German election preview: Aiming at a grand reset

Germany is poised to revamp its policies, and positive effects are expected to materialise, albeit with a lag

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Key points

- Germany heads to the polls on 23 February – the Christian Democratic Union is likely to return to the Chancellery
- However, beyond the usual error margin of polls, precise Bundestag seat projections are fraught with uncertainty given the electoral system. Finding a coalition partner, or partners, to form a stable majority is unlikely to be straightforward
- We expect lengthy government coalition discussions, which are likely to prove contentious, particularly regarding Germany's fiscal stance
- Time is of the essence to get the economy restarted given both the short and medium-term challenges it faces
- While we welcome a shift in Germany's economic stance towards a pro-growth agenda, we think marked positive effects are likely to come with a significant lag

A much-awaited restart

Germany holds snap elections on 23 February - nine months ahead of schedule, following the collapse of Chancellor Olaf Scholz's 'traffic light' coalition with the Greens and Free Democratic Party (FDP) in November 2024.

Germany has endured a reality of no economic growth for the past four years. Expansion expectations are low given the reduced potential growth estimates from official institutions. Furthermore, the economy is highly vulnerable to any upcoming trade tariff disruptions. Germany requires a strong government to quickly implement a new set of policies to revive its short- and medium-term economic prospects.

Current polling suggests Christian Democratic Union (CDU) leader Friedrich Merz will become the next Chancellor. In this paper we review the German electoral system, assessing the different routes Merz may be able to take to form the future government coalition. Besides needing a stable absolute majority in the Bundestag, he will need to achieve the 66% majority required in Parliament to reform the constitutionally enshrined debt brake rule, should he elect to do so. Finally, we look at political parties' proposals to restart growth.

Policy change appears to be on the horizon in Germany, but lengthy discussions ahead will come hand-in-hand with significant structural headwinds, making any decent economic rebound unlikely in the short term.

A complex electoral system

German members of the Bundestag are elected with a one-round voting system. Voters are effectively voting twice in one go as they elect their district representative (local) and a party for the federal election.

The district election uses a simple majority (the 'first past the post' system), while the federal vote allocates Parliamentary seats on a proportional basis. Notably, parties can only enter the Bundestag if they reach at least 5% of votes or win at least three direct votes of the 299 districts. This is particularly important for parties with a regional anchor such as The Left (Die Linke – East Germany), or the Christian Social Union (CSU) in Bavaria. Following 2023's electoral reform, candidates who win a seat via the district vote will only be granted a Parliamentary seat if the resulting seat distribution corresponds to the respective party's national relative vote share (i.e. no more overhang seats).

These rules make accurate projections of national polls into actual Bundestag seat allocations difficult, particularly this time around with three parties very close to the 5% threshold (Exhibit 1). Additionally, electoral reform has cut the number of seats for the upcoming election to 630 from the current 735.

Exhibit 1: Polls suggest Christian Democrats at the Chancellery

Germany election polls	Sep-17 Election		Sep-21 Election		nov-24		Latest polls 04 Feb
	Seats	%	Seats	%	Seats	%	%
SPD	153	20.5	206	25.7	207	28.2	17
CDU/CSU	246	32.9	197	24.1	196	26.7	30
Greens	67	8.9	118	14.7	117	16.0	13
FDP	80	10.7	92	11.4	91	12.4	4
AfD	94	12.6	83	10.4	77	10.5	22
Die Linke	69	9.2	39	4.9	28	3.8	5
BSW	-	-	0	0.0	10	1.4	6
Independent	-	-	1	-	7	1.0	-

Source: Politico polls of polls and AXA IM Macro Research, February 2025

Over the past year, the Christian Democrats (a CDU/CSU alliance) have maintained a large lead in voting intentions. Despite losing some momentum in the past few weeks (down three points), seemingly to Alternative for Germany (AfD), their seven-point lead all but ensures them a return to the Chancellery. But since the snap election was announced in November, AfD has secured second place, gaining some four points (taking it to 22%) which has pushed it well ahead of the Socialist Democratic Party (SPD), with 17%. Meanwhile, the Greens have also gained some momentum, polling a solid fourth at 13%.

