

Prospects

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Germany – Political renewal after Merkel?

- The race is on. After 16 years with Angela Merkel at the helm, Germany is about to decide who will succeed her as chancellor in federal elections on 26 September. Amid mounting uncertainty about the shape of a new coalition and who will lead the next government, the polling data show three candidates with around 20% of voting intentions. The field of possible coalitions is wide open and a two-party alliance a more distant prospect. Here's a look at Germany's chancellors-in-waiting and their headline policies. We'll take a deep dive into the possible coalition governments – in light of what the latest polls say – and their consequences for economic policy.
- Four-time chancellor, Angela Merkel established a stable legislative framework for a prosperous and competitive economy, but there are challenges ahead. Pressing issues include pension reform and the need for sustainable public investment. And then there's the energy transition – and its potentially higher cost to the public purse. Voters face a starker choice than in previous election campaigns, with far sharper differences between where the parties stand on the top issues. Germans can choose a party offering greener and more social policies – and therefore a less dogmatic public spending policy – or more neoliberal policies.
- Very volatile opinion poll results during the summer months have upended trends and forecasts. Of the many permutations mathematically possible, some seem more likely than others.
- We think that Germany is heading towards one of two possible three-party coalitions. And the shape will depend on which party comes out top. If the CDU gets the most votes, a "Jamaica" coalition (Germany's coalitions are often described in terms of country flags) with the Greens and the FDP

seems fairly likely. But if the SPD or the Greens beat the conservatives, then a "Traffic Light" coalition of the SPD, Greens and FDP would be on the cards. The emergence of the Greens and Liberals as potential coalition partners will play a decisive role in deciding the direction of future government strategy. Domestic spending policy would be slightly tighter in one scenario and looser in the other. We see any alliance with the FDP as a risk to deeper economic and monetary union in Europe. But this risk would be somewhat lower in a "Traffic Light" coalition. In any case, the sheer number of parties involved and relatively little overlap between their political agendas point to tortuous post-election negotiations on the formation of a new governing coalition that can command a majority in the Bundestag.

Germany prepares for change as Angela Merkel bows out. She leaves the country with sound economic fundamentals – and some big challenges. A European export powerhouse, Germany is also in the process of shifting its economic model to give more weight to domestic demand. Nor has social policy stood still: the country has introduced a minimum wage and opened its doors to one million migrants in 2015. It had the fire power to counter coronavirus and provide massive support for businesses and workers thanks to its controversial policy of zero new borrowing and balanced budgets – known in Germany as the "schwarze Null" or "black zero". However, of the many challenges ahead, the repeatedly differed issue of pension reform looms large. The outgoing government has committed to two promises on pensions: to keep them at 48% of salary at least and to cap the pension contribution rate at 20%. But if nothing is done, these twin conditions threaten the stability of the pension system from 2025. Another burning issue in this election is the need to invest more in infrastructure. Neglected for too long, public

investment is now an important part of Germany's recovery plan. Under the parties' proposals, spending could be either extended over longer periods or increased. The number 3 topic is the risk of higher green transition costs. Let's take a look at what the candidates are proposing and gauge whether the country's economic policy refresh will be equal to the challenges ahead.

Who are the main candidates and what do they stand for?

The Conservative Union parties (CDU/CSU) are ranged behind **Armin Laschet**. He was elected Premier of North Rhine-Westphalia, the country's largest industrial region. In 2017 in a coalition with the liberals of the FDP. Despite his ability to galvanise his network in the Christian Democratic Union, he has struggled to convince voters that he is the right man for chancellor because of the popularity of his ally and Bavarian contender, Markus Söder, with the party base. The majority of Laschet's support came from party delegates, thanks to Angela Merkel's backing for him as the best candidate to continue the party line. He is running on fairly moderate centre-right reforms to quickly return to the "debt brake" and reduce the ratio of debt to GDP. He wants to lower corporation tax to 25% from the current 30% and to abolish the "solidarity surcharge". Turning to the environment, he is fully committed to achieving carbon neutrality by 2045 to meet the target in the bill amending the Climate Action Law passed by the outgoing parliament. Laschet is not in favour of further intervention in the labour market and wants to cut red tape for companies so they remain competitive. On pension reform, the party wants to keep the retirement age at 67 and is proposing to beef up the private supplementary pension scheme. The idea would be to introduce a new investment vehicle: an "intergenerational pension" account would be created at birth for everyone. It would be funded by the federal government and would allow money to be invested in high-yield products.

