

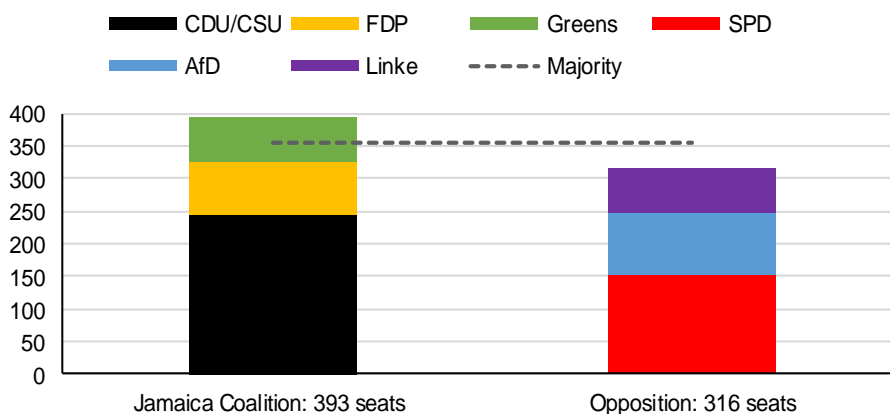
Merkel's Government to Push Ahead, Despite Weakened Authority



On 24 September 2017, Chancellor Angela Merkel was given an expected mandate for a fourth term. However, the CDU/CSU's election result was worse than anticipated. Moreover, the weak performance of the SPD and the party's decision to enter opposition leaves Chancellor Merkel in the delicate situation of building a three-way coalition with the centre-right Free Democrats (FDP) and the Greens. While the far-right Alternative für Deutschland (AfD) became the third largest force in the Bundestag, the party is unlikely to materially impact government policy, except in specific areas. Scope expects a CDU/CSU-led government to ensure relative continuity in Germany's economic policy framework with moderate changes. However, as the election outcome has weakened Ms Merkel, the speed and depth of further European integration could be more constrained than originally anticipated.

In this past Sunday's election, Chancellor Angela Merkel was given a mandate for a fourth term, with the Christian Democratic Union (CDU)/Christian Social Union in Bavaria (CSU) bloc receiving 34.7% of the seats, significantly underperforming its 2013 election result. The hollowing out of Germany's political establishment (the Social Democrats (SPD) also significantly underachieved targets, receiving 21.6% of seats) supported the rise of smaller parties including Alternative für Deutschland, which received 13.3% of the seats (the third most), becoming the first far-right party to enter the German Bundestag in decades. The entry of AfD to the Bundestag could well influence the political debate in areas like migration.

Figure 1: Results of the 2017 German Federal Election, and possible coalition



In 'German Elections: Low risk event but important for reform prospects in Europe' published on 12 September 2017, Scope highlighted the risk to Chancellor Merkel's European reform agenda should FDP be a junior partner in the next government. The expected formation of a 'Jamaica Coalition' with FDP and the Greens could have important implications for the speed and depth of euro area integration. While a coalition with FDP would make negotiations for any future financial assistance for Greece and/or expansion of the role of the European Stability Mechanism (ESM) more onerous, it remains unclear to what extent, given the need to balance opposing viewpoints within such a coalition. However, it is Scope's opinion that the election outcome has weakened Ms Merkel domestically, and thus reduced her ability to speedily and comprehensively push for some of the deliberated areas for European reform. Finally, in Scope's view, the formation of a new government under the Jamaica Coalition constellation is unlikely to materially change the German government's approach on Brexit.

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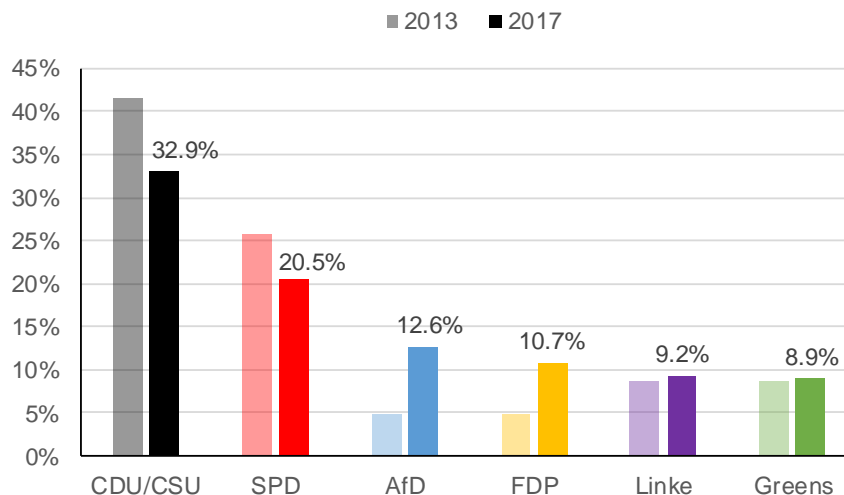
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CDU/CSU wins plurality, despite greater fragmentation in Bundestag