Final Parliamentary seat allocation – key for coalition talks – will heavily depend on whether the left-wing populist Sahra Wagenknecht Alliance (BSW), The Left and/or Free Democratic Party (FDP) will enter the Bundestag.

Threshold majorities difficult

Germany has a well-established tradition of seeking compromise in forming governments (and in social partners' talks). This time should be no exception, and if anything is more complicated owing to two key interlinked issues: with which party, or parties, will the CDU/CSU strike an agreement to govern with a stable, absolute majority in the Bundestag? Could opposition parties join forces and constitute a 33% blocking minority – across both lower and upper house - to reform the constitutionally enshrined debt brake?

The outcome will of course depend on how close to the indicated polling the final result will be. Polls have been broadly steady over recent months, suggesting some confidence in the outcome. However, we have witnessed the sharp impact that social media has had, and will watch the AfD in particular, given the public backing from Elon Musk, chief executive of US car manufacturer Tesla, and the recent attacks in Bavaria and Magdeburg which likely underpinned their recent increased support. Also, scheduled debates throughout February involving Friedrich Merz (CDU), Olaf Scholz (SPD), Robert Habeck (Greens) and Alice Weidel (AfD) may alter the latest polling[1].

But beyond the ability of political parties to (dis)agree - and there's always the possibility of individual dissent - the outcome heavily depends on the final allocation of seats in the Bundestag. We illustrate the complications of this allocation with three simulations (Exhibit 2), based on the 5% threshold only (about 31 seats) though we are cognisant that parties can enter the Bundestag with a fewer number of seats.

Exhibit 2: Securing appropriate majority is not straightforward

Germany election polls	Latest polls - 04 Feb	Simulation A	Simulation B	Simulation C
	% of votes	% of seats in the Bundestag		
SPD	17	19.4	18.4	17.5
CDU/CSU	30	34.2	32.4	30.9
Greens	13	14.8	14.0	13.4
FDP	4	0.0	5.1	4.8
AfD	22	25.1	23.8	22.7
Die Linke	5	0.0	0.0	4.8
BSW	6	6.8	6.5	6.2
Independent	-	-	-	-

Source: Politico polls of polls and AXA IM Macro Research, February 2025

[1] (Debates occur 16, 17, 20 and 22 February)

In our first simulation, A, FDP and The Left fall short of the 5% threshold and would not enter Parliament. A CDU/CSU-SPD governing coalition would get a c.54% majority, while a CDU/CSU-Greens coalition may fall short of an absolute majority (49%). The non-mainstream AfD and BSW parties would total 32%, short of a blocking minority for amending the constitution.

In simulation B, we assume the FDP gets into the lower house. This would automatically reduce the representation of other parties, meaning the CDU/CSU-SPD coalition would get just 51%, and CDU/CSU-Greens would be below the absolute majority threshold (46%). AfD and BSW would get 30%, though may be able to strike an agreement with the fiscally very conservative FDP, preventing the government from passing a debt rule reform.

In simulation C, we assume The Left also enters Parliament, together with the FDP. Here a governing coalition would quite possibly require an agreement across three parties: CDU/CSU-SPD-Greens (the so-called Kenya coalition). Likewise, a four- party coalition could get over the 33% blocking minority preventing a revision of the constitutionally enshrined debt brake.

In each simulation our fundamental assumption is that a firewall against far-right parties holds, and that the CDU/CSU would not engage in any coalition discussions with these parties. We maintain this assumption; however, we note that despite rejecting any readiness to collaborate with AfD early in the campaign, CDU leader Merz has recently manoeuvred, with AfD support, an attempt to pass a law to curb immigration which generated a significant backlash.