The Social Democrats (SPD) have put their money on experience with their choice of **Olaf Scholz**. He was Minister for Employment and Social Affairs in Merkel's first government and is currently Finance Minister and Vice-chancellor. The pandemic has played in his favour by making clear that markets can't do everything and highlighting the need for state intervention to redress the balance and offset the harmful effects of exogenous shocks on economic growth. While he was in favour of sticking to a balanced fiscal policy early on in his term as Finance Minister, Olaf Scholz was quick to wield what he described as the "big bazooka", opening the money taps to support businesses and households during the pandemic. He also pledged aid to victims of the July floods. The main points of the SPD's electoral platform are: to raise the

minimum wage to €12 per hour from €9.50; increase family benefit; keep pension levels stable at 48% of wages over the long term and hold the retirement age at 67. He wants all workers – employees, civil servants, self-employed and MPs – to pay into the basic mandatory pension fund and to expand supplementary pension schemes to make them more appealing. He would reform private supplementary pensions and introduce new products and state subsidies for those on lower incomes. The SPD's advocates a generous social policy, part-funded by taking on more debt (without contravening the constitutional debt brake), reintroducing the wealth tax and raising taxes at the top of the income scale.

Annalena Baerbock is the Green candidate to succeed Angela Merkel as chancellor. She was elected to the Bundestag in 2013 but is not very well known. Her reputation has been tarnished recently by accusations of plagiarism, failing to declare all her income and embellishing her CV. Here are the essentials of the two main proposals she is trying to sell voters: first, a more ambitious green agenda to amp up the outgoing government's policy under the Climate Action Law to cut CO₂ emissions by 70% (versus 1990) by 2030 and complete the transition to renewables by 2035. She would quit coal eight years earlier and make Germany carbon-neutral five years ahead of today's target. Her bold policy of accelerating the energy transition would see public investment increase by €50 billion per year until 2030. The second is to reform the debt brake to allow for far greater financing of public investment. The German debt brake keeps the country's debt to 0.35% of GDP every year. The Bundestag suspended it in 2020 and 2021 to fund pandemic-induced spending. On pensions, the Greens would keep the retirement age at 67 and, like all the other parties, the pension would remain at 48% of wages. On the other hand, they want to expand mandatory retirement cover to the self-employed and MPs and to convert the basic pension for low earners into a "guaranteed pension". The private supplementary pension scheme could become a "citizen fund" managed by a state agency, and occupational pensions could be expanded.

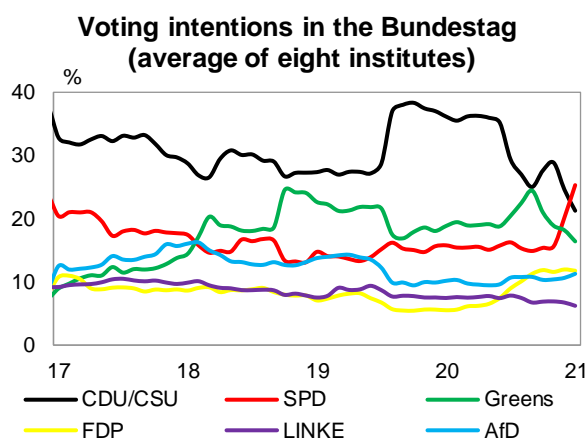
The Liberal Party (FDP) candidate, **Christian Lindner**, was elected to the Bundestag in 2009 and has led his party since 2013. He intends to reduce corporation tax to 25% and to lower the burden on middle-income earners. His vision for the labour market also marks him out from his rivals: he wants greater flexibility and to combine social benefits into a single "citizen's income" (amount to be determined). The FDP candidate would like to make pension entitlements more portable when people move jobs or switch from employment to self-employment. He also advocates boosting private pensions by introducing a mandatory equity pension to be part-funded by contributions to the mandatory

retirement scheme. The party says it is in favour of overhauling European institutions and working towards a decentralised, federally constituted EU with more power (including greater legislative power for the European Parliament). Christian Lindner is more conservative when it comes to deepening monetary union: he is against risk sharing between countries within the banking union (the community system for insuring deposits and risk-weighting sovereign holdings), but in favour of quickly restoring the rules of the Stability and Growth Pact, beefing up sanctions and creating a procedure for restructuring sovereign debt under the control of the European Stability Mechanism (ESM), which should also have a role in supervising budget policy.

