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GERMAN POLITICS: THE LIMBO IS OVER

Berenberg Macro Flash

A new term for Merkel. Europe and Germany can breathe a sigh of relief. Germany's centre-left SPD has agreed to join chancellor Angela Merkel's centre-right CDU/CSU in a renewed "grand coalition". SPD members endorsed the draft coalition deal which party leaders had struck four weeks ago with a 66% majority, that is by a bigger margin than expected. This bodes well for the stability of the new government.

The Bundestag is scheduled to re-elect Merkel for her fourth term on 14 March. After almost six months of limbo, Germany will thus have a regular government again in time for the EU summit on 22-23 March. While the SPD has yet to officially nominate its six ministers for the government, the current mayor of Hamburg, Olaf Scholz, looks set to be the new finance minister. Although many of the SPD rank-and-file may have preferred to renew their party in opposition, the fear that the SPD might drop even well below last September's dismal 20.5% in potential new elections probably tilted the balance strongly towards a "yes". The fact that the SPD has secured the finance ministry for itself in the envisaged new coalition may also have helped. The result of the SPD vote was somewhat closer than it had been in 2013 when a 76% majority of SPD members had approved a much less controversial coalition with Merkel. Today's result also strengthens the SPD's two top leaders, Olaf Scholz and the designated new party boss Andrea Nahles.

Will Merkel stay on for a full term until autumn 2021?
Probably yes, at least for almost a full term. Agreeing on a post-election coalition has been more difficult than ever before in German post-war history. With little love lost between the CDU/CSU and SPD, the risk that their coalition may fall apart prematurely is real. Nonetheless, remember that Germans value stability. Whoever breaks the coalition may be punished by voters at the next opportunity. As a result, CDU/CSU and SPD are likely to stay in their pragmatic arrangement for a full term although the SPD has reserved the right to review the coalition agreement mid-term. Merkel herself has repeatedly stressed that she had campaigned to stay on as chancellor for a full term. While she may possibly anoint a successor and yield office a little ahead of the next regular election in the autumn of 2021, she probably will not step down mid-term.

What happens after this term?
Merkel is unlikely to run again in 2021. She has now promoted a few young and rising CDU politicians (Annegret Kramp-Karrenbauer, Jens Spahn, Julia Klöckner) to visible national roles who might be potential candidates to succeed her in a few years. "Grand coalitions" between centre-right and centre-left tend to strengthen the smaller opposition parties including the fringes such as the right-wing AfD (currently at 13-15% in opinion polls). Judging by experience, including that of the CDU/CSU-SPD grand coalition that Merkel had led in her last term, both major parties may lose votes again in 2021. However, whether that rule will really hold in 2012 is an open question. Both parties will be led by new leaders for the 2021 election. Experience around the Western world in the last few years has demonstrated the decisive impact which charismatic new leaders can make (think France's Emmanuel Macron and Austria's Sebastian Kurz). If CDU/CSU or SPD run with somebody in 2021 who convinces voters, they may still win rather than lose the next German election.

Will German policies change significantly?
No, not much. By and large, Germany will continue along the path which the same CDU/CSU-SPD coalition under chancellor Merkel had taken in the last four years already. In addition, for many issues concerning Europe, migration and taxes, the CDU/CSU-SPD coalition will need the supports of some Greens in the

upper house of parliament (Bundesrat), as was the case in the last few years. Broadly speaking, German policies will remain driven by a consensus between most mainstream parties. That limits the scope for sudden policy shifts.

On European issues, we do not expect the likely transition to Olaf Scholz (SPD) as new German finance minister to make a decisive difference. The current mayor of Hamburg is seen as a safe pair of hands on the more conservative side of his party. He has vowed to maintain the "black zero", that is a small budget surplus at the federal level. He will be highly visible and play a significant role in European negotiations. But as was the case with Wolfgang Schäuble, Merkel will ultimately call the shots. The German position will not soften by more than the conservative parts of Merkel's CDU/CSU can accept. Offers of more German money will remain tied to tough conditions. A major increase in powers for the European Commission and/or the European parliament looks unlikely, especially as Martin Schulz (former head of the European parliament) had to resign as SPD leader three weeks ago. Instead, expect modest progress towards a banking union (such as the ESM turning into the final backstop in case that a major bank needs to be wound down) and some steps towards a building up a joint deposit insurance in the eurozone over time. We also look for progress on non-economic issues such as defence.

At home, key policies of the new government will be a modest increase in government spending while maintaining a small fiscal surplus ("black zero"), small tax cuts (partial abolition of the "solidarity surcharge" to the income tax). Unfortunately, Germany is also heading for further small-scale reversals of the labour market and health-care reforms of the years around 2004 that had turned the country from the "sick man of Europe" into the continent's major growth engine. At the behest of the SPD, the new government intends to remove the cap on employer contributions to the health care schemes for their employees, tighten the rules for temporary work contracts and make some pension entitlements more generous.

Can German afford more "GroKo" policies?

At full employment and in the midst of a cyclical upturn, Germany can easily afford these policies for a while. The modest damage to the country's supply potential may only become visible in the wake of the next cyclical downturn. With a somewhat less flexible labour market and higher non-wage labour costs to fund the mandatory pension, health-care and nursing care schemes, companies may be more reluctant to raise employment in the next cyclical recovery than they are at the moment. In the coming decade, Germany will likely fall back from its position close to the top towards the middle of the European growth league while France may surge close to the top thanks to the Macron reforms.

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