

Merkel IV will be her most fragile government with unclear implications for Europe



Scope
Ratings

Scope expects 'Merkel IV' to provide overall policy continuity domestically, but recognises the risks of tensions within the coalition parties diverting attention from the European reform agenda. Scope believes this would be a missed opportunity. The upcoming EU Council on 22-23 March will provide greater clarity on this administration's willingness and ability to push ahead with key European reforms.

On Sunday, the Social Democratic Party (SPD) released the result of their internal membership vote with a turnout of 78.4%, a two-thirds majority voted to support the party entering another 'grand coalition' with the CDU/CSU, paving the way for Merkel's fourth administration to be established by 14 March.

Scope has noted on previous occasions¹ that any coalition government led by the Christian Democratic Union (CDU) and Christian Social Union (CSU) will provide continuity for Germany's (AAA/ Stable) economic policy framework, with only moderate changes and thus no significant credit implications. While the coalition agreement indicates some fiscal easing in the form of higher investments in education, research and digitalisation (EUR 6bn), increased social spending (EUR 12bn for families, child and social measures as well as EUR 4bn for social housing) and marginally lower taxes (gradually abolishing the solidarity tax yielding approx. EUR 10bn), the goal of balanced budgets and no new debt remains in place².

However, Merkel IV is critical for the European reform agenda. In Scope's opinion, the new iteration of the grand coalition is different, particularly given the tensions within the parties, which leads to three scenarios for the likelihood and ambition of the European reform agenda:

- The downside risk, in which, despite agreeing on the overall direction, less political capital is spent on European issues and, instead, Germany's coalition parties, and the SPD in particular, now in charge of the Ministry of Finance, will tend to look inwards, not outwards.
- Conversely, the European reform agenda could gain in importance for the Chancellor, possibly also driven by an increasing desire to secure her own legacy. In this scenario, a Merkel/Macron leadership duo could provide the important political impetus Europe needs. This scenario would be viewed positively by Scope for the ratings of all euro area member states.
- Finally, it is also possible that the need to secure a political win on the European policy agenda effectively translates into the agenda moving away from more finance-related issues such as completing the banking and capital markets unions, which would contribute to the resilience of the euro area, towards less controversial regional issues, such as defense and security of external borders.

Overall, Scope believes Merkel IV will be the most fragile administration she has led. The upcoming EU Council on March 22-23, as well as the next one scheduled for June, will provide key signposts of the degree to which this administration is willing and able to invest the political capital to bring about meaningful European-level reform.

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² https://www.spd.de/fileadmin/Dokumente/Koalitionsvertrag/Koalitionsvertrag_2018.pdf

Grand Coalition presents an opportunity to reform the EU

Grand coalition to support EU reforms...

The benign economic backdrop in Europe and the favourable election calendar with less national elections ahead should facilitate EU reform momentum. Moreover, as Scope argued previously, the speed, breadth and depth of further euro-area integration is likely to be greater under a renewed grand coalition than under any other feasible coalition arrangement. Indeed, the coalition deal with the SPD calls for close cooperation with France to strengthen the euro area, increasing funds for economic stabilisation, social convergence and structural reform in the euro area as well as enhancing EU finances with a stated preparedness to pay more into the EU budget.

In addition, the coalition agreement calls for the European Stability Mechanism to be transformed into a European Monetary Fund under parliamentary control, anchored in EU law. Hence, the direction of European reforms is clear and positive. However, the breadth and depth of these reforms might be constrained to a greater-than-previously-expected degree by divisions within the grand coalition parties.

...but divisions within parties risk diverting policy attention

In Scope's opinion, this iteration of the grand coalition is different:

- Previous Merkel-led administrations have eroded the SPD's identity, and Scope views the flip-flopping of the party's leadership to eventually endorse and form Merkel's fourth administration as being driven by the SPD's legacy as the main party of the moderate left, rather than an actual desire to participate in government. Scope notes that despite only receiving 20.5% of the votes (154 of the 709 seats), the SPD extracted strong concessions from the CDU/CSU on policies as well as ministerial posts, securing the finance ministry without giving up the foreign ministry or labour and social affairs ministry. In Scope's opinion, the fact that the party's base remains disheartened, as captured by the lukewarm reception to the announcement of the vote to enter the grand coalition on Sunday, represents a potential stability risk for this coalition. The SPD will need to secure quick policy wins, heightening tensions with the CSU/CDU³.
- At the same time, Merkel's choice of ministers reflects her need to pacify her own MPs, many of whom feel too much ground, on both substance and ministerial posts, particularly the Ministry of Finance, was conceded to the SPD. This feeling is further aggravated as the CSU/CDU faces the threat of being outflanked by the far-right Alternative für Deutschland (AfD), which is now the major opposition party in the Bundestag.

As a result, Scope believes Merkel IV will be the most fragile administration she has led with uncertain consequences for Europe. The upcoming EU Council on March 22-23, as well as the next one scheduled for June, will provide key signposts of the degree to which this administration is willing and able to invest the political capital to bring about meaningful European-level reform.

³ Scope notes that the SPD's crisis is a phenomenon affecting most social democratic parties across Europe: France's Socialists (PS) were ousted by Macron and the far left, Italy's PD was overtaken by left and right-wing populists in Italy; Spain's PSOE is positioning itself against the extreme left (Podemos) and centrists (Ciudadanos).



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