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GERMAN COALITION: THEY HAVE A DEAL, BUT NOT YET A GOVERNMENT

Berenberg Macro Flash

Germany takes another step towards a new government: Chancellor Angela Merkel 's centre-right CDU/CSU and the centre-left SPD have agreed on the terms of forming a "grand coalition" (GroKo). As expected, the coalition deal tilts towards some SPD demands that place long-term burdens on the German economy. During the almost 24 hour discussions on the last day, the SPD extracted some concessions on contentious issues such as restricting temporary employment further and more funding for the public health care system (both SPD demands). The SPD may also want to sell to its members the SPD-led finance ministry.

One more important step to go: With the party leaders having sealed a deal, it is up to the SPD's rank-and-file to decide whether a new coalition government will actually be formed. 460k SPD members will be asked to vote on the terms of the coalition, possibly with the results announced on 4 March – it takes about three weeks to prepare and hold that vote. The result is valid as long as more than 20% of all SPD members participate. We see a serious risk of, say, 30% that the SPD members will say "no" to the coalition terms. In the end, we expect the SPD rank-and-file to narrowly approve the deal – they have pushed through most of their demands, and are getting the most important position after the chancellor, the finance ministry. In a much less controversial vote on joining the previous "GroKo" with Merkel in 2013, 76% of SPD members voted yes, with a participation rate of 78%.

The risk of a "no" among SPD's rank-and-file is serious: The SPD has recorded 25k new members since the start of this year. Most of them have joined the SPD since the conclusion of the preliminary talks on the 12 January and an initiative led by the SPD's youth organisation to prevent the "GroKo" and instead revive the SPD in opposition. On 21 January, an SPD party convention approved coalition talks with the CDU/CSU with a narrow 56.4% majority. Only 52% of the ordinary delegates – that is excluding party leaders who may have a vested interest in the perks of government offices – voted for coalition talks. If the party rank-and file split in a similar way in the referendum on the eventual coalition deal, then 25k new members who are highly likely to take part and vote "no" could make a decisive difference. That would be a major setback – this would cause a new attempt of a Jamaica coalition, Merkel-led minority government or repeat elections. The continued period of political uncertainty would be negative for the economy, its impact, however, limited. For a brief "what if" discussion, see our note from 19 January.

More concessions and SPD-led finance ministry could seal the deal: On balance, the majority of SPD members will shy away from rebuking virtually their entire leadership and from running the risk of new elections which would probably sink the party even below its disastrous 20.5% result of last September. In recent polls, the SPD scores merely 18%, just 4% ahead of the radical right AfD. In a recent infratest-dimap poll among SPD supporters (not members) 52% approved another grand coalition. What may be a game changer for some SPD members so far reluctant to support another "GroKo" is that not just the foreign ministry and the labour ministry will be spearheaded by a SPD minister but also the finance ministry. This is a major concession by Merkel. A SPD led finance ministry could lay the ground for more government spending domestically and a slightly softer stance on some European issues. The SPD candidate for finance minister, Olaf Scholz, mayor of Hamburg, is, however, seen as safe pair of hands. He is a realist, less of a federalist than his party boss Schulz, and, within the SPD, probably the closest to ex-finance minister Schäuble.

Progress for Europe: The coalition agreement very much confirms the draft which CDU/CSU and SPD leaders had presented on 12 January. It matters because it defines not only the common ground between SPD and CDU/CSU but also within the CDU/CSU. It 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 22-23 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. Leading the finance ministry, the SPD may push for more decisive steps. However, on European issues, Chancellor Merkel will have the final word. The German position won't soften by more than the conservative parts of the CDU/CSU can accept. For example, the coalition agreement makes it clear that the role of national parliaments (the power to veto serious financial commitments) will not change.

Long-term burden for German economy: The substance of the CDU/CSU-SPD compromises 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.

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