German election result

On 24 September 2017, Chancellor Angela Merkel was given an expected mandate for a fourth (and final) term, with the CDU/CSU receiving 34.7% of the seats, significantly underperforming the grouping's 2013 election result of 49.3% (of seats) and more akin to its 2009 election result (when it received 38.4% of seats). The hollowing out of Germany's political centre (the Social Democrats also significantly underachieved objectives, receiving 21.6% of seats) supported the rise of smaller parties including Alternative für Deutschland, which received 13.3% of the seats (the third most in the election). AfD's result was modestly higher than opinion polls indicated prior to the vote (though just under peaks in opinion polling for AfD reached in 2016), helping the party become the first far-right, populist party to enter Germany's Bundestag in decades. Higher support for anti-establishment parties and the fragmentation of the political centre have been a phenomenon across Western nations since the Global Financial Crisis, owing to factors including globalisation, migration/security and economic instability.

Figure 1: 2017 election versus 2013 election result, % of party votes



Source: Bundestagswahl

The election leaves Chancellor Merkel in the delicate situation of building a new coalition government with few options on the table. On Sunday, after receiving news of its worst result since the Second World War, SPD leader Martin Schulz indicated that the party would be entering and leading the opposition. In 'German Elections: Low risk event but important for reform prospects in Europe' released on 12 September 2017, Scope noted the difficulties for SPD leadership in the re-conception of the Grand Coalition, with party membership broadly against a further four years as the junior partner.

The Jamaica Coalition is widely expected

The most likely coalition outcome is expected to be the so-called Jamaica Coalition¹, comprised of the CDU/CSU, the Free Democrats (which saw a resurgence to receive 11.3% of seats, re-entering the Bundestag) and the centre-left Greens (with 9.4% of seats). As CDU, CSU, FDP and the Greens have opposing views on multiple issues including refugee policy, security, tax, energy/environment and responses to the diesel emissions crisis, coalition talks will be complex and protracted. However, an alliance of the three groups, while never tested at the national level, is not wholly unprecedented: a CDU-FDP-Greens coalition was formed at the state level in Schleswig-Holstein earlier in 2017. Moreover, Ms Merkel's experience and calculated negotiation approach could lead

SPD to enter opposition

¹ Named after the party colours in such a coalition, which match the colours of the Jamaican flag.

her to offer each partner a role in specific policy areas. While Scope expects the Jamaica Coalition negotiating partners to find agreement and become Germany's government for the next four years, the risk that an agreement is not found is not off the table – an outcome that would force CDU/CSU to offer meaningful concessions in exchange for the SPD to come back to the negotiation table. But, with some good fortune, a Jamaica Coalition would see a unison of Chancellor Merkel's preference for stability, a greater degree of economic modernisation (perhaps with a digital angle), an environmental concentration, and a renewed commitment to Europe.²

Election's impact on Germany

As we recently wrote³, Scope does not expect the conclusion of Germany's 2017 election to impact Germany's sovereign rating of AAA. German public finances are sound with a budget surplus of 0.8% of GDP in 2016 and a debt-to-GDP ratio of 67% (as of Q1 2017) and on a declining trend. Scope does not anticipate any major shift in fiscal policy after the election, despite some modest fiscal loosening probable. Under a Jamaica Coalition, the FDP will push for larger tax cuts (of EUR 30bn) than the other groups, but Scope does not expect the scale of fiscal loosening to amount to more than 1% of GDP, with potential coalition members committed to prudent fiscal management.

In Scope's view, a balanced approach between tax rate cuts for lower- and middle-income households and greater public infrastructure investment is possible. An increase in public investment in transport infrastructure, research and development, as well as in renewable energy – per Die Grünen's focus on a quicker transition to sustainable energy – would represent appropriate use of Germany's existing fiscal space (in view of a record post-reunification budget surplus in 2016) to boost long-run growth prospects, whilst simultaneously contributing to regional and global rebalancing.

