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POLITICAL UPDATE: GERMANY, BREXIT

Berenberg Macro Flash

GERMANY: MORE OF THE SAME?

A renewed “grand” coalition between chancellor Merkel’s CDU/CSU and the SPD now seems to be the most likely outcome of Germany’s political turmoil. After the heavy pressure which German president Steinmeier exerted on the centre-left SPD last week, and amid some soul-searching within the SPD, the threat of new elections next spring has receded somewhat. The big tanker ship SPD is not well suited for immediate U-turns. It can thus take a while for the SPD to complete the move from the immediate “no” to a new coalition with Merkel last Monday to detailed talks about renewing the CDU/CSU-SPD alliance for another four years. Major stepping stones towards coalition talks could be the joint discussion to which president Steinmeier has invited the leaders of the CDU, CSU and SPD for this Thursday and the SPD party congress on 7 December. Of course, a grand coalition is no foregone conclusion at all. For example, the SPD is also considering to offer no more than occasional support for a Merkel-led minority government. A serious risk of repeat elections remains, for instance if a potential agreement between the CDU/CSU and the SPD were to be voted down by SPD members who seem to be torn between a desire to sharpen their party’s brand in opposition and to shape policies while they can. In any case, it may take months before the political limbo is finally over.

Major parts of the SPD believe – probably rightly so - that a renewed co-operation with a weakened Merkel would give them the opportunity to implement even more of their own policy agenda than before. Four years ago, the SPD pushed through a minimum wage and an early retirement scheme for some workers at the age of 63 as a price for entering the government. Relative to a Merkel-led Jamaica coalition with the Greens and the FDP, the option that fell flat a week ago as the FDP pulled out at the last moment, a renewed CDU/CSU-SPD alliance would probably mean:

- less emphasis on income tax cuts
- a modest further increase in government spending, including more generous pension entitlements for some workers
- a further partial rollback of labour market reforms, for instance by tightening rules for temp agency employment
- a slower phasing out of coal power stations
- somewhat stronger support for some of French president Macron’s European reform initiatives

Regardless of the precise shape of the government Merkel may eventually lead into her fourth and probably final term, most key policy initiatives will have to be agreed in the end between the CDU/CSU, SPD and the Greens as all three parties can wield a de facto veto in the upper house of parliament, the Bundesrat. In this sense, the major result of the FDP’s decision to walk out of coalition talks a week ago is that the FDP will once again have no impact on policies for the time being. The FDP is not represented in enough state governments to have a veto in the Bundesrat. The FDP decision to avoid the messy compromises of a coalition with Merkel and the Greens may or may not be good for the future electoral prospects for the party itself. But it means that Germany will pursue economic and social policies that are further away from those for which the FDP had fought its election campaign.

Of course, we have to add the usual disclaimer: Berlin finds itself in an unprecedented political situation. The outlook is not yet settled enough for firm conclusion. Looking much further ahead, the current contortions on the way towards a likely fourth term for Merkel do suggest that, if a new government lasts a full four-year term, both the CDU/CSU and the SPD will be led by a new generation of leaders at the next regu-

lar vote in 2021. As in Austria, a long period of a "grand coalition" between a country's two major parties can give way to a period of surprises.

BREXIT: STRONGEST SIGNS YET OF A BREAKTHROUGH SOON

All eyes on the December EU summit: Reports that EU leaders expect progress in December, after UK Prime Minister Theresa May agreed to increase the UK's offer on the Brexit bill when she met with EU Council Leader Donald Tusk last Friday, support our call for a breakthrough in the Brexit negotiations soon. Following the meeting on Friday, Tusk said the UK had ten days - until a 4 December dinner between May and EU Commission president Juncker - to meet the EU's demands for 'sufficient progress' on the Brexit divorce. If such progress is made, the EU would be ready to move negotiations on to potential transitional arrangements and post-Brexit trade at the 14-15 December EU Summit.

While this is now doable, a potential sticking point remains - the Irish border question. Before Dublin will allow talks to move on, it wants formal assurance from the UK that no hard border will be introduced between Northern Ireland and the Republic of Ireland when the UK leaves the EU in March 2019. As the post-Brexit UK-EU rules governing migration and trade will be the result of future negotiations - and are thus unknown - promising that the border can remain open is no small feat, to put it mildly. If Dublin were to argue in December that the Brexit divorce discussions had not yet yielded sufficient progress, they could prevent talks moving forward. That Dublin is currently going through its own political turmoil - flirting with snap elections - and could see its own interests better served by playing hardball with the UK adds to this risk. However, that the UK has dropped its hardline view on the Brexit bill - the most contentious issue on the UK side - signals that London is now serious about moving the talks forward. We expect the UK to offer the necessary compromise with Dublin on the Irish question soon.

The market would likely respond positively to any real progress on the Brexit talks this side of Christmas. It could underpin a rebound in sterling and add some upside risk to our near-term growth calls for the UK (1.6% in 2018 and 1.7% in 2019). It would also re-enforce our base case for Brexit: By late 2018 we expect the UK to accept a transition deal (possibly similar to the Norway deal minus some financial market privileges) for 2 or 3 years (70% probability). Since it will be difficult to change such an arrangement very much over time, major parts of this arrangement could solidify into the final terms for post-Brexit trade between the UK and the EU. In this base case, Brexit could reduce trend growth to 1.8% from the pre-Brexit rate of 2.2%. The key risk remains that the UK will or opt for a hard Brexit with few follow-up arrangements for privileged access to the EU27 market (30% risk).

For more please see, 'Brexit update: Will there be a breakthrough soon?'

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