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STRATEGY FOCUS

Elections in Germany : difficult to lift the debt brake !

SOCIETE GENERALE
Private Banking

Elections in Germany: difficult to lift the debt brake

SUMMARY

- ***Towards a new grand coalition led by the CDU-CSU.*** General elections will be held in Germany on 23 February, after the current coalition led by Olaf Scholz (SPD) lost a vote of confidence. According to the polls, the conservative CDU-CSU party - and its leader Friedrich Merz - would emerge victorious and form a coalition, either with the Social Democrats of the SPD or with the Greens. Given the fragmentation of the parliament, a broad tripartite alliance with these three parties may even be necessary. Despite its recent rise in the opinion polls, the far-right AfD will not be part of any coalition, but it will be the largest opposition party.

- ***A difficult compromise***. Finding a government agreement will not be an easy task, between the expenditure, welfare and tax cuts promised by the CDU-CSU and the high-income tax hikes of the SPD or the Greens. The result could therefore include only moderate measures (a few tax cuts, a gradual increase in the minimum wage and a limited reduction in public spending).

- ***An economic model at a standstill***. The German economy has been at a standstill since Covid. The economic model has been shaken by an accumulation of factors: 1) Covid, 2) the energy crisis following the war in Ukraine, 3) the drop in demand for German companies (Chinese slowdown and energy transition) and 4) increased competition from China. Possible US customs duties and a US military withdrawal would add fuel to the fire.

- ***The issue of the debt brake***. The central issue for the new government will be whether to change the restrictive budgetary rules, i.e. the 'debt brake', which has held back any growth in public finances. A loosening of these rules would allow the new government to boost demand and revitalise the economic model. However, reaching an agreement between the parties of the future coalition will not be easy. What's more, such a reform requires a two-thirds majority in Parliament, which is not guaranteed insofar as many opposition parties are opposed to it. The debate could last a long time.

- ***Towards a change of gear in terms of economic policy ?*** Over and above the short-term difficulties of reaching an agreement, a change in fiscal policy could give the euro area's largest economy renewed impetus. There is a significant need for investment to support the transition: in innovation, defense and public infrastructure. A more accommodative stance would have a positive impact on the country's economy and could allow a broadening of the equity market performance beyond large caps.

ELECTIONS IN GERMANY

AN ELECTORAL SYSTEM WHICH FAVOURS COALITIONS

Two votes in one election... On 23 February, Germans are called upon to elect their Members of Parliament. They will vote twice: once for a candidate in their constituency (first-past-the-post system) and a second time for the list of the political party they prefer (proportional representation system). The Parliament, the Bundestag, will thus be made up of the candidates who come first in each of the 299 constituencies and the representatives of the parties that obtain more than 5% of the votes in the second vote.

...making it difficult to predict the outcome. An additional complexity lies in the compensation mandates: several seats is allocated, region by region, for each party according to the results of the two votes. This compensates for lists whose candidates perform poorly locally but well nationally, and vice versa. As a result, the number of MPs varies from one election to the next (739 in 2021, compared with 598 officially).

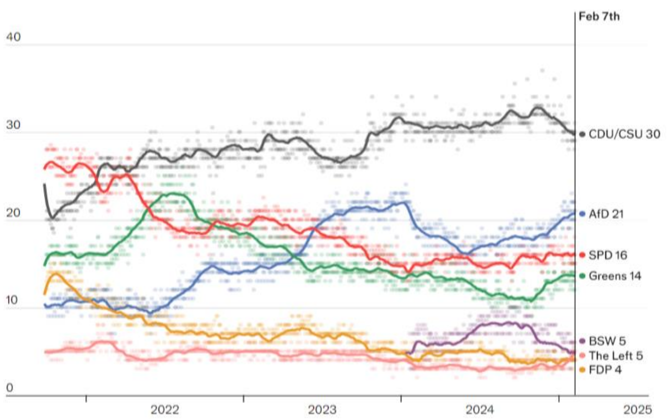
An electoral system that favours coalitions, with a degree of stability. Proportional representation ensures that votes are truly representative but encourages fragmentation of Parliament. Germany is therefore used to dealing with coalition governments. In addition, the Constitution limits the power to topple the government in power. This can happen in two scenarios. The first occurs if the Chancellor dissolves Parliament after losing a vote of confidence requested from Parliament (like Mr Scholz's current coalition). In the second case, MPs can table a so-called ‘constructive’ no-confidence motion. This requires a substitute coalition ready to govern immediately if they want to topple the current one. In the recent past, only one government has been toppled by such a motion (Schmidt in 1982)

