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POLITICAL UPDATE: GERMAN COALITION, SPANISH ELECTION

Berenberg Macro Flash

Germany: a progress report with two major snags

Angela Merkel's coalition is discussing its mid-term progress report today. By the usual standards of coalition governments, the record is not too bad. After less than two years, the coalition has either implemented or largely completed more than 60% of the projects it had outlined in its coalition agreement in spring 2018 according to a separate count by *Bertelsmann Stiftung*. With this progress report, CDU/CSU and SPD ministers want to jointly demonstrate that the government is working and that they would like to serve out their full term until the next regular election in autumn 2021. Finance minister **Olaf Scholz** intends to use the report as a key argument why he – jointly with **Klara Geywitz** – should be the next leader of the SPD and why the SPD should stay in government. In a run-off ballot to be held 19-29 November, the 425k SPD members can choose between Scholz/Geywitz and the more left-wing duo **Saskia Esken/Norbert Walter-Borjans** as the next SPD leaders to be formally appointed at the 6-8 December SPD party convention. Esken is highly critical of the coalition with Merkel's CDU/CSU and seems more inclined to bring down the government.

Unfortunately, the mid-term progress report comes with two major snags attached:

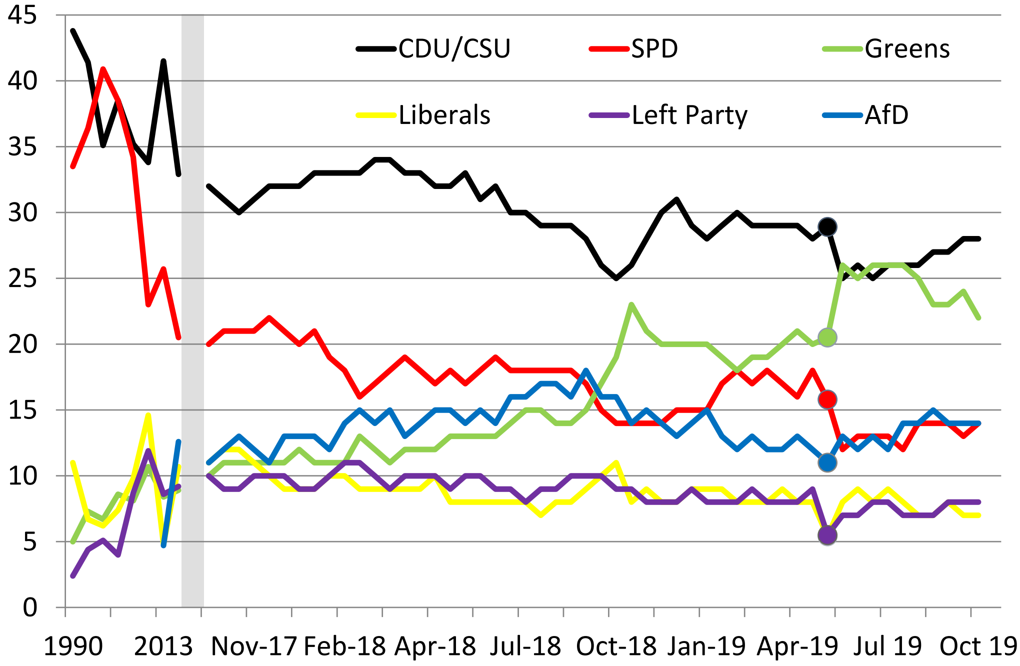
1. The coalition has implemented more SPD than centre-right projects. This may help Scholz to argue that the SPD should stay in power. However, it also shows that policies have focussed more on re-distributing income than on safeguarding Germany's growth potential. The record also stifles resistance in the CDU/CSU against further concessions to the SPD.
2. Contrary to initial plans, the coalition has not managed to agree on a key project yet, a more generous "basic pension" for people who have paid into the public pension system for at least 35 years but whose pension still does not surpass minimum welfare income by much. Whereas the CDU/CSU demands that the top-up pension should be means-tested, the SPD rejects that. This adds to the strains between the coalition parties.

Coalition experts reportedly came close to a compromise over the basic pension last weekend. However, Merkel's influence over the CDU/CSU is no longer as strong as it was before she stepped down as CDU leader last December. Although she reportedly made a passionate plea to her parliamentary party yesterday to accept the envisaged compromise, many in the CDU still seem to be dragging their heels on the issue. In response also to setbacks at recent regional elections (especially Thuringia on 27 October), many in the CDU see a need to sharpen their party's political profile. Part of that profile is a desire to safeguard public finances and respect rather than change the "debt brake" in the German constitution. Expect no more than a "slow motion" fiscal stimulus.

The new restiveness in the CDU makes it more difficult to strike the usual kind of compromise which has so far characterised Merkel's current coalition: both sides can spend some extra money. In this case, this could mean that the SPD gets a more generous and thus costly basic pension whereas, in return, the SPD agrees to a corporate tax cut which the CDU wants. A CDU desire to be more visible could also hold back Scholz who wants to make faster progress on European issues. His comprehensive proposals for completing banking union including a European deposit re-insurance scheme outlined today in the *Financial Times* may well be acceptable to Merkel. But Merkel would probably have a tough time to get most of the CDU on board for this SPD idea.