In summary, consistent with Germany's proportional system, the more parties that enter the Bundestag, the more challenging the situation becomes in terms of achieving the required threshold majorities. Given the above – and the relative closeness of policies – we think a return to a grand coalition, with the CDU/CSU partnering with the SPD, seems the most likely outcome even allowing for the uncertainties.

Towards lengthy discussions

Depending on how close the election outcome mirrors one of our simulations, the government formation may take less (A), or more, time (B, C). It is worth remembering that in the past three elections, government formation talks took an average of 110 days. This time, we think an early resolution is unlikely for three reasons.

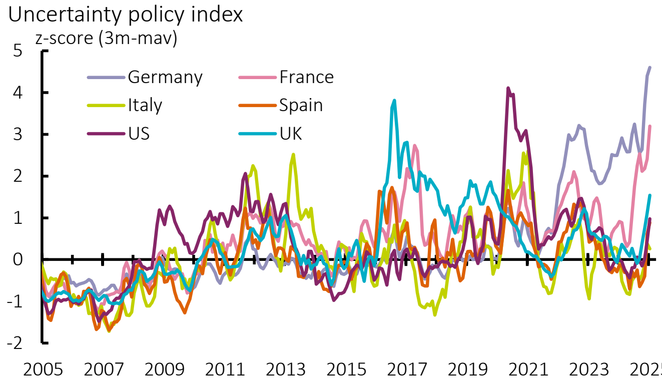
First, it is critical the future government can rely on a stable absolute majority to pass laws in the Bundestag – recent general election outcomes in several European Union (EU) member states have shown this is not easy. Second, like other northern countries, coalition agreements usually end up in a fully written document where concrete (spending) policies are explicitly spelled out – together with the financing strategy (largely missing in manifestos). This tends to create stronger coalitions but takes more time to achieve than more 'high level' agreements, where dissent and votes of no confidence can be used. Third, although not featuring prominently in party manifestos, there is a wide agreement among centrist policymakers (including Germany's central bank) and recently among the German population that the constitutionally enshrined debt brake should be amended. We therefore expect this subject to take centre stage in the governing coalition's early technical and political discussions (although it is not technically a requirement for a government formation).

As a result of lengthy political discussions in a bid to form a solid government policy stance, we do not anticipate a set of enacted bills to kick-start the economy before the end of spring, despite the economy facing large cyclical and structural challenges. We expect the most crucial changes to come in the 2026 draft budget discussion from September.

Germany's struggling economy

The Eurozone's largest economy has not grown since the final quarter of 2019. The latest business confidence measures show increasing divergence between the bloc as a whole and Germany. That may be due to the material increase in policy uncertainty generated by the triggering of snap elections and/or the election of President Donald Trump and his narrative on potentially hitting Europe with trade tariffs, which Germany would be particularly sensitive to. Policy uncertainty is rife – some measures show it is higher than the UK's peak during the Brexit vote (Exhibit 3). The European Commission has estimated that a one standard deviation rise in uncertainty could affect German GDP to the tune of 0.25 percentage points (ppt) after one year.[2]

Exhibit 3: German policy uncertainty through the roof



Source: Datastream and AXA IM Macro Research, February 2025

[2] The cost of uncertainty – new estimates, European Commission, November 2024

Furthermore, international institutions - the International Monetary Fund (IMF), European Commission and Bundesbank – have lowered their estimates of Germany's potential growth rate. Estimates range between 0.4%-0.7% for the next few years versus 1.4% between 2011 and 2019, mainly owing to the expected decline in its working age population and the projected ageing-related slowdown in total factor productivity growth.