Time-consuming negotiations ahead. Germany is used to coalitions. The party that comes out first is in charge negotiations between the parties, to reach a government representing at least 50% of the seats in the Bundestag, a necessary condition for its functioning and the passing of legislation. In the past, such negotiations have taken between several weeks and several months. Olaf Scholz's current government took around 2 months to form in 2021, compared with almost 6 months for the previous government led by Angela Merkel.

A sharp rise in the AfD at the expense of the parties in the current coalition. The parties in the current coalition (SPD, Greens and FDP) are showing a clear drop in the polls compared with previous elections. The FDP is not even guaranteed to obtain the 5% threshold needed to have MPs, making it virtually impossible to repeat the current coalition. The far-right AfD (Alternative for Germany) would double its number of seats compared with the previous elections, with 19% of voting intentions. The main parties have so far completely ruled out an alliance with the AfD, which would become the largest opposition group.

The polls favour a Grand Coalition led by the CSU-CDU. With nearly 30% of voting intentions, the CDU-CSU would come out on top and oversee organising a new coalition. It could form a new Grand Coalition with the SPD, at 16% in the polls, or a ‘Black/Green’ (Kiwi) alliance with the Greens, at 13% in the polls. The fragmentation of the Bundestag would appear to be reinforced, particularly if the parties that are close to 5% of the votes cast (FDP, Die Linke and BSW) exceed this threshold. It therefore remains possible that a coalition of 3 parties will be needed to obtain a majority. A coalition between the CDU-CSU, the SPD and the Greens could then be envisaged. A coalition without the CDU-CSU, comprising the SPD, the Greens and one or more far-left parties, seems unlikely at this stage, either in arithmetical or political terms.

Poll of polls



Sources: Société Générale Investment Solutions, Macrobond, Bloomberg

The main political forces in Germany

BSW	Greens	SPD	FDP	CDU	Afd
Left-wing populist	Ecologist	Social-Democrat	Liberal	Christian Democrat	Far Right

The (arithmetically and politically) possible coalitions

Sources: Société Générale Investment Solutions, Macrobond, Bloomberg

THE CDU-CSU IS SAID TO BE IN CHARGE OF DISCUSSIONS TO FORM A NEW COALITION

Two bipartisan coalitions and one tripartite coalition appear arithmetically and politically possible, all under the conservatives CDU-CSU leadership: a grand coalition with the SPD or one with the Greens. However, the main economic measures of these 3 parties show that compromise will be difficult.

CDU-CSU: further tax cuts. The CDU-CSU is proposing further cuts in compulsory social security contributions and taxes for households and businesses. These tax cuts would be financed by a reform of the social protection system and cuts in public spending. Other key measures include continued aid to Ukraine, increased military spending, possible recourse to nuclear power and a review of the ban on fossil fuel cars. CDU-CSU candidate Friedrich Merz has also suggested a possible reform of the debt brake, excluding public investment from the public deficit framework

SPD : increases in public spending… The Social Democrats are proposing the creation of a €100bn fund (public-private partnership) to finance the energy transition and the development of new technologies. The SPD also mentions a reform of the debt brake, to enable the government to eventually take over from this investment fund. Other measures include a further increase in the minimum wage, more progressive taxation and lower energy and food prices. The programme would be financed by higher taxes on high incomes, inheritance and capital gains.

…and for the Greens. The Greens' economic programme focuses on measures linked to climate change: tax rebates for the purchase of electric vehicles, subsidies for renewable energies, etc. This would be financed by a reform of the debt brake and the creation of an investment fund and a wealth tax. This would be financed by a reform of the debt brake and the creation of an investment fund and a wealth tax.

