

Economics and Rates

Desk Strategy

European Macro Strategy

19 August 2021

Angela's Ashes

The Merkel succession and Markets

Germany's federal elections in September mark the biggest political event in the European calendar in 2021 (in an otherwise politically-calm year). Merkel's 16-year term will be over, and it is not yet clear who her successor will be. The two front-runners in the polls (Greens and the incumbent CDU/CSU) are losing ground to SPD, which makes the outcome of the elections increasingly uncertain, and a three-way coalition more likely. The composition of the alliance, rather than who takes the Chancellorship, may therefore matter more.

Markets will mostly be focussed on two important questions: i) what does the new government imply for European integration and ii) what does it imply for fiscal policy (both domestically and at the European level)?

For markets the scope for real surprise looks limited. (i) The Greens are likely to enter government as a substantial junior partner in most realistic scenarios; (ii) The AfD lacks momentum and is likely to remain marginal; and (iii) Germany has already shifted on fiscal policy, becoming more fiscally active at home and more accepting of fiscal 'innovation' in the Euro Area. **Most realistic coalitions will still be pro-EU and pro-fiscal policy, albeit to varying degrees.**

Market implications

On fiscal and European policy the key shifts have already taken place. For markets, although the outcome is increasingly uncertain, there are two key takeaways, which remain unchanged. Both tend to confirm the recent shift toward a relatively more pro-European and more agnostic fiscal stance.

i) Greens are likely to be in government, even if Baerbock is not Chancellor. As we outline below, nearly all feasible coalitions include the Greens in some way. The only route to a majority government without the Greens could potentially be a repeat of the incumbent (CDU/CSU-SPD) or a combination of CDU/CSU-SPD-FDP, both of which we attach a low probability to. The Green's influence on the fiscal policy agenda and on the European project should be taken positively by risk markets in particular.

ii) AfD is very unlikely to be in government. This is the real risk case for markets, given their strong right wing agenda and Eurosceptic rhetoric. AfD currently polls at a stable ~10%, and it is highly unlikely that any other party would form a coalition government that includes AfD.

Markets will look at 'instinct' as much as manifestos... that's probably right. Rather than the election itself, the risk event may be the more drawn-out 'getting to know' the new Chancellor and government. That said, markets will assume that coalitions led by the CDU or involving the FDP will focus on returning sooner to the debt brake and greater vigilance on European public finances. That is, these are more

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bund-positive/periphery-negative outcomes. SPD/Green might be the opposite. A CDU/Green government would be the market-neutral base case, we expect.

We summarise the potential outcomes with associated probabilities we attach to each, plus the likely stance on EU integration and fiscal policy in the table below. Keep reading for more detail on the party policies, and likely coalitions.

German elections at a glance - NWM Playbook							
Coalition	NWM probability	Parties	Current vote share	Fiscal stance (longer bar = more fiscally expansive)	European integration (longer bar = more pro-EU)	Impact on 10y bund yields	Impact on 10y BTP spreads
Black-Green	35%	CDU/CSU-Greens	44%			+1bp	-2bp
Jamaica	32.5%	CDU/CSU-Greens-FDP	56%			+1bp	-2bp
Traffic light	10%	Greens-SPD-FDP	50%			+2bp	-2bp
Grand coalition + Green	10%	CDU/CSU-SPD-Green	63%			+1.5bp	-2.5bp
Left alliance	5.7%	Greens-SPD-Linke	45%			+4bp	-6bp
Grand coalition + FDP	3.4%	CDU/CSU-SPD-FDP	56%			-3bp	+3bp
Grand coalition	3.4%	CDU/CSU-SPD	44%			-2bp	+2b

Changing of the guard

Whatever the outcome of the Federal Elections (26 Sep), it will mark the end of Angela Merkel's 16-year Chancellorship in Germany. The potential political shake-up comes at a crucial point in the economic recovery which has been heavily supported by very expansive fiscal policy. The future direction of fiscal policy (amongst other things) could be influenced by the outcome of this election; hence it should be viewed as a somewhat important juncture for European politics (in a year that has otherwise been very quiet on the political front in Europe).

Who is in the running? Meet the candidates and their policies

We expect markets to be most concerned about where candidates (and their parties) lie on their attitudes towards Europe and European integration, and fiscal policy (both domestically and at the European level).

