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GERMAN SPD NARROWLY BACKS NEW TERM FOR MERKEL - BUT RISKS REMAIN

Berenberg Macro Flash

A deeply divided SPD has narrowly given the green light for formal coalition talks with German chancellor Angela Merkel's CDU/CSU. 362 of the 642 delegates at a special SPD convention voted in favour on Sunday afternoon. For a proposal backed by almost the entire party establishment, a 56.4% majority is not a strong result. To attain a majority, party leaders had to promise to extract further concessions from the CDU/CSU in the coming negotiations beyond those the SPD had achieved in the exploratory talks that resulted in a 28-page paper on 12 January. More likely than not, Merkel's current caretaker government composed of CDU/CSU and SPD will morph into a full "grand coalition" government of these parties by mid or late March. While we expect the 440k SPD party members to approve the outcome of coalition talks in a party referendum likely to be held in early March, the risk that the SPD rank and file may say "no" and potentially trigger repeat elections remains serious. At the SPD grassroots, sentiment against a third tie-up with Merkel may well be even stronger than among the convention delegates today who often hold positions of responsibility on the local, regional and national level and are thus somewhat experienced in the art of the political compromise.

THE TIMELINE

Coalition talks could start this Monday already with the party chiefs possibly gathering for a first meeting on Monday evening. These talks may last two to three weeks, followed by roughly three weeks to prepare and hold the referendum among SPD party members on the contents of the agreement. If the SPD says yes, the new government may then be formed within a few days. Until then, the SPD will try to avoid a debate as to who would get which job in the government, including the question as to whether the SPD will claim the finance ministry, who may be the new finance minister and which ministry will take the lead on European reform discussions. More likely than not, a new "grand coalition" (GroKo) will be in place in Berlin just in time for the EU summit on 22-23 March.

THE SUBSTANCE

By and large, a renewed grand coalition in Berlin is good news for European reforms but very mixed news for the long-term health of the German economy. On **Europe**, the key debates are not between pro-Macron Merkel and the pro-Macron SPD but within the CDU/CSU. The draft coalition agreement which CDU/CSU and SPD leaders had presented on 12 January matters because it has defined the common ground within the CDU/CSU and can thus serve as the starting basis for German negotiations with France and its other European partners. Germany and France want to co-ordinate their positions as much as possible ahead of the March EU summit. First reforms could possibly be endorsed by the EU summit in June. Such first steps could include the upgrading of the European Stability Mechanism to a proper European Monetary Fund as well as some progress on banking union and in the fight against corporate tax evasion.

On **domestic issues**, the SPD wants further CDU/CSU concessions beyond the draft agreement of 12 January on three counts: additional serious restrictions on temporary work contracts, some changes in the health-care system and more generous exemptions to the rule that certain refugees cannot bring in their family members for the time being. Getting the CDU/CSU to agree to these extra demands at least somewhat will be tough. But as Merkel is a master of forging compromises, party leaders will probably overcome this hurdle. SPD negotiators will point to the strong reservations within their party about a new grand coalition as an argument why the CDU/CSU ought to offer them more. The substance of the CDU/CSU-SPD compromises outlined on 12 January such as more generous pension entitlements and small-scale reversals of reforms to the labour market and the financing of the health-care system may turn out to be expensive over time. Germany may pay a price for them with slightly reduced trend growth and a less solidly financed budget after the next recession. While the business cycle is humming and the country is running a fiscal surplus, they won't make a material difference to the economic and financial market outlook for the next few years, though.

See also our previous two comments on the draft coalition deal from 12 January, focussing on the domestic and European angle respectively.

THE RESIDUAL RISK

Whether the final coalition agreement will satisfy the SPD rank and file remains a very open question. As our best guess, we expect SPD party member to shy away in the end from rebuking virtually their entire leadership and running the risk of another heavy defeat in early elections. More likely than not, they will reluctantly vote in favour of a renewed coalition with Merkel. After the previous two coalitions with Merkel (2005-2009 and 2013-2017), the SPD lost votes. This time, the SPD may console itself with the thought that Merkel is unlikely to lead the CDU/CSU again in the 2021 election after the end of her current new term. Instead, if she secures some significant reforms in Europe within the next two years, speculation may mount eventually whether and when she will anoint a potential successor in the latter part of her likely fourth term in office. This would reshuffle the pack for 2021 and – possibly – let the SPD hope for a rebound then. For the time being, however, this is not yet an issue.

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