A difficult compromise. In the weeks following the election, the parties will discuss a coalition government programme. None of these programmes will be applied as such. A compromise between the measures of the constituent parties will form the basis of the future government's plan. But this will not be an easy task: the CDU-CSU's coalition partner (SPD or Greens) will not be able to accept the spending and social protection cuts promised by the Conservatives as they stand. Conversely, the tax rises on high incomes promised by the SPD or the Greens would be rejected by the CDU-CSU. A government agreement could therefore be limited to moderate measures (a few tax cuts, a gradual rise in the minimum wage and a limited reduction in public spending).

A limited reform of the debt brake. The three main government parties appear to be in favour of reforming the debt brake, although their objectives and procedures differ. However, other parties (AfD and FDP) are opposed to it, and the new BSW party could also reject it. Such a reform requires a two-thirds majority in parliament. According to the polls, the CDU-CSU, SPD and Greens could achieve this, but there is considerable uncertainty. If there is to be a reform, two options seem conceivable. On the one hand, the so-called Golden Rule: public investment would be excluded from the calculation of the deficit. Its scope could nevertheless remain limited in order to avoid a drift in public finances. Secondly, a system in which the authorised deficit would depend on the level of public debt: for example, 1% for a debt-to-GDP ratio of less than 60% and 0.5% if the debt is between 60% and 100% of GDP. Finally, it should be noted that the debate on this front could extend well beyond 2025.

No change in Germany's European vision. It seems likely that Germany will continue (even more so with a conservative Chancellor) to argue for the status quo regarding the new government's position on Europe: structural reforms and public debt reduction as a sine qua non conditions for further European integration.

	Economic policy	
	Revenue	**Spending**
CDU/CSU	Lower taxes and social security contributions	Reducing public spending + **Overhauling the welfare system** + Reforming the debt brake
SPD	Increase in the minimum wage + **Creation of a wealth tax**	Increase in public spending + Reforming the debt brake + Increase in the minimum wage
Greens	**Creation of a wealth tax**	Reforming the debt brake

Blue = major points of disagreement

ELECTIONS IN GERMANY

A BUSINESS MODEL IN DISARRAY

Underperformance since Covid. German growth was again slightly in negative territory in 2024. Germany has managed to avoid a technical recession (2 consecutive quarters of negative growth) since 2022 but has alternated between quarters of contraction and expansion. Overall, GDP, after its post-covid rebound, has remained virtually stable since 2022, while it has grown by 5% in the euro area (4% in France, 5.5% in Italy and 7.5% in Spain).

This underperformance follows relatively dynamic pre-Covid growth (1.5% on average between 2012 and 2019, compared with 1.3% for the euro area). Germany benefited from its mercantilist model, whose main driver was exports (of machine tools to China and cars to the rest of the world). This model was based on a skilled and relatively cheap labour force (in Germany thanks to the labour market reforms of the 2000s and in Eastern Europe) and on attractive energy prices (with Russian gas accounting for around 15% of local energy consumption at the time).

A shaken model. This model has faced several shocks since the Covid :

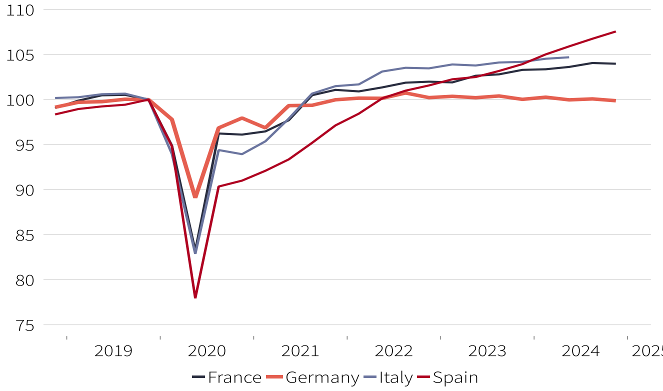
- **Tensions on the labour market have resulted in wage increases** that have not been offset by productivity gains. The German labour market was already showing signs of overheating before the Covid, so the post-Covid tensions appeared even greater than elsewhere
- **Energy tensions following the war in Ukraine.** German companies have had to cope with a particularly sharp rise in energy costs due to their heavy dependence on Russian energy.
- **The slowdown in the Chinese economy combined with the energy transition** (and therefore the announced end of fossil fuel cars) has caused a drop in demand for German companies.
- **Competition from Chinese exporters**, particularly in sectors in which Germany has traditionally been dominant (e.g. automotive).

