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GERMANY: LASCHET VERSUS BAERBOCK - WHAT IS AT STAKE?

Berenberg Macro View

The parties have made their choice. “Continuity” candidate Armin Laschet will run for the CDU/CSU to succeed Angela Merkel as German chancellor after the 26 September election. The Greens already nominated Annalena Baerbock as their candidate yesterday without any fuss. The noisy conflict between Laschet (CDU) and his challenger Markus Söder (CSU) has drawn attention away from the key question: will German policies shift significantly after 16 years of Merkel at the helm – or will the changes remain gradual?

In many respects, Germany works largely by consensus. Big shifts like the 2003/2004 “Agenda 2020” reforms, the exit from nuclear energy as well as the shift away from coal are mostly negotiated and agreed between the mainstream parties in government and opposition. Such shifts usually reflect longer processes rather than sudden policy reversals after a federal election. Apart from culture and history, one reason for the consensus approach is that major changes such as those affecting key taxes or German support for the EU usually need to be passed by both houses of parliament. More often than not, the mainstream opposition has a veto in the upper house of parliament, which represents the governments of Germany’s 16 federal states. On its own, therefore, the federal government backed by a majority in the Bundestag thus has limited powers. The current haphazard approach to lockdowns provides a key example. However, the federal level has significant leeway in many regulatory and social policy fields. This matters.

In the **Green** party, the lead candidate Baerbock is far more pragmatic than much of her party base. The same holds for the centre-left **SPD**, whose candidate to follow Merkel (current finance minister Olaf Scholz) hails from the pragmatic wing of his party. If Greens (and/or) SPD govern in a coalition with either the CDU/CSU or the liberal FDP, the result would likely be a set of pragmatic policies that would not do serious damage to the Germany economy. But if Greens and SPD formed a government without CDU/CSU or FDP and team up with the hard-left Left Party instead, the key corrective element would be missing. Instead, the left-wing grassroots supporters of these parties may force their leaders to implement more radical policies. The tight cap on housing rents imposed by the red-red-green government of the city state of Berlin is a key example of such harmful policies. Although Germany’s constitutional court just rejected this de facto cap in many housing rents, it did so only on the formal grounds that the state of Berlin cannot regulate the sector – that is a federal prerogative. As a result, many on the centre-left and left now want to impose such a cap for major cities through a federal law if they win the election.

THE TAIL RISK

A look at the German labour market illustrates the tail risk. After a costly approach to unification in 1990, Germany turned into the “sick man of Europe”. Companies relocated jobs abroad to escape excessive regulations and non-wage labour costs. The “Agenda 2010” reforms of 2003/2004 turned the situation around with a little lag. From early 2006 to early 2020, the number of core jobs subject to payroll taxes surged by 28.5%, followed by a minor drop during the pandemic – see



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chart 1. More jobs translated into higher living standards, more tax receipts and modest fiscal surpluses without any need for austerity. As a result of the “Agenda 2010” reforms and a number of further changes enacted around that time, Germany enjoyed a “golden decade” in the ten years before the Covid-19 pandemic.

To different degrees, the Greens, the SPD and the Left Party intend to soften or reverse some of the reforms that have underpinned Germany’s economic success over the last 15 years. A “green-red-red” coalition between the Greens, the SPD and the left-wing Left Party without any corrective element from CDU/CSU or FDP could herald a major shift in German policies, notably towards tighter labour, housing and product markets regulations that would reduce German trend growth. See also: [German politics: what the Greens are up to \(16 March 2021\)](#) and page 7 the **slideck** attached. All other coalition options would likely have some consequences for individual sectors of the economy but not for the overall macroeconomic outlook.

POTENTIAL OUTCOMES OF THE SEPTEMBER ELECTION

We do not change our probabilities for the outcome of the German election in response to the decisions in favour of Laschet and Baerbock this week. Some eight days ago, we downgraded the chance that CDU/CSU would win from 70% to 65% on account of (i) the open conflict within the CDU, (ii) a higher chance that Laschet may win over Söder (with a lot of up-and-down in the meantime) and (iii) that the Greens would choose Baerbock. If Söder had made it, we might have indicated an upside risk to the CDU/CSU probability.

After 16 years in power under the helm of Merkel, we see a 65% chance that the CDU/CSU will also lead the next German government, most likely with the Greens as junior partner – see chart 2. Laschet would be chancellor. A government without the CDU/CSU (35% probability) could be a coalition of the Greens and the SPD with either the liberal FDP (20%) or the far-left Left Party (15%) as third partner.

In any coalition, the strongest partner would nominate the chancellor. A government without the CDU/CSU would most likely be led the Greens rather than the SPD, which continues to lag well behind in the opinion polls. Of the 35% probability for a government without the CDU/CSU, we thus see a 30ppt chance for a Green chancellor (Baerbock) and 5ppt for an SPD chancellor (Scholz).

Slicing the same numbers differently yields a 95% probability that the Greens will be part of the next German government, either as junior partner of the CDU/CSU (60%), as senior partner of a three-way coalition which includes the SPD (30%) or as junior partner of such a coalition (5%).

