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GERMAN UPDATE: REPEAT ELECTIONS INSTEAD OF JAMAICA? VERY UNLIKELY

Berenberg Macro Flash

Forming a black, yellow and green „Jamaica“ coalition to support Angela Merkel for a fourth term as German chancellor will be difficult. No real surprise. But does that entail a serious risk that Germany won't get a new government after some huffing and puffing and may even head for repeat elections in early 2018? Life is full of tail risks. We need to ponder them. Nonetheless, it remains highly likely that CDU, CSU, FDP and Greens will build a stable alliance in the end despite some serious policy differences. They would have little to gain from torpedoing Jamaica. Germans value stability. Any party that would get the blame for having forced new elections by shying away from the compromises needed to govern could lose badly at hypothetical repeat elections.

Agreeing on a “Jamaica” coalition has de facto turned into a two-stage process. First, the CDU and its Bavarian “sister party” CSU need to sort out their differences while exploring informally what the other parties may find unacceptable. Second, the “black” centre-right CDU/CSU will then jointly discuss future policies with the “yellow” liberal FDP and the Greens.

THE CSU HAS LITTLE TO GAIN FROM ROCKING THE BOAT TOO BADLY

For now, the CSU has become the most prickly potential partner. Party boss Horst Seehofer faces serious headwinds from within his own party. Having suffered particularly heavy losses with a decline in the share of the Bavarian vote by 10.5 points from 49.3% in 2013 to 38.8% in 2017, the CSU seems to be worried stiff that it may lose its majority at the Bavarian state election in the autumn of 2018. As the right-wing AfD has done better in Bavaria than in any other West German state, the CSU is tempted to take a very hard line on immigration policy, for instance insisting to cap the number of refugees Germany can let in at 200k per year. Merkel as well as the FDP and Greens reject such a hard cap. Taken at face value, the positions seem irreconcilable. However, politics is the art of the possible. Merkel excels at bridging differences.

First, consider the situation of the CSU. It is not clear that an overly soft stance on migration in the wake of the autumn 2015 surge in refugees has been the main cause of the weak result for the CDU/CSU, and especially for the CSU in Sunday's election. The CDU/CSU lost more votes to the liberal FDP (1.36mn) than to the AfD (0.96mn) as the AfD advanced mostly because it mobilised people (1.2mn) who had not voted in 2013 (source: infratest dimap). That the CSU had loudly objected to Merkel's refugee policy until late 2016 did not help the party. Instead, the noisy dispute seems to have driven many voters away from the CSU to the calmer FDP. For the CSU, getting the blame for preventing a Jamaica coalition in Berlin and possibly even for forcing repeat federal elections could be the worst possible starting position for the Bavarian state elections next autumn. Amid serious soul searching, the wounded CSU now wants to be seen as driving a hard bargain but will probably shy away from obstructing Jamaica.

Second, look at the substance. After the closure of the West Balkan route for migrants in early 2016 and the gradual hardening of the German stance towards migrants who don't qualify for asylum or refugee status, the number of new arrivals has fallen significantly to 189k in the twelve months to August 2017. Extrapolating the year-to-date arrivals yields a similar estimate for the likely 2017 outcome. Arrivals are below the 200k hard cap which the CSU demands. It should thus be possible to agree on a package of policies (from more support for home countries of migrants to faster deportation procedures and restrictive rules for bringing family members of refugees into Germany) that are explicitly designed to prevent a rise in arrivals



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above the current level without a legally dubious hard cap of 200k. More money for Africa and for the integration of those refugees who are already in Germany could sweeten the deal for the Greens.

HOW COULD JAMAICA WORK?

Money helps: yes, the policy platforms of CDU, CSU, FDP and Greens are far apart on many issues. However, a country that is running a fiscal surplus of almost 1% of its GDP in 2017 can afford to grant each potential coalition partner in Berlin some of its wishes without busting the budget. That can defuse many conflicts. Jamaica can work if each of the parties can claim that it is achieving something significant for its constituents in its core areas of competence. In a potential line-up for a Jamaica alliance that re-elects Merkel (CDU) as chancellor for a fourth term, the CDU could grant its partners quite a bit. For example:

CSU: gets the ministry of the interior, some hardening of immigration policies and a significant rise in the number of police officers

FDP: significant say over finances, possibly coupled with assuming the finance ministry, to implement a noteworthy income tax cut; FDP may also get a ministry in charge of the digital economy

Greens: foreign ministry and environment ministry, with a coalition agreement to phase out dirty lignite coal faster and to speed up the transition towards cleaner mobility

The CDU itself could claim that it is fulfilling one of its major election promises (no tax hikes), that many of the policies outlined above are close to the CDU's election manifesto anyway and that it will continue to shape European and foreign policies, largely through the strong role which Merkel plays on the European stage.

IS UNCERTAINTY BAD FOR THE ECONOMY?

Political uncertainty can be bad. However, the residual uncertainty in Germany is largely about how long it will take to form a new government and about a tiny tail risk of repeat elections. It is not about the overall direction of policy, which would not change very much under any scenario. As a result, we do not expect a potentially noisy process to form a novel "Jamaica" coalition in Berlin to weigh on the economy very much.

On major questions of European and global significance, all mainstream parties (CDU/CSU, SPD, FDP and Greens) have fairly similar views anyway. Most major changes in law need to be ratified by the upper house of parliament, the Bundesrat, where the CDU/CSU, SPD and Greens have a de facto veto. That underpins a German tradition to work through consensus. If major decisions on European and foreign affairs had to be taken in the interim phase while the new government has not been formed and the old one carries on in a caretaker position, the parties would almost certainly be able to do so.

At home, policy may look somewhat paralysed until the new government has been formed. That sounds scarier than it is. A country in good shape can easily live for a while with a caretaker government. Take two extreme examples: (1) The Netherlands have not been able to form a new government since the 15 March 2017 election. Nonetheless, Dutch GDP surged by 1.5% qoq in Q2 2017. Although economic sentiment in the Netherlands has brightened by much less in the last six months than elsewhere in the Eurozone, Dutch sentiment is currently more positive than it was ahead of the election. (2) From mid-2010 to late 2011, the Belgian economy slightly outperformed the Eurozone average although it took 541 days to agree a new coalition government after Belgium's June 2010 election.



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Following many informal talks in the next few days, we expect serious negotiations on a Jamaica coalition in Berlin to start after the 15 October 2017 state election in Lower Saxony. Most likely, the difficult talks can be concluded just in time for Christmas. Tail risks exist. But they usually do not materialise.

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