Energy prices remain high. Inflation in Germany is close to that of the euro area, averaging 2.5% in 2024. But since 2019, prices in Germany have risen by a cumulative 24%, higher than in Spain, Italy or the euro area (around 20% cumulatively over the same period) and even higher than in France (+17%). More importantly, because of Russia's invasion of Ukraine and the embargo on Russian gas purchases, electricity production prices have remained well above those of its peers: almost 20% higher than in the euro area and 30% higher than in France. As a result, Germany continues to suffer from a sharp deterioration in its terms of trade (export prices/import prices) and therefore in its competitiveness.

Solid public finances. Unlike France or Italy, public finances are in a very favourable position, as is the trade balance, which appears to be in substantial surplus. With a public deficit of 2.5% of GDP and a public debt of 60%, Germany is a amongst the best performer in Europe, despite significant support measures during Covid and the energy crisis. The next German government will therefore have the budgetary resources to take action to boost demand and revitalise (or even radically change) the economic model. However, even if it has the means to do so, the next government will still need to comply with its own budgetary rules (debt brake), voted in 2009 and according to which the structural public deficit (excluding the effect of the cycle) is limited to 0.35% of GDP.

Real GDP

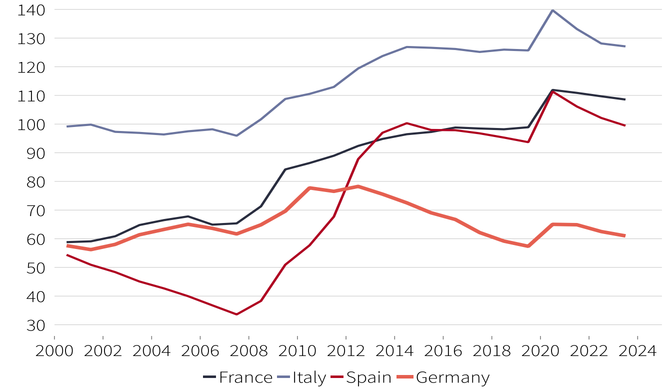
100 in 2019



Sources: Société Générale Investment Solutions, Macrobond, ONS, BEA, Eurostat, INSEE, DESTATIS, Istat, INE 2024 Q4

Public debt euro area countries

As % of GDP



Sources: Société Générale Investment Solutions, Macrobond, INSEE, Bank of Italy, BDE, MOF, BUBA 2023

ELECTIONS IN GERMANY

TOWARDS A CHANGE OF GEAR IN TERMS OF ECONOMIC POLICIES?

The priorities of the new German government will be above all budgetary, whether for 2025 or for the years to come.

Budget 2025: avoiding a sharp squeeze. As the previous Parliament was unable to pass the 2025 budget, the 2024 budget was extended, automatically leading to a tighter fiscal policy. However, the previous government left a budget gap of around 0.5% of GDP. Therefore, without a change in the fiscal rule, the next government will be forced to tighten its fiscal policy significantly.

A change to the debt brake is decisive. A change to the debt brake would therefore be more than necessary. If an agreement is reached by the new Parliament, this would not only give some breathing space in budgetary terms, but also in terms of financing public investment and military spending.

Increase in military spending. Like most NATO countries, Germany has substantially increased its military spending over the past five years, exceeding the threshold of 2% of GDP in 2024. Nevertheless, given the war in Ukraine and the possible disengagement of the United States, an additional effort of 0.5 to 1 point of GDP in the coming years seems inevitable.