The fiscal divide. Die Linke (the Left), SPD and the Greens are the most fiscally expansive, with ambitious plans for investment and proposing at least some softening of the debt brake. Die Linke is the most extreme in calling for the debt brake to be abolished, the Greens suggest it can be softened/re-designed, whilst SPD will seek to use the "constitutionally possible leeway" for borrowing. SPD leader Scholz has previously stated his ambition to return to the debt brake by 2023, but this was not in the party manifesto. FDP, CDU/CSU and the AfD all call for a return to the debt brake, with FDP and CDU/CSU explicitly stating a preference in their manifestos to return to balanced budgets as soon as possible, and a debt ratio of below 60%.

The divide on Europe. SPD and the Greens emphasise further integration, completing the banking and looking for progress on the fiscal side too. In its manifesto, the Greens explicitly call for a permanent EU-wide investment fund (similar to that of NGEU). FDP and CDU/CSU, although still pro-integration, reject the idea of a debt union – both parties also advocate a swift return to the Stability and Growth Pact (SGP) rules without reform, with CDU/CSU explicitly referencing the one-off nature of NGEU.

In the table below, we summarise key views of all parties on these issues (from left to right on the political spectrum).

Angela's Charlies: successors strike their poses to carry on the good fight						
Party	Lead candidate	Fiscal policy, taxes	Debt Brake	EU/ Euro	EU fiscal policy	Climate change
Die Linke	Janine Wissler and Dietmar Bartsch	Pro fiscal expansion. Wants to leave policies of austerity behind. Proposing a wealth tax, heavier inheritance tax, high corporate tax	Abolish the debt brake	Pro-integration, with some reforms (e.g. to European taxes)	Debt and deficit rules need to be adjusted - SGP needs to be reformed such that the EU can invest "without a handbrake". In favour of EU bonds	Climate neutral by 2035 at the latest
SPD	Olaf Scholz	Pro fiscal expansion in the near-term: plans to legislate €50bn/year to invest. Wants to make tax system more equal, bring back wealth tax, reform inheritance tax.	Wants to use the "constitutionally possible leeway" for borrowing.	Pro-integration: wants EU to evolve into a fiscal, economic and social union, with completion of the banking union	Believes in fiscal union at EU level: "A crisis-proof EU must be able to act in terms of fiscal policy"	Climate neutral by 2045 at the latest. Increase the reduction target for 2030 significantly (to 65%), which increases to 88% for 2040
Greens	Annalena Baerbock	Pro fiscal expansion: proposing investment of €50bn/year for next decade, and wants to create more tax equality	Re-design debt brake such that necessary investments can be made whilst ensuring sustainability of future interest burden	Pro-integration: believes in a "democratically strengthened" EU that has more capacity to act against today's challenges. Wants to complete banking union with EDIS	Wants to make an EU-wide sustainable investment fund a permanent feature	Raise reduction target for 2030 to 70%, and achieve 100% renewable energy by 2035, so that climate neutrality can be achieved in 20 years
FDP	Christian Lindner	Fiscally conservative: wants Germany's debt ratio to return to below 60% ASAP. Lower income tax rate to below 40%, reduce corporate tax rate to 25%	Return to the debt brake	In favour of reforming EU institutions, against a fiscal and banking union	Rejects a debt union and an EU tax. Wants a return to SGP rules (without reform).	Climate neutrality by 2050
CDU/CSU	Armin Laschet	Fiscally conservative: want balanced budgets again without new debt as quickly as possible and reduce the debt ratio to below 60%	Return to the debt brake. Rejects any changes to Basic Law to soften it	Pro-integration: advocate a "stability and growth" union	Rejects debt union. NGEU is a one-time borrowing. Fiscal rules of SGP must be restored and violations must be consistently sanctioned	Climate neutrality by 2045
AfD	Alice Weidel and Tino Chrupalla	Fiscally conservative. Lower tax burden, abolish inheritance tax, implement a national digital tax on tech giants	Return to the debt brake	Believes the euro has failed and there should be a return to national currencies to ensure political sovereignty	There should be no borrowing at the EU level. Believes the NGEU breaks the European Treaties	Rejects decarbonisation measures, any form of CO2 tax to be abolished, rejects the EU's green deal, believes Germany should resign and withdraw support from "climate protection" organisations