AfD likely to influence immigration debate

Chancellor Merkel said Monday she accepts that her policy is in part responsible for Germany's polarisation, with the leader of sister party CSU, Horst Seehofer, calling for a review in 'closing the right flank' of the bloc to recapture voters lost to AfD. However, while there are echoes in the German election aftermath of an anti-immigration debate happening across Europe and the US, AfD remains a considerable distance from exercising direct power in Germany at the federal level, debarred from all coalition scenarios. However, Scope notes that the party could influence the policy direction indirectly by pushing the CDU/CSU further to the right on specific issues, like, for example, on refugee and security policy. To a significant extent, AfD has already done this (after entering 13 of 16 German state assemblies), and the party will continue to weigh on some issues: the prospect of further losses in a state election in Bavaria in 2018 has compelled CSU to renew calls for a cap (of 200,000 per annum) on refugee arrivals, a proposal rejected by Chancellor Merkel and which may well complicate coalition negotiations. However, ongoing internal divisions between radical and more moderate elements of AfD will limit the party's effectiveness somewhat. Frauke Petry, AfD's national co-chairwoman, announced on Tuesday her decision to quit the party, and stated on Monday she would instead sit as an independent in the next Bundestag, to distance herself from the party's direction.

The election will not impact Germany's rating, despite some fiscal loosening

Outside of specific areas, AfD's impact will not be significant

² Bershidsky, Leonid. Bloomberg, 24 September 2017.

³ <https://www.scooperatings.com/#search/research/detail/155029EN>

A Jamaica Coalition with FDP will impact Europe agenda, in terms of content and speed, though unclear to what extent

Election's impact on Europe and Brexit

Scope highlighted⁴ that although all the established parties are pro-Europe and endorse reform in the euro area, the speed and depth of further euro-area integration would probably be greater under a renewed Grand Coalition with the SPD than under a coalition involving the Free Democrats. With the FDP aiming at the finance portfolio (for the party's 38-year old leader Christian Lindner), Ms Merkel may find herself in tough negotiations over accommodating FDP ambitions and finding an appropriate role for now-Finance Minister and party-colleague Wolfgang Schäuble. Lindner's comments entertaining support for a Greek exit from the euro area (though not from the European Union) and questioning the parameters surrounding any theoretical euro area budget have created concern that a coalition with the FDP may weaken chances of significant reforms resting on greater solidarity within Europe. While Lindner would make negotiations for any future financial assistance for Greece and/or expansion of the role of the European Stability Mechanism – the euro area's bailout fund – more onerous, it remains unclear how a Jamaica Coalition government's policies in these areas would diverge from that of coalitions without FDP, given the need to balance opposing viewpoints with the CDU and Greens. Moreover, Ms Merkel retains powers on how Germany votes in the European Council, moderating major shifts. However, it's Scope's opinion that the election outcome weakens Ms Merkel domestically, and thus reduces her ability to speedily and comprehensively push for reforms at the European level.

In the special comment 'Euro area: At a turning point' published on 12 May 2017⁵, Scope argued that while the euro area's economic governance framework has been strengthened materially since the euro area crisis, concrete steps to further enhance the resilience of the Economic and Monetary Union would be credit positive, and support the sovereign ratings of euro area member states. Certainly, any further progress in areas to shore up the euro area, such as the transformation of the ESM into a European Monetary Fund or the creation of a euro area budget, will depend on a push from France and Germany, where a continued Merkel/Macron leadership structure presents an opportunity to further the agenda. French President Emmanuel Macron laid out his vision regarding this agenda in a speech on Tuesday to mixed reactions in Germany.

Germany's negotiating stance on Brexit unlikely to change

In Scope's view, the formation of a new German government is unlikely to materially change Germany's Brexit stance. Even with pre-election posturing on Brexit no longer extant and a possible new government with the FDP (who favour a 'Europe of different speeds'), the disparity in positions of a new German government compared with the previous one is unlikely to result in a substantive change in Germany's approach on Brexit. This is notwithstanding the fact that FDP may be somewhat more sympathetic to UK concerns. Moreover, a more cooperative approach on Brexit from Germany will be constrained by complicated coalition negotiations now underway, alongside the CDU's weakened position, which limits the Chancellor's means to consider material concessions to the UK, even as the clock before the UK's set departure date in March 2019 continues to run down.

⁴ Ibid.

⁵ <https://www.scoperatings.com/#search/research/detail/154145EN>



Merkel's government to push ahead, despite weakened authority

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