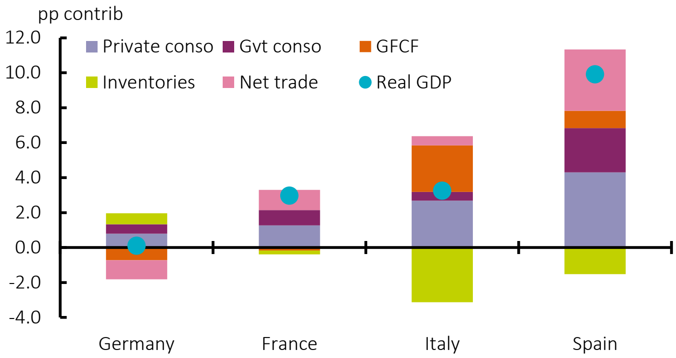
Cyclical and structural factors call for a swift implementation of policies to revive both short and medium-term growth. At odds with longstanding trends, we think the German economy should be rebalanced towards domestic demand. In the following section, we review the mainstream parties' policy proposals, although we note that these have remained elusive on reforming the debt brake rule. We thus conclude by looking at several options on this specific topic.

Parties' proposals for reviving growth

Exhibit 5 highlights Germany's muted economic performance since the Russia-Ukraine conflict, both in terms of overall growth and expenditure components. Compared with other large Eurozone countries, Germany is faring worse on every single subcomponent, unsurprisingly more remarkably on trade. A message echoed in the polls is that the economy is a key topic on voters' minds.

Exhibit 5: German economy needs a restart

Contributions to GDP growth since Q4 21



Source: Refinitiv and AXA IM Macro Research, February 2025

It therefore comes with little surprise to see a broad convergence of policy proposals underpinned by a pro-growth agenda as summarised in Exhibit 4.

We nonetheless highlight some key differences which will likely form some of the contentious points in striking a governing agreement.

- On the corporate side, CDU/CSU have put the emphasis on reducing the headline tax rate while the SPD and Greens have focused on tax rebates for investment

Exhibit 4: Key policy proposals from mainstream parties

Germany elections - Key policy proposals			
	CDU/CSU	SPD	Greens
Taxation	- Lower corporate tax to maximum 25% (from c.30%) and make depreciation rule more attractive - Lower social insurance contributions to 40% from currently 42% - Remove income tax for extra hours and pensioners income up to €2000 per month - Reduce VAT on hospitality food from 19% to 7% - Increase commuter allowances - Gradually increase the threshold before income tax is due and increase highest tax bracket from c.€67,000 per year to €80,000 per year, link income tax to inflation - No reactivation of the wealth tax, and higher allowances for inheritance tax, lower property tax - Abolish the solidarity surcharge	- Introduce "made in Germany" bonus for business investment (e.g. 10% tax rebate) - Lower taxes for 95% of taxpayers - Reduce the VAT on food from currently 7% to 5% - Keep the solidarity surcharge	- Introduce a 10% business investment (ex construction) tax rebate for five years - Tax incentives for child care - Increase the work-related costs that can be deducted from taxes without receipts to €1500 per year - Introduce tax rebates to help lower incomes - Up to 70% subsidy for carbon-neutral heating systems - Wealth, inheritance and real estate tax reform - Keep the solidarity surcharge
Labour market and social	- Social partners set minimum wage - Weekly instead of daily maximum working time - Legal support for work-from-home - Increase child benefits	- Raise minimum wage from €12.82 to €15 per hour - Abolish fixed-term contracts without justification	- Raise minimum wage from €12.82 to €15 per hour - Flexible pension that allows for work past retirement age

Source: Political parties' manifestos and AXA IM Macro Research, February 2025

- The CDU/CSU aim to abolish the solidarity surcharge[3] while the SPD and Greens have pledged to keep it
- All parties are looking to boost households' disposable income. CDU/CSU emphasises higher income tax cuts/raising tax-free allowances, increasing working participation. The Greens also support the latter (for the retired); they set the same recommendation as the SPD to increase the minimum wage by 17% to €15 per hour
- On the energy front, we note the CDU/CSU aims to reassess the possibility of re-entering nuclear power (and abolish the end-date for combustion engines) while the SPD and Greens propose to lower electricity tax and focus on renewables.