Source: NWM, Party manifestos

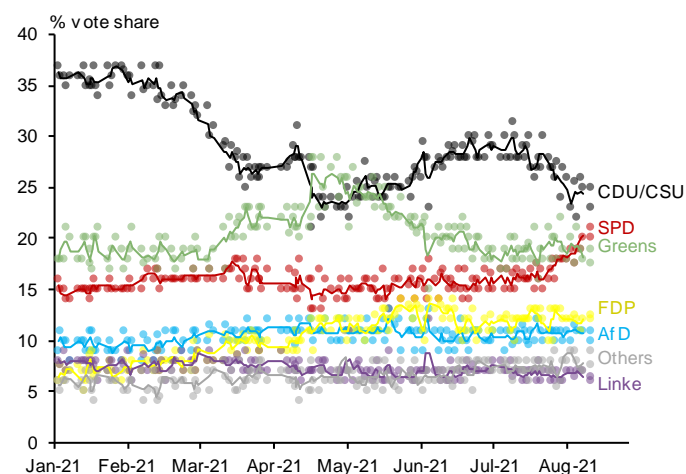
Evolving polls currently imply high degree of uncertainty

Polls have shifted considerably in the last few weeks. Greens and CDU/CSU had been clear front-runners (with an alliance of more than 50% looking likely) but are now losing ground to SPD. CDU/CSU still tops the list of voting intentions (having regained its lead over the Greens a few weeks ago), but only at 25%, down from highs of 36%

at the beginning of the year. SPD has now overtaken the Greens, polling at 19% vs 18%, as the charts below show.

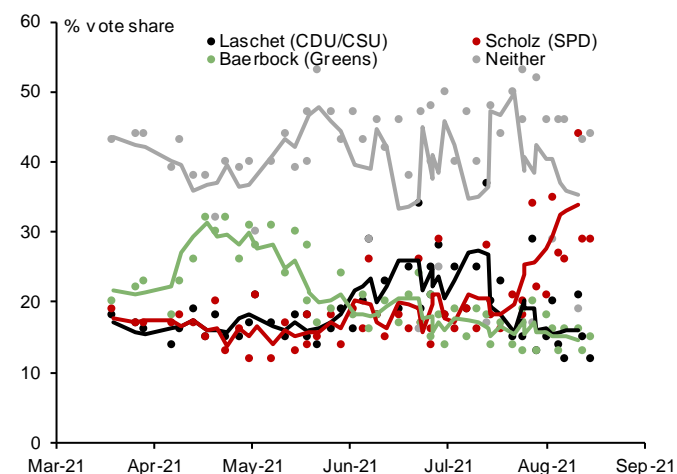
Polls of voting intentions by party

Source: NWM, Wikipedia



Chancellor polling – Scholz has become clear front runner

Source: NWM, Wikipedia



Greens likely to be the kingmaker, despite shifting polls

Germany looks set for another coalition government. But the greens will be hard to exclude on most projections. We expect that a CDU/CSU-SPD ‘grand coalition’ will be very strongly resisted if alternatives are available. If the second or third largest party, as polls suggest, the Greens will likely be the kingmaker. The most likely scenarios are:

Base case. “Black-Green”, CDU/CSU+Greens. This is the currently only realistic two-way governing alliance. Current polls give the Black-Green pairing a total of 44%, still short of an outright majority of 50% (although likely less than 50% of votes would be required for a majority due to smaller parties dropping out due to thresholds to enter parliament).

“Jamaica” Black-Green-Yellow, CDU/CSU+Green+FDP. If a CDU/CSU- Green alliance needs a third party to get them over the line, the FDP would be the most obvious choice, given CDU/CSU is unlikely to want to govern with the Left, has ruled out an alliance with AfD, and SPD will likely want to position itself in the opposition rather than as junior partner to CDU/CSU again. This “Jamaica” coalition is currently the most popular party combination according to the polls. FDP did pull out of such an alliance during negotiations in 2017, however.

CDU/CSU-Greens (with or without FDP) implies Laschet will be Chancellor, given CUD/CSU would most likely be the senior partner. Even as junior partner, however, having the Greens in government would be positive from both a fiscal policy and European integration perspective, and should be viewed as such by markets.