Decades of public underinvestment to be reversed. German public investment has underperformed its peers since at least the mid-1990s. On average, since 1995, it has represented just 2.5% of GDP, compared with 3.2% in the euro area and 3.6% in the United States. Increasing the public investment ratio even only to the euro area average would therefore represent a major effort of at least 0.7 points of GDP.

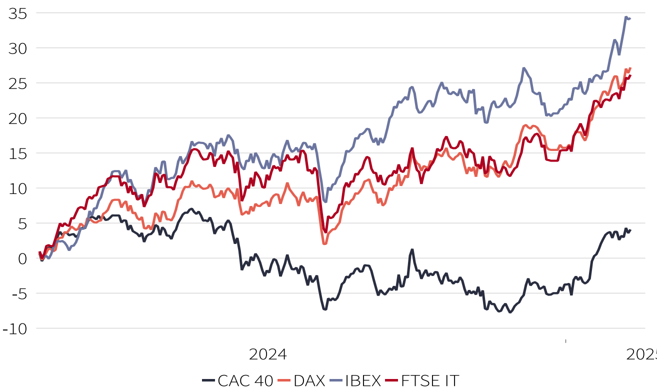
A potentially significant economic impact. In total, the need for investment and additional spending would represent between 1.2 and 1.7 points of GDP over the coming years. So, if the debt brake is reformed and/or a public fund (such as the one to finance Covid-related expenditure) is created, Germany would be at the origin of a substantial recovery plan. This could support German - and to a lesser extent European - growth, enabling an upward climb out of the current economic slump. There are, however, a number of pitfalls, whether arithmetical (whether or not a two-thirds majority is required in Parliament), political (agreement between the various parties) or logistical (risk of delays to the various investment projects). In any case, given the likely lengthy discussions to form a government and reform the budgetary rules, the economic impact will not be felt until 2026 or 2027 at the earliest.

Positive for equity markets… Despite the sluggishness of the local economy, the German equity market has performed strongly since the start of 2024 (up more than 25%). Hopes of a change in economic policy may have been a factor, even if most of the rise came from a few stocks in the defence, artificial intelligence and data centre sectors. Conversely, the performance of the mid-cap index has been flat since the start of 2024. These stocks and the more traditional large caps could benefit from a German stimulus plan - which remains uncertain, however. Defence and infrastructure sectors of Germany's main trading partners could also see a bump in demand.

…possible upward pressure on Bund yields. In the event of a stimulus plan, even a limited one, this could impact the bond markets via two channels: 1) increased bond issuance and 2) renewed economic growth. It should be noted that a rebound in domestic demand in Germany could also benefit its main trading partners (France, Spain, Italy), limiting the potential for a tightening of credit spreads.

Performance of equity indices in total return

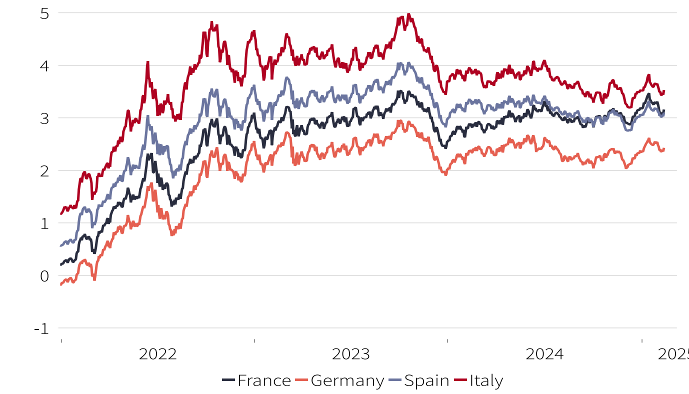
In %, over 1-year, local currency



Sources: Société Générale Investment Solutions, Macrobond, Euronext, Deutsche Boerse, MSE, FTSE Russell 10/02/2025

10-year sovereign bond yields

Yield in %



Sources: Société Générale Investment Solutions, Macrobond, Macrobond 11/02/2025

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