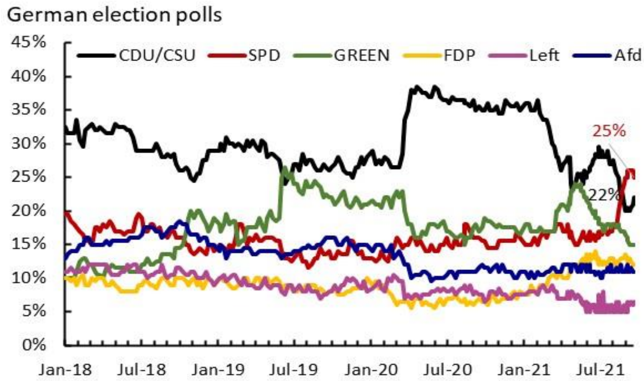
Germany goes to the polls on 26 September to elect representatives to the Bundestag – the federal parliament (see annex for details of the electoral process). This election represents a historic moment as the current Chancellor Angela Merkel is stepping down after 16 years in power. The election thus marks a significant political change that will have domestic ramifications. However, it can also be expected to have an impact at a European Union (EU) level as several issues, such as tackling climate change and the future of fiscal rules, are now top priorities across the broader region.

Pre-election polls suggest that no single party will achieve an outright majority in these elections. Indeed, current polling suggests that a three-party coalition is likely to be necessary to achieve an overall majority in the Bundestag. So once the election results are known, the different parties will begin negotiations to form a governing coalition (i.e. more than 50% of the Bundestag seats to avoid a persistent blocking situation). Such negotiations can last weeks or months – as in 2017, when the Christian Democratic Union/Christian Social Union (CDU/CSU) finally formed a coalition with the Social Democratic Party (SPD) after nearly six months. With several parties likely to have the ability to form a coalition, negotiations this time could be complex and lengthy.

Polls are our only compass

The current polls show the SPD, led by current Finance Minister Olaf Scholz, leading at 25%, ahead of the CDU/CSU (22%), the Greens (15%), the centre-right and liberal Free Democratic Party (FDP) at 12%, the extreme-right Alternative for Deutschland (AfD) at 11% and the Left party (6.5%). The German political landscape appears more fragmented than ever and no party currently polls more than 25% of the votes – whereas historically, the two main parties used to get at least 70% of the votes. This echoes broader trends across European countries where traditional parties have been strongly challenged in recent years.

Exhibit 1: The SPD is still ahead of the CDU/CSU



Source: wahlrecht.de, INSA, YouGov and AXA IM Research, 20/09/2021

Exhibit 1 shows how the SPD has enjoyed good momentum over the summer and now looks set be the main partner in any coalition and likely to secure the Chancellery. By contrast, the CDU/CSU has declined substantially following strong disagreements within the party, partly explained by a turbulent succession battle after Merkel, but also from blunders from the CDU/CSU candidate, Armin Laschet – for example when he was caught laughing at a joke during a ceremony to honour the victims of this summer's floods. However, the CDU/CSU have recently stabilised in the polls and the gap with the SPD has tightened to three percentage points. The Greens continue to fall (down three points since mid-August), losing some of their influence as all candidates – except the AfD – now include a strong climate dimension in their programmes. The FDP is stable around 12% to 13% of the vote and the Left Party continues to fluctuate between 5% and 7%.

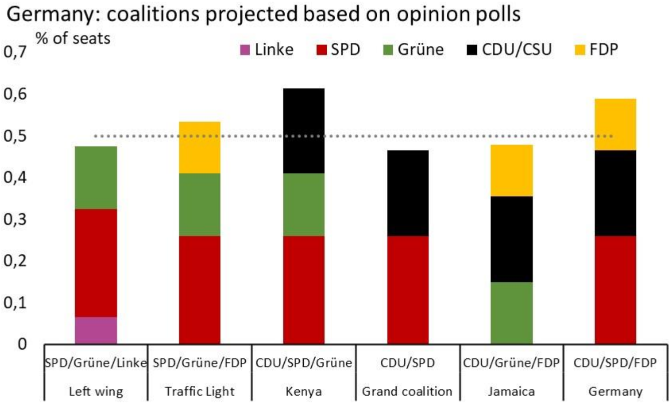
Recent shifts in the polls should also be viewed as tactical as voters now begin to consider strategies for feasible coalitions. Thus, some Green votes have probably switched to the SPD to avoid a strong split (their manifestos are now similar) – and that could benefit the CDU/CSU. Another uncertainty comes from undecided voters, who in this complex election constitute an understandably high proportion of 40%. Finally, usual polling margins errors, estimated around plus or minus two percentage points always leave some uncertainty about the outcome.

Given the significant level of uncertainty, we consider different scenarios which could emerge.