Tail risks of other scenarios are rising with the SPD’s polling numbers. A government without CDU/CSU is possible. Indeed, the Greens may prefer to pursue such a strategy in order to secure Chancellorship, rather than be junior partner to CDU/CSU.

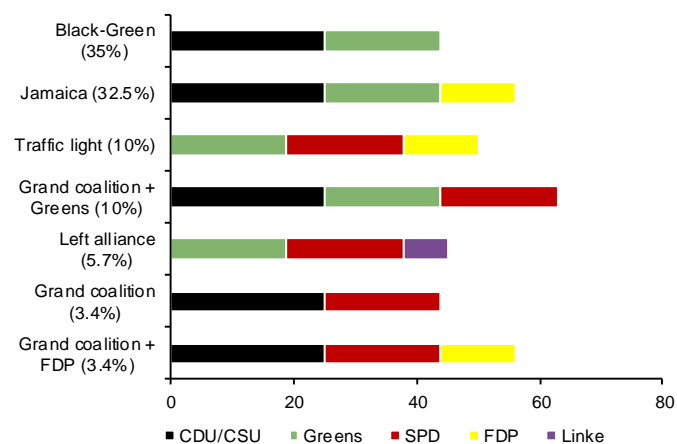
“Traffic light”, SPD+Green+FDP, is (increasingly) possible from a numbers standpoint – current polls would give them 50% of the vote share (i.e. the third most popular three-way coalition behind Jamaica and CDU/CSU, SPD, FDP, which we think is unlikely). But FDP leader Lindner has already rejected the idea, preferring to differentiate FDP from both parties.

“Kenya”, Black-Red-Green, CDU/CSU + SPD + Greens. After two grand coalitions, we expect that, the SPD will strongly resist a junior role again. The CDU would resist a junior role also, although a Scholz premiership might, just, be possible in this configuration.

A Left alliance is also possible, but likely further apart on policies than Greens and CDU/CSU. Greens, SPD and Die Linke together currently command 45% of the vote share. The compromises required on all sides to come to this agreement, however, may be too much.

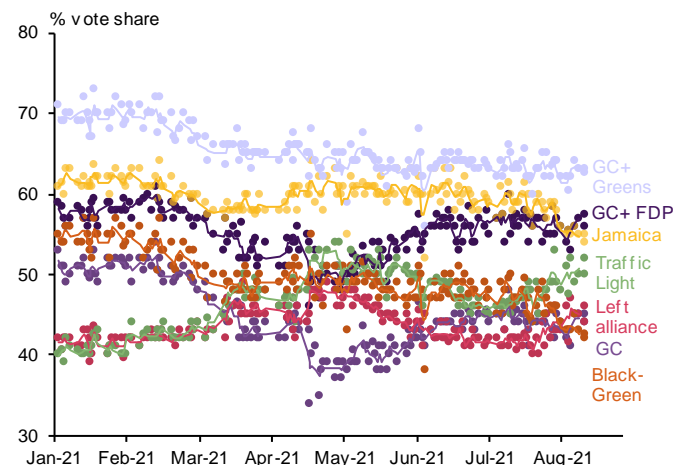
Current coalition vote share (NWM probability in brackets)

Source: NWM, Wikipedia, pollofpolls.eu



Potential coalition vote shares over time

Source: NWM, Wikipedia



Timeline – negotiations could drag into 2022

German’s will go to the polls on 26 September, between 8am and 6pm (CET).

Exit polls will be published shortly after 6pm. Preliminary results are then likely to be published in the early hours of Monday morning (in 2017 this was done at ~5am).

A new government might not be sworn in until 2022. Current polls imply a higher degree of uncertainty in the election results than previously, with the three biggest parties sharing an almost equal portion of the vote. If this is the case, then negotiations could be lengthy. For context, in 2017, Merkel announced that she would invite the Greens and the FDPs to begin preliminary coalition talks on 18 October, ~ 3 weeks after the election was held. These talks broke down in November, and an alternative agreement between CDU/CSU and SPD was not formally agreed until 7 February – 164 days after polls had closed. In 2013, formal coalition talks began nearly two weeks after polls closed, and a new government was sworn in 86 days after the election. There is no official deadline post-election by which a government must have been formed.

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