Heading up the radical left (Die Linke) we have **Janine Wissler and Dietmar Bartsch**. Mrs Wissler is a political scientist and head of the left grouping in the Hesse parliament since 2009. Mr Bartsch has been head of the left grouping in the Bundestag since 2015. The party's agenda includes raising the hourly minimum wage, unemployment and other benefits. It also wants to increase pensions to 53% of salary and lower the official retirement age to 65 and the early retirement age to 60. What's more, it would abolish the private supplementary pension system in favour of the mandatory basic system. Die Linke advocates higher public spending on social housing and public transport. Looking outward, the party is often criticised for its openly anti-NATO positions. It states that it is pro Nord Stream 2.

Tight and volatile opinion polls

With elections fast approaching, the pollsters are weighing in with their share of insight and uncertainty. Early in the summer, the Greens had the wind in their sails and were ahead of the Christian Democratic Union (CDU/CSU) in the opinion polls, leading to speculation about a possible two-party coalition. Meanwhile the Social Democrats (SPD) languished in the polls. Things look very different now.



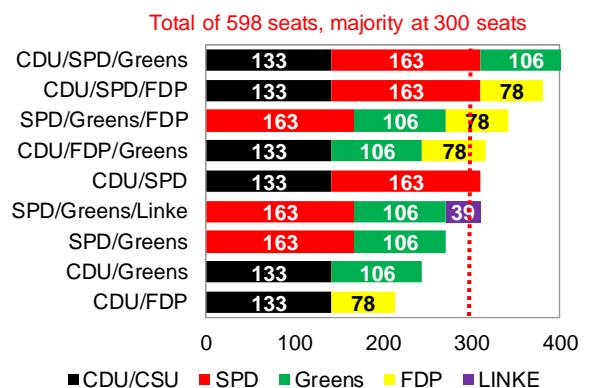
Sources : Wahlrecht, Crédit Agricole S.A.

The Greens and CDU/CSU have slipped to 16% and 20% of voting intentions, respectively, while support for the SPD has surged to 25%, placing it in the lead and throwing the field of coalition possibilities open.

Main possible coalitions

Going on polling data and with 6 days to go, we see six possible coalitions where the maths would give the partners a majority in the Bundestag (300 seats are needed for a majority), which is essential to govern the country effectively. As things stand, the only two-party combination that would command a parliamentary majority is a "Grand Coalition" between the CDU and the SPD.

Projected number of seats in the Bundestag



"Kenya" coalition: Black/Red/Green

The coalition that would bring together the most seats is the so-called "Kenya" coalition of the Conservatives, Social Democrats and the Greens. But, it would be dominated by a Social Democratic chancellor, who would tilt significantly towards social and environmental policies and relegate the Conservative coalition partners to a more minor role in this three-party permutation. Shifting the balance of power to the centre left of the political chessboard would be hard for the Conservatives to swallow. This outcome would also intensify the risk of an expansionist fiscal policy over a longer period of time and pose a greater challenge to the German debt brake. The SPD's election platform includes promises to maintain spending under the Next Generation EU (NGEU) programme, while the Greens want a massive hike in spending to gear up the energy transition. And both these parties are keen to reinstate the wealth tax abolished by Kohl's fifth government (in 1997). But the Conservative party has ruled out bringing back this levy on the rich.

"Germany" coalition: Black/Red/Yellow

A coalition of the Conservatives, Social Democrats and the liberal FDP is the second most likely

outcome based on seat projections for the parties. These are the colours of the alliance that has recently taken over the reins of regional government in Saxony-Anhalt. As a ruling coalition in a federal government, the “Germany” coalition would probably tilt towards the more liberal end of the spectrum and relegate the SPD to a more junior role – which it is unlikely to accept. The SPD would opt for a spell in opposition rather than compromise in an openly conservative government. The regional gains made by the Greens make them a compelling partner in any coalition government.