The game of coalitions

Based on current polls, the SPD should secure the most votes, followed by the CDU/CSU. The Greens are therefore likely to be the principal coalition partner of the SPD, as already pledged by SPD leader Scholz. But this alliance would constitute only 40% of votes in the polls. It would still require a "junior" partner to consolidate a majority in the Bundestag (Exhibit 2).

Exhibit 2: 'Traffic light' coalition as central scenario



Source: wahlrecht.de, INSA, YouGov and AXA IM Research, 20/09/2021

We currently consider a 'traffic light' coalition, with the SPD, Greens and FDP as kingmaker, as the most likely outcome, albeit that such a coalition would struggle to form a coherent economic and social agenda (see details in Exhibit 3). Such a coalition would likely include:

– Difficulties over an agreement on tax policies. Where the FDP excludes any tax increases, the SPD and the Greens suggest a tax reduction for low-middle income, a reintroduction of a wealth tax, an increase in inheritance tax and the introduction of a tax on financial transactions. The FDP also proposes to remove the top tax rate and cap the tax burden on corporate profits at 25%.

– More broadly, the SPD and Greens have pledged to loosen the approach on balancing the budget to significantly increase public investment. The Greens propose a 10-year investment programme worth €50bn (1.7% of GDP) per year while the SPD has insisted on the improvements of public transport and rail by 2030. The FDP unveiled an ambitious €600bn plan in the form of tax incentives focused on modern technology and internet access. The Greens suggest modifying the debt brake rule to exclude public investment. This seems unlikely as even the SPD has not made any explicit call to change it[1]. The

[1] The debt brake rule is a constitutional law stating that the general government fiscal deficit should not exceed 0.35% of GDP. It was designed to ensure that gross public debt would be brought back below 60% of GDP. It needs a two-thirds majority at both the Bundestag and Bundesrat upper house to modify it.

FDP has also rejected such an option and is already calling to re-instate the debt brake rule as soon as possible (2023).

- Both the SPD and Greens propose a significant increase in the minimum wage to €12 per hour from €9.50 and to increase social benefits. This is not part of the FDP's programme which focuses more on restricting unemployment benefits, promoting more flexible vocational training and more flexible working hours. No parties intend to modify the current pension scheme. Retirement age is currently 65 years but will gradually rise to reach 67 years in 2030.

- At an EU level, the SPD wants to reform the Stability and Growth Pact (SGP), reiterate the Next Generation EU (NGEU) experience and promote a "genuine fiscal, economic and social European Union". The Greens' programme is largely reconcilable, but it goes further, wishing for a Federal European Republic, turning NGEU into a permanent instrument to finance climate investments while strengthening EU taxes on carbon, plastics and big technology firms. In addition, it wants to complete the banking union with a common deposit insurance scheme and turn the European Stability Mechanism (ESM) into a European Monetary Fund, which provides credit lines without conditions. Lastly, the Greens would seek a change to the European Central Bank's mandate to include employment and social welfare. The FDP rejects all these initiatives, from EU taxes to permanent NGEU and further EU integration, that could be done at the expense of Germany's sovereignty and a reduced benefit from the better management of the public finances.

- On climate change, all three parties are committed to achieving carbon neutrality by at least 2050, but actual positions diverge here too. The SPD wants to achieve carbon neutrality for electricity production by 2040 and more broadly by 2045, focusing on the expansion of electricity grids, railway or hydrogen lines and charging stations. The Greens went further with ambitious proposals such as emission-free cars by 2030, a mandatory sustainability assessment for all investments, CO_2 pricing raised to €60 per ton in two years and deploying solar energy at very large scale. The FDP rejects any driving ban and prefers to focus on improving local public transport and trusts the Emission Trading System (ETS) as the best tool to cap CO_2 emissions[2].The FDP also strongly relies on developing new technologies as a mean to tackle climate change.

- Finally, these parties do not have a common interpretation of German foreign affairs. No parties want to retire from the North Atlantic Treaty Organization (NATO), but the Greens want to overhaul it while the SPD and FDP want to reinforce a European Army. They are also divided over Russia and China. The SPD is ready to have a constructive dialogue with Russia if it conforms to the Minsk agreement over conflict with Ukraine. The Greens are pushing for further sanctions against Russia and are strongly opposed to the Nord Stream 2 gas pipeline. Greens are also joined by the FDP in seeking improvements in human rights. Statements on China are more elusive, condemning human rights violations, but supporting dialogue on other issues.