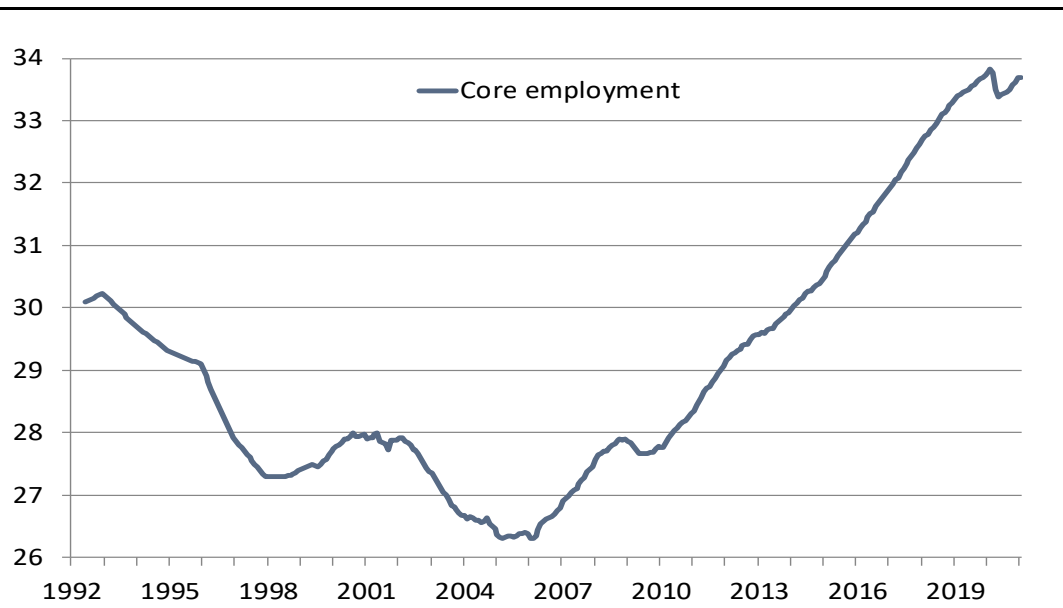
For the CDU/CSU, the choice between Söder and Laschet was about style, charisma and perceived electoral appeal rather than major differences on substance. Laschet is widely seen as the continuity candidate. He has usually supported Merkel on other policies including her handling of the 2015 refugee crisis. His somewhat unassuming style and penchant to moderate and bridge differences resembles Merkel’s approach. Hailing from Aachen on the Belgian and Dutch border, he



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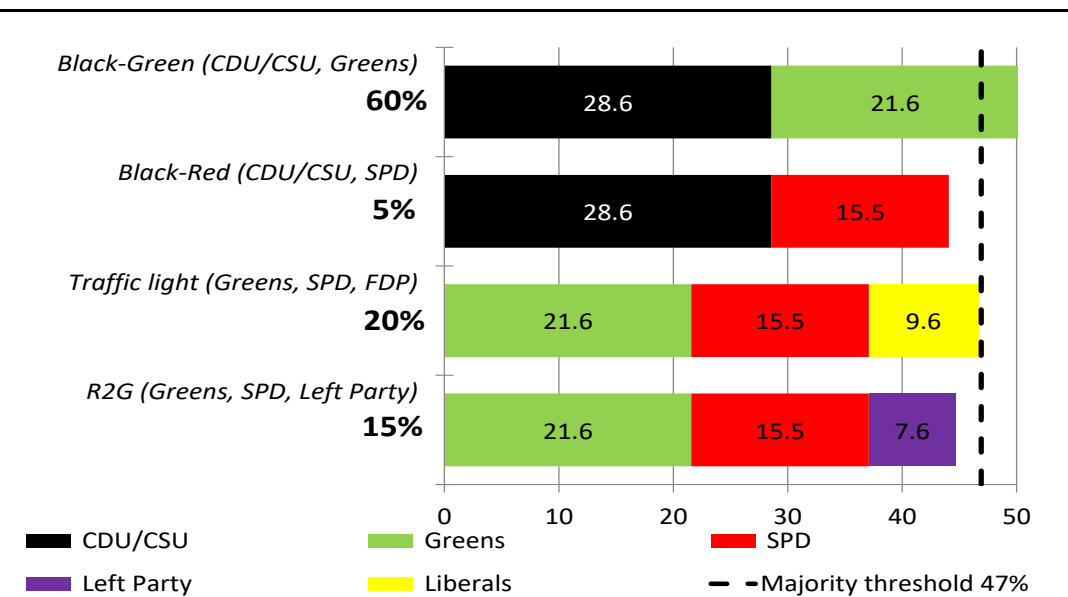
would be willing to go along with some additional fiscal burden sharing in the EU and the Euro-zone. But his party as well as Germany's constitutional court would likely limit his room for change significantly on European issues.

Chart 1: Reforms work - Germany's post-reform employment miracle



Core employment not subject to payroll taxes, in million. Source: Bundesbank

Chart 2: Potential German coalitions after the 26 September election



Berenberg probabilities for coalitions after the 26 September 2023 election. Numbers in the bars: average of recent opinion polls in %. Parties with less than 5% of the vote get no seats. As they may get 6% in total but not seats, 47% of the vote is needed for a majority of seats. Sources: Allensbach, FGW, INSA, Kantar, Forsa, infratest dimap, Berenberg



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