However, at its party convention on 3 February, the CDU communicated a 15-point immediate action plan effectively shelving its plan to reduce corporate tax, to reconsider nuclear power while focusing on working time, cutting energy prices (electricity tax), and strengthening the rollback of bureaucracy. While this may help with finding compromise with other parties, it also raises questions as to the CDU's openness to reform the debt brake.

One common characteristic across parties' manifestos is that policy measures' financing seems (very) partial, possibly owing to the fact that parties know they will have to compromise, including on raising the country's annual borrowing capacity. This is a thorny technical yet eminently political issue, which may explain why 'debt brake' only appears once in the CDU's 81-page programme – on page 75. We consider ways it can be reformed to allow for a more supportive fiscal policy given Germany's short- and longer-term challenges.

Adding to centrist mainstream policymakers (mainstream parties and international organisations such as the IMF and Bundesbank), public support for such reform has also sharply increased. Some 55% of Germans now support an overhaul of the strict borrowing limits, according to a January poll by Forsa on behalf of the German Council on Foreign Relations, compared with just 32% last July.

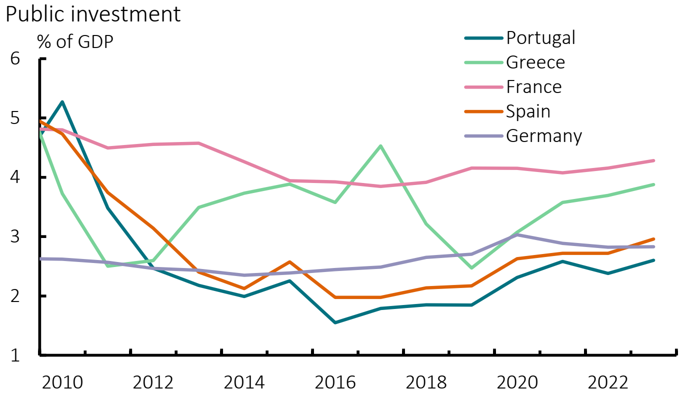
Towards more supportive fiscal policy

In 2009, then Chancellor Angela Merkel (CDU) and her Finance Minister, Peer Steinbrück (SPD) introduced a so-called debt brake rule (*Schuldenbremse*) in Germany's constitution, aiming at securing the state's financial capacity to act, particularly concerning intergenerational fairness.

In its strict form, the *Schuldenbremse* only allows for a federal deficit of 0.35% of GDP in cyclically adjusted terms and 0% at regional (Länder) level. In 2013, Germany reached a balanced budget and since then the *schwarze Null* (black zero, i.e. zero deficit) became a looser, political slogan from the original rule.

Generating an average primary surplus worth 2.2% of GDP between 2011 and 2019 meant that German fiscal policy tended to be (too) restrictive, not ideal when this is pro-cyclical (i.e. when the output gap is negative, suggesting slack in the economy). In turn, this has put Germany on a path of underinvestment since the global financial crisis (Exhibit 6). On the bright side, with the public debt-to GDP ratio at 62.9% of GDP in 2023 (well below its peers and the Eurozone average of 89.0%), Germany has ample space for targeted fiscal loosening to meet the country's short- and medium-term growth challenges.

Exhibit 6: Subdued public investment dynamics



Source: Refinitiv and AXA IM Macro Research, February 2025

(New) dependents

Recouping under-spending in the past decade implies there is little shortage of candidates for increased investment.

- The ministry of digitalisation and transportation estimates transport infrastructure investment needs are worth €200bn by 2030 (4.7% of GDP)
- One study estimated that yearly public investment would need to increase by at least 0.2% of GDP to meet Germany's climate-change mitigation targets[4]
- There is a clear necessity for Germany to secure reliable and less expensive sources of energy across industrial firms and for households. Having exited from nuclear plants in 2022, Germany aims to exit coal-fired production in 2038 and gas in 2045; massive renewable energy investment efforts are required to meet these targets
- The European Commission's 2024 Ageing Report estimates that Germany's public pension and health expenditures will increase by 0.6 and 0.3 percentage points (ppt) of GDP, respectively, over the next five years and by 0.9 and 0.7ppt by 2040

[3] A tax surcharge on income, capital gains and corporation tax to meet the costs of German reunification

[4] Brand and Römer (2022)

- An IMF study in July 2024 showed that to meet its NATO targets, Germany's defence spending will have to rise by 0.3ppts of GDP in the near term. Although the special fund for defence set up in 2021 will likely take the lion's share, it is due to expire in 2027. Meanwhile, President Trump has been floating the idea of much increased defence spending targets, as much as 5% of GDP.