Our base case: CDU/CSU and SPD will probably manage to agree on a basic pension shortly. Although Scholz/Geywitz may be trailing behind Esken/Walter-Borjans in the SPD-leadership election, the SPD will probably decide to stay in government for the time being. The alternative - namely possibly snap elections next spring at which the SPD could lose a third of its seats - is just not attractive enough (see Chart 1 for opinion polls). We continue to see a 70% probability that Merkel will still be in office next spring – which entails a 30% risk that she may be out by that time. See also: German politics: more upheaval but no new direction and Quirky SPD race could decide Merkel's fate.

Chart 1: Germany - support for political parties



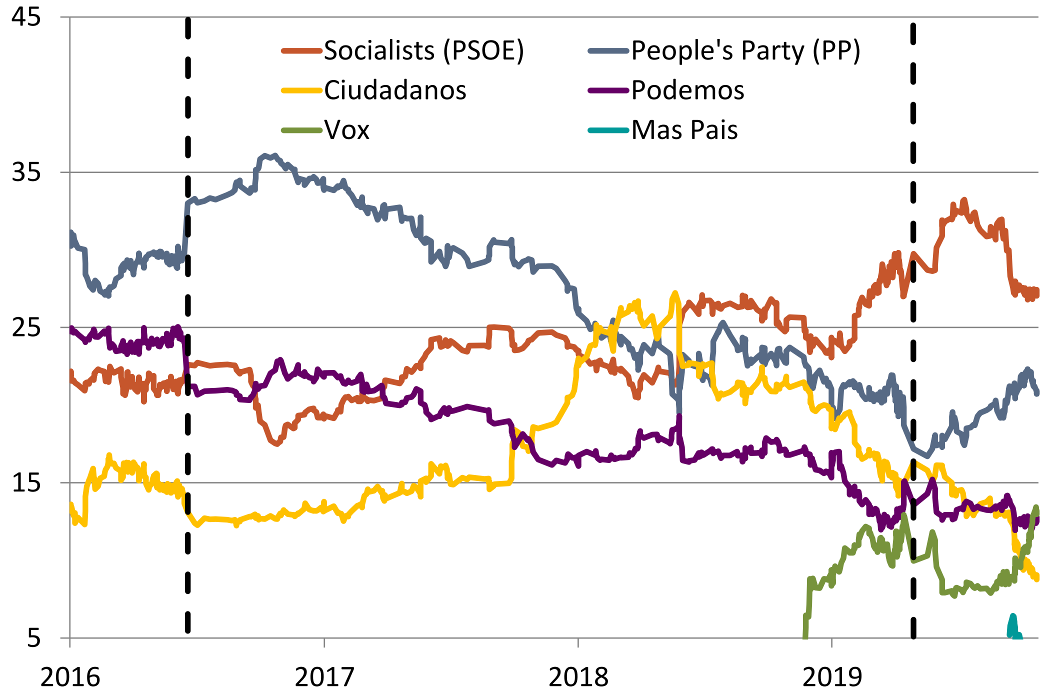
Election results 1990-2017; "ARD DeutschlandTrend" opinion polls thereafter; the dots mark the European election result of 26 May 2019. Sources: ARD, Bundeswahlleiter

Spain: another stalemate likely

Judging by the last batch of opinion polls published over the weekend, the Spanish election on 10 November will not end the country's political stalemate. Instead, the fourth election in four years – and the second in 2019 – could have the same result as the previous ones: a prime minister without a majority in parliament and an opposition that is too disunited to form a stable alternative government. Fortunately, Spain's economy remains in reasonable shape. Benefitting from the reforms introduced by then Prime Minister Mariano Rajoy from 2011 to 2018, helped by an ongoing rebound from the 2008-2013 residential construction bust and supported by some recent fiscal easing, Spanish GDP continues to expand at a pace well above the Eurozone average, with a 2.0% yoy gain in real GDP in Q3 2019 versus 1.0% for the remainder of the Eurozone. As before, Spain can continue to outperform for a while even without a government that can get things done. However, the ongoing Catalan conflict and the prolonged political uncertainty have started to weigh on Spain. In October, the European Commission's Economic Sentiment Index for Spain fell to 101.2, its lowest level since April 2014. Spain's growth advantage over the Eurozone looks set to narrow further in coming quarters unless a new government can finally defuse the Catalan problem and return to the path of pro-growth reforms. Both conditions are unlikely to be met.

If the opinion polls are any guide, the Socialists of Prime Minister Pedro Sanchez can expect a result similar to or slightly below that of the 28 April 2019 election (see Chart 2). Even if the Socialists were to enter a formal coalition with left-wing Podemos, which Sanchez has so far refused to do, the two parties may fall just short of a majority of seats. On the other side of the political spectrum, a would-be coalition of the centre-right with a liberal party and a right-wing party is also treading water. The Catalonia conflict has served to strengthen the more hardline Vox party and – to a lesser extent – the centre-right People's Party at the expense of liberal Ciudadanos. Together, the three parties can expect 43-44% of the popular vote. That would most likely not be enough for a majority of seats either. Barring a surprise, the Spanish election may not resolve anything. To form a government with a majority in parliament, some of the parties will eventually have to co-operate with partners whom they currently reject. See also: elections in Spain: limited risks.

Chart 2: Spain - support for political parties



Support in % for centre-left Socialists, left-wing Podemos, centre-right People's Party, liberal Ciudadanos, right-wing Vox and new leftist Mais Pais; average of last seven polls. Vertical lines give election results 2016 and 2019. Source: national opinion polls, Wikipedia

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