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GERMAN ELECTION FLASH: IT COULD BE MESSY

Berenberg Macro View

New government without fiscal space? The centre-right CDU/CSU has won the German election – but possibly only sort of. As expected, the CDU/CSU has come well ahead of the right-wing AfD (in second place) and the two centre-left parties (SPD and Greens) of the current rump government. CDU/CSU leader Friedrich Merz will almost certainly be the next chancellor.

However, first projections available by 18:40h local time do not yet provide a clear answer to the two key questions:

(1) Will Merz be able rule in a coalition with one centre-left partner (SPD), or will he have to forge a more messy alliance of his CDU/CSU with two other mainstream parties for a government that has a 50%+ majority of seats in the Bundestag?
(2) Will the populist protest parties from the right (AfD) and the left (The Left and the BSW) garner more than one third of the seats in the Bundestag?

Judging by these projections, the risk that a three-party coalition will be needed and that the parties from the political fringes get more than one third of seats and could thus jointly block any changes to the German constitution is serious. If so, they could veto any loosening of the debt brake enshrined in the constitution. At a time when it is crucial to raise spending for the military and Ukraine and ease the tax burden for workers and firms, Germany may struggle to find the fiscal space to do so. A failure to ramp up military spending could get Germany into deep trouble with its NATO partners. By infuriating US president Donald Trump, it would also add to the risk of a US-EU trade war.

The average of the projections (ARD and ZDF) shows 28.8% for the CDU/CSU, 19.75% for the AfD, 16.25% for the SPD, 12.75% for the Greens, 8.75% for the Left, 4.95% for the FDP and 4.9% for BSW. Whether the FDP or (less likely) the BSW will clear the 5% threshold to gain seats in parliament remains unclear based on the projections. Relative to pre-election polls, the CDU/CSU has done slightly less well and the SPD a bit less badly than expected. Riding a wave of support due a slick social media campaign and a pro-migration stance that has energised the minority of Germans who want to keep borders open for uninvited immigrants, the Left party has exceeded expectations. Whether or not the FDP and BSW make it into parliament could decisive.

The chart below gives the share of seats based on the average of projections. The four scenarios differ in the assumptions whether or not the FDP and/or BSW cleat the 5% hurdle. In three of the four scenarios, a two-party alliance between CDU/CSU and SPD would not command a majority of seats. Furthermore, in two of these scenarios, the four mainstream parties (centre-right CDU/CSU, centre-left SPD, centre-left SPD and centre-right FDP) would not have the required two-thirds majority to change the constitution.

What if?
A key issue is whether or not protest parties will get one third of seats and thus a blocking minority against changes to the constitution. The three relevant fringe parties, the AfD, the Left and the BSW differ on many counts. But they oppose aid to Ukraine. The mainstream would not negotiate a change to the constitution (or any other issue) with the AfD. Getting the left-wing fringes (The Left and BSW) to agree to more defence spending including more help for Ukraine could be close to impossible as well. The Left wants to ditch the debt brake. But its policy platform of (soak the rich, raise welfare spending, cut military spending) is exactly

the opposite of what Friedrich Merz wants (pro-growth tax cuts, a pruning of welfare spending and more money for the military).

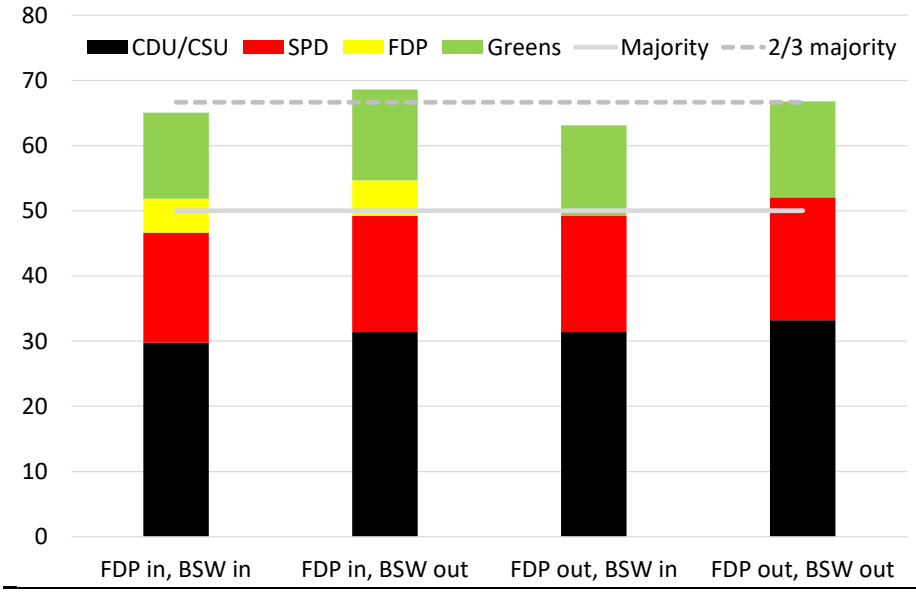
Without more fiscal space, Merz would find it difficult to convince his potential centre-left partner(s) to agree to serious pro-growth reforms. In addition, he would lack the fiscal space to ramp up military spending decisively while increasing public investment and easing the burden on companies and households with significant cuts in taxes and electricity charges at the same time.

But even in this case, a new coalition between, say, the CDU/CSU and the SPD, could still find some fiscal space by pruning some welfare spending, reforming the inefficient energy policy and injecting capital into semi-public institutions such as KfW development bank or the railways to enable them to borrow more. Merz may even raise the value added tax (hiking the standard rate from 19% to 20% could yield c19bn per year). However, this would be highly unpopular as people still reel from the 2022/23 surge in inflation.

To mitigate the risks from a lack of fiscal space somewhat, Germany may in this case consent to more common borrowing on the European level for a one-off common defence and/or Ukraine support fund in addition to the likely redirection of some unspent funds from the post-pandemic NextGenEU funds for these purposes. If the situation in Ukraine deteriorates badly, as seems quite possible after the recent pro-Russian moves by US president Donald Trump, the new German government may also declare a national emergency with a simple majority and suspend the national debt brake temporarily as Germany had done during the pandemic. However, the legal hurdle for that is high as the Constitutional Court would only accept this under genuinely exceptional circumstances and not for a long-term rise in public spending.

We will distribute an update once the result has become clear, probably after the preliminary official result has been published.

Chart: Potential majorities (seat shares in % for mainstream parties)



Simple majority for a government coalition and 2/3 to change the constitution. Seat shares depending on whether the FDP and/or BSW clears the 5% threshold to enter parliament. Based on average of projections as of 18:40 German time. Source: ARD, ZDF.

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