“Traffic Light” coalition: Red/Green/Yellow

A pact between the SPD, Greens and FDP without the Conservative CDU/CSU would probably be a centre-left government tempered by the liberal partner. Regional elections in Rhineland-Palatinate produced this type of coalition last March. The FDP would probably be against higher taxes or any substantial extension of benefits and instead stress the need to stick to the budget rules. It would also be against deepening the Economic and Monetary Union. Yet, one path to compromise could be to increase debt-funded public investment – without breaching the debt brake rule – and easing the tax burden on low- and middle-income earners. While the Liberals would be better off in a “Jamaica” alliance, this formation would give them a seat on the executive, an option the party would find hard to turn down if the SPD pulls ahead and comes out top when the votes are counted on 26 September.

“Jamaica” coalition: Black/Green/Yellow

A “Jamaica” government of the Union parties, Greens and Liberals could still be a realistic option, with the liberal CDU/CSU-FDP balanced by the reforming Greens. The Green party is going for a bold fiscal policy. It wants to change the debt brake to free up financing over a fairly long period. But the FDP’s inclusion in the mix would cool the Greens’ ardour for public spending. The negotiations to agree this type of coalition pact would be arduous indeed. But the spectre of the failed 2013 negotiations seems to have receded, if the Liberal leader’s statements in the press in recent weeks are anything to go by. Although a “Jamaica” alliance might be more palatable for the FDP than a “Traffic Light” combination that would force Lindner to make more concessions to his partners, it mainly depends on how well the conservative CDU/CSU does on election night.

“Left Union” coalition: Red/Green/Purple

We wouldn’t rule out the possibility of a left-leaning SPD-Die Linke coalition with the support of the Greens. However it remains the least likely outcome according to the polls with only a wafer-thin majority. The SPD centre-left party and the Greens are still fairly reticent to consider getting into bed with the

radical left Die Linke. Nor do we know if Die Linke would be willing to make the concessions necessary to get their hands on the levers of power in a ruling coalition. It’s true that the partners agree on many issues, such as a more expansionary fiscal policy, the urgency of the need for greener policies and raising the minimum wage and benefits. But they have very different positions on foreign policy: the radical left is opposed to NATO and in favour of Nord Stream 2, poles apart from both the SPD and the Greens who are committed to NATO. This type of coalition would probably see public spending soar and an attempt to abandon the debt brake. In opposition, the CDU/CSU and FDP would ensure the two-thirds majority needed to change the debt brake remained out of reach, but the three coalition partners could try to get around the rule to roll out a vast public investment programme.

The “Grand Coalition”

Renewing the current grand coalition of the SPD and CDU-CSU seems mathematically possible, but in all likelihood will be avoided by both parties. The two leaders’ popularity has been dented by their time in two previous such governments with voters complaining they’ve made too many compromises. We think that both parties will now turn towards new alliances, rather than continue with more of the same.

Minority coalitions?

Unlike in the 2017 parliamentary elections, there is not much talk of a minority government, since any two-party alliance other than the “Grand Coalition” would fall too far short of a majority in the Bundestag.

What combinations are most likely?

Let’s take a look at what kind of coalition government is emerging from the latest polling results. We think a “Jamaica” or “Traffic Light” alliance are the two most likely combinations in light of the emerging role of the Greens as a third partner post Grand Coalition (“GroKo”). Both of the Grand Coalition partners (SPD/CDU-CSU) seem ready to break up and are keen to avoid prolonging an arrangement that is steadily eroding their voter base. Yet, negotiations to bring in a third partner could be more complicated and drag on for a long time. **A “Jamaica” coalition could provide centre-right continuity** and becomes increasingly likely if the CDU/CSU Union emerges with the most seats on election night. It would squeeze out the SPD but could accommodate the demands of both the Greens and the FDP. A Black/Green/Yellow pact wouldn’t upend Germany’s fiscal policy completely and would guarantee environmental targets were applied, with the help of subsidies and/or tax incentives to speed up the transition to a greener economy. But, the Greens plans for higher

domestic and European spending could be derailed. **The other possibility is a centre-left government in a “Traffic Light” coalition**, if the Social Democrats take the most votes on 26 September. This would oust the Conservative party from power – a historical first. Fiscal policy would be more accommodating but without jettisoning the debt brake, with the Liberals on board to keep an eye on the purse strings. However, the election results could be closer than the polls predict and postal

voting (which is under way) could also tilt the outcome one way or another. Remember, the leader of the party with the most votes is not necessarily the next occupant of the German Chancellery. Negotiating prowess and the skill to build consensus will be decisive in electing the new chancellor: someone who can motivate and inspire a majority of MPs to agree to a coalition plan for the next four years. ■

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