Germany's fiscal stance: Options for reform

Broadly speaking, there are four non-mutually exclusive ways to reform Germany's fiscal stance. Final outcomes will likely depend on the ability to strike political and technical agreements, alongside a willingness to spend quickly. In any case, Germany will still have to comply with EU fiscal rules, implying an overall downward trajectory in its public debt-to-GDP ratio towards 60% – it was 62.9% in 2023.

One swift option could be to again use off-balance sheet funds such as the €100bn military fund (2021-2027), or the stabilisation fund during COVID-19 (€200bn). Germany has had dozens of such funds. In 2023, the ratio of spending off-balance sheet funds represented up to 36% of total federal budget spending. One key constraint though remains: these are not easily adjustable as evidenced by the Karlsruhe ruling in late 2023.

Another option is to invoke (again) the exemption from the constitutional rule, which can be done by a simple majority. Current debt brake exemptions are natural disaster/other extraordinary emergency situations beyond the control of the state. Though, we are not sure this would fly in case the constitutional court is seized. Alternatively, the wording of the exemption could be amended altogether, replaced by a looser definition, and the use of the exemption backed, for instance, by a vote by the German Council of Economic Experts[5].

Several types of more technical amendments could be brought to the existing debt brake rule, as some political parties have suggested. These could include better measurement of the cycle or a longer period of adjustment before coming back to the anchor perhaps under certain conditions – EU fiscal rules allow for seven years of deviation from its anchor. A (conditional) higher budget deficit ceiling could also be set. On the latter, the German Council of Economic Experts has for instance put forward that the cyclically adjusted deficit could reach 1% of GDP when public debt is below 60% of GDP and 0.5% when debt is between 60% and 90% of GDP.

Finally, last December, the Financial Times newspaper floated the idea that "EU countries are discussing a €500bn joint fund for common defence projects and arms procurement".[6] However, on 4 February, it was reported that "Brussels is open to increasing flexibility" of the EU's fiscal rules to spend more on defence, meaning that some of the additional spending could be taken up by the EU, either in intergovernmental bodies (e.g. the European Stability Mechanism providing loans), or via joint issuance – NextGenerationEU (NGEU) 2.0. Given NGEU funds still run until the end of 2026, and the current political vacuum in Europe, we think the former option is more likely in the short run. Though to be palatable for Germany, the financing cost would have to at least equate to the country's borrowing costs in financial markets, though again may face the challenges from Karlsruhe.

The road ahead

What the polls indicate and forecasting how they could turn into actual Bundestag seats, comes with a high level of uncertainty. However, we believe the CDU is likely to return to the Chancellery. But finding a coalition partner to form a stable majority in the Bundestag is unlikely to be a straightforward task.

Political party manifestos all point towards pro-growth measures, but compromise points are not obvious, and as such any agreement may take time – even more so given that easing Germany's fiscal stance is likely to prove contentious, both politically and technically.

Time is of the essence in terms of getting the economy firing again, and it faces both short and medium-term headwinds.

While we welcome the expectation of change to the German economic policy stance, which should help lower the uncertainty hurting growth, we think any positive effects are likely to come with a significant lag.

[5] An academic body, mandated with the task of providing an impartial expert view helping economic policy makers and the general public to make informed decisions

[6] Tamma, P., Foy, H., Varvitsioti, E. & Rathnone, J.P., "Europe races to set up €500bn defence fund", Financial Times, 5 December 20024

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