To summarise, there are strong disagreements, but also some overlaps. Despite "completely different perspectives, completely different policy content", Christian Lindner, the party chief of the FDP, opened the door for such a coalition as long as Scholz would be able to "make an attractive offer". After eight years out of office, the FDP are keen to return to power. In this regards, fiscal and tax policies would probably be revised. But compromises could be found, especially on fiscal rules and the exclusion of public investment. The Greens have already proposed an off-balance sheet investment fund that would be able to issue debt and invest (following a similar model already used for German railways). Laschet, the CDU/CSU candidate, has also expressed his support in principle for a similar construction. The FDP would probably endorse such an initiative as it also has strong investment objectives but has not yet identified financing.

The Left party in ambush?

Though a plausible scenario, polls are uncertain, and the above compromises may not be made. Other coalitions must be considered. In this context, the Left coalition, swapping the FDP for the Left party, would be a breakthrough scenario.

Politically, this coalition would share common objectives such as raising minimum wages, improving social benefits, income redistribution and affordable housing. Moreover, on European issues, the Left party's programme mirrors Green pledges. Such a government would probably break with the German tradition of fiscal discipline with significant increase in public expenditures likely, partially compensated by higher taxes on top-rate income, inheritance and corporate profits. Higher revenue for low-middle income would probably stimulate the aggregated demand as they have a higher propensity to consume, although this can leak through spending on imports. However, the impact on competitiveness and long-term potential growth is more uncertain.

However, most fundamentally, there is a strong disagreement on German foreign policy. The Left party wants to dissolve NATO and the European Defence Agency and retire from current military intervention. On Russia, though opposing its invasion of Ukraine, the party calls for an end to

[2] Le Damany, H., "Fit for 55: carbon pricing upheaval", AXA IM Macro Research, 27 July 2021

sanctions. Despite some red lines raised by both the SPD and Greens on foreign policies, neither have excluded a coalition with the Left party. We see several reasons for this. The SPD and Green electoral bases are probably more left-wing than their party leaders. Then, a Left party coalition alternative is valuable in negotiations with other parties, especially in the attempt to form a 'traffic light' coalition with the FDP. Moreover, as a junior partner in the coalition, the Left might be persuaded to shelve its more contentious foreign policy goals, in favour of supporting a more consistent domestic agenda. That said, the Left party is not guaranteed to achieve the minimum 5% vote (or at least three constituencies) required to take up Bundestag seats, currently polling at 6.5%.

Don't write the CDU/CSU off just yet

The CDU/CSU may still have a chance to remain in power and retain the Chancellery if they could form a coalition with the FDP and Greens in a 'Jamaica' coalition. This option failed in 2017 as the FDP walked away. This time the FDP would have more incentive to align with the CDU/CSU as their policies are likely to be more aligned than with SPD and Greens. However, the Greens would likely prefer a coalition with the SPD. With uncertainty in both poll margins and the number of undecideds, this outcome cannot be excluded. This coalition would be tilted to the centre-right, meaning status quo on fiscal and taxation policies with more of a trade-off on public investment likely. However, it might appear an odd outcome if this were formed despite the SPD attracting the most votes.

Otherwise, only a 'Kenya' coalition (SPD, Greens, CDU/CSU) or a 'Grand' coalition (SPD, CDU/CSU) – assuming some divergence from current polling – would see the CDU/CSU in a governing coalition. We remain sceptical that such coalitions could emerge as we do not see the CDU/CSU accepting being a 'junior' partner to the SPD. After three Grand coalitions under the four terms of Angela Merkel, these two parties are likely to be reluctant to work together once again (in 2017, the SPD initially refused to enter in a Grand coalition), not least as the SPD has until recently seen a significant reduction in its voting base under these coalitions.

Beyond coalitions, there is a bandmaster

The race to the Chancellery is at least as important as coalitions. Chancellor Merkel's era was a testimony to the impact that the Chancellor has on the German political agenda, both domestically and at an EU level. In many ways Merkel avoided being seen as pushing a particular EU agenda or for further integration. However, Merkel was a key implementer of several material and historic decisions, which most recently have included the adoption of the NGEU during the pandemic. As it stands, the SPD's Scholz is well placed to become the next Chancellor, running with approximately 30% to 35% of the votes while Laschet (CDU/CSU) and Annalena Baerbock (Greens) stand at 15%.

We believe a Scholz Chancellery would adopt a more proactive stance at the EU level. Politically, he seems to be close with French President Emmanuel Macron and Italy's Prime Minister Mario Draghi, which could trigger a more positive environment for further EU integration, benefitting peripheral countries. But uncertainties on Draghi's mandate and around French elections would postpone any engagement in the short run.

Uncertainties on results but less on policy stance

The above review of different political scenarios highlights a fragmented political landscape and significant uncertainty surrounding possible coalition outcomes, particularly as polling error margins, undecided and tactical voters complicate the outlook. Most of these uncertainties will disappear as exit polls – usually quite accurate – are published around 18:00 on Sunday, 26 September.

Then, the coalition negotiations will begin. As explained, we consider the complexity of the negotiations leading to a period of several weeks, if not months, to finalise. However, with the exception of a Left party coalition, we do not expect dramatic changes to German policies, neither domestically, nor at the European level. The range of coalitions considered in the main includes one junior party that would likely neutralise (or centralise) the direction of the larger parties. In the case of the big spenders' plans, particularly in our most probable 'traffic-light' coalition, these would likely be more or less offset by the strong commitment of junior coalition members opposed to tax increases and in favour of fiscal discipline.

Annex: The German election process

Germany uses a mixed member proportional representation system. It combines proportional representation with first past-the-post voting. The seats are distributed between the 16 states in proportion of eligible voters. Each elector has two votes – a constituency vote and a party list vote. The first vote fills half the seats while the second votes are used to respect proportionality for parties, first at the state level and then in the Bundestag. If a party wins fewer constituency seats in a state than its second votes would entitle it to, it receives additional seats. However, in contrast, if a party receives more seats than it would be entitled according to the second vote, the other parties receive compensation seats. Due to this specific rule, the Bundestag usually has more than 598 members (currently it has 709 seats). Importantly, a party must win three single-member constituencies via first votes or exceed a threshold of 5% of the second votes nationwide to qualify for seats.

Exhibit 3: Party manifestos

	Policies				
Party	Taxation	Fiscal/economic	EU	Climate change	Foreign affairs
SPD	Income tax reduced for low-middle income Reintroduction of wealth tax (1%), increase in inheritance tax Introduce a financial transaction tax	Balancing budget approach is loosened Increase public investment No explicit call to change the debt brake rule Significant increase in the minimum wage (€12 per hour) and in social benefits	Reform the Stability and Growth Pact (SGP) Common EU investment policy financed by joint debt	Carbon neutrality for electricity production by 2040 (2045 otherwise) Expansion of electricity grids, railway, hydrogen and charging stations	More independent EU versus the US Critical towards China for human rights abuse Constructive dialogue with Russia if it conforms to Minsk agreement
CDU	Income tax reduced for low-middle income Reject tax hike No wealth tax Capping the tax burden for corporate profits at 25% Faster depreciation of some investments (IT, green, new rental housing)	Quick return of the debt brake rule and to a balanced budget Public investment fund to finance infrastructures, energy and climate transition (€500bn over 10y) No further increase in pension age, generation fund, compulsory private pension fund for low wage	Reinstate the SGP Reject joint debt issuance, "NGEU is exceptional" Strengthening the European integration Harmonisation of corporate taxes	Carbon neutrality by 2045 Expanding ETS and hydrogen Hybrid cars but not ban on diesel More freight by rail and inland waterways	Proactive approach on NATO and United Nations institutions Close cooperation with China Continue to ask an end of the Ukraine conflict / supports Nord Stream 2 Supports an EU defence union
Greens	Increase top income tax up to 48% above €250,000 Wealth tax of 2% of assets above €2mn EU minimum tax base on corporate profit at 25% Accelerated depreciation for investments in digitalisation and climate protection	€50bn per year during 10 years Change the debt brake rule by excluding public investment Compensate industrials for the transition cost Increase the minimum wage and some social benefits.	Turn NGEU into a permanent instrument Complete the banking union with a common deposit insurance scheme Turn the ESM into a European Monetary Fund that provides credits without conditions	Carbon neutrality by 2040 Systematic environmental regulations No combustion cars after 2030 CO_2 pricing raised to €60/ton in two years, compensation for households, deploy solar panels at large scale	Overhaul of NATO Vocal about China human rights violations Asking further sanctions on Russia and wants to stop Nord Stream 2
FDP	Remove the top income tax rate to 42% (above €90,000) Capping the tax burden for corporate profits at 25% Tax increases red line	Re-instate the debt brake rule as soon as possible Sell unnecessary state shareholding	Reinstate the SGP Reject joint debt issuance, "NGEU is exceptional" Turn the ESM into a European Monetary Fund that provides credits with conditions	Develop new technologies to tackle climate change Cancel the levy on renewable energy Expand ETS No combustion engine bans	Strengthen multilateralism Common European foreign and security as well as a European army Nord Stream 2 suspension until Russia improves human rights Cooperation with China
Left Party	Massive increase for high income, up to 75% above €1mn revenue Wealth tax for assets above €2mn	Increase employment in public and social services Increase the minimum wage and social benefits	Replace the SGP with a pact for sustainable development	Phase out coal by 2030 and carbon neutrality by 2035 Stronger market regulations	Dissolving NATO and replace by collective security system focusing on disarmament (including Russia) Reject military missions abroad.

Sources : Barclays, Société Générale, party manifestos and AXA IM Macro Research, September 2021

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