12 September 2017 — Special Comment

German Elections: Low Risk Event but Important for Reform Prospects in Europe

The German federal election takes place on 24 September, with polls indicating a fourth term for Chancellor Angela Merkel. A CDU/CSU-led government could come with four potential variations on coalitions. However, Scope expects that any coalition government led by CDU/CSU will represent relative continuity in Germany's economic policy framework with only moderate changes. However, the election outcome may hold important implications for the European reform agenda, amidst talk of further European integration, including the creation of a European Monetary Fund.

Germany will elect its new parliament on Sunday, 24 September 2017. According to the latest opinion polls, Chancellor Angela Merkel will very likely be re-elected for a fourth term, ensuring a degree of policy continuity under a continued Christian Democratic Union (CDU)/Christian Social Union (CSU)-led government. In Scope's assessment, there are four potential coalition scenarios:

German election coalition scenarios

1) 'Grand Coalition' (CDU/CSU & SPD)
2) 'Jamaica Coalition' (CDU/CSU & FDP & Greens)
3) CDU/CSU & FDP
4) CDU/CSU & Greens

NB. The Social Democratic Party (SPD); Free Democratic Party (FDP); Die Grünen (The Greens).

Scope does not expect the outcome of the German election to impact Germany's sovereign ratings (AAA, Stable Outlook). Germany's 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. While some modest fiscal loosening may materialise post-election, Germany has the fiscal space (with a budget surplus) to boost long-run growth prospects in the face of demographic challenges, and, at the same time, contribute to regional and global rebalancing.

The results of the German election are important for the European agenda: the speed and depth of further euro-area integration will probably be greater under a renewed Grand Coalition with the SPD than under any coalition involving the Free Democrats, who have been calling for stricter compliance with current fiscal rules and the introduction of an insolvency regime for euro area sovereigns. However, any progress in areas for reform – including proposals to transform the European Stability Mechanism (ESM) into a European Monetary Fund – will initially depend upon an alignment of views between France and Germany, with a continued Merkel/Macron leadership structure after this month's election presenting a significant opportunity. However, Scope notes that proposals for significant euro-area reform are still at an inchoate stage and that numerous political compromises will mould the final form of any legislation. In Scope's view, while the euro-area governance framework has been strengthened since the euro area crisis, concrete steps to further enhance the resilience of the Economic and Monetary Union (EMU) would be credit positive, and support the sovereign ratings of euro area member states.

Finally, in Scope's opinion, the election is unlikely to materially change the German government's approach on Brexit. As such, the outcome to Brexit negotiations is unlikely to significantly shift due to the election. Given the concurrent timing of Brexit negotiations and the debate on strengthening the EMU, these issues are likely to become interwoven.

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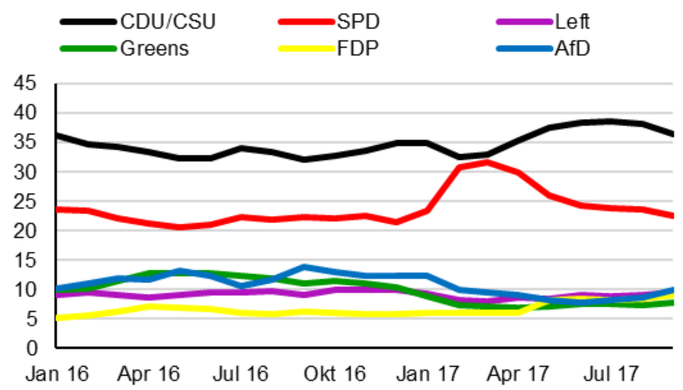
German election overview

Chancellor Merkel to be re-elected for a fourth term

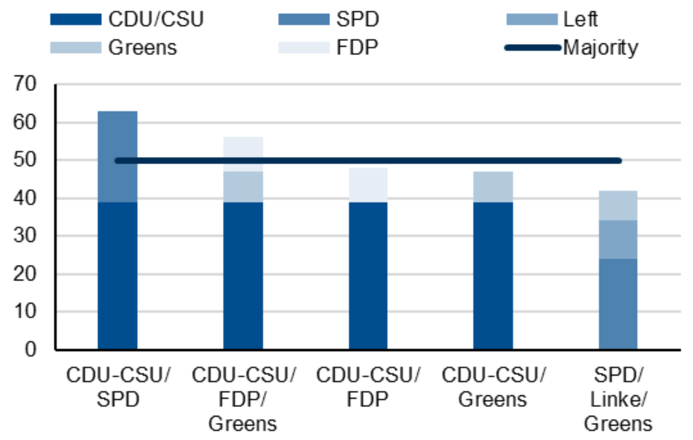
Germany will elect its new parliament on 24 September 2017. While Scope expects that Chancellor Merkel's CDU/CSU faction will remain the largest grouping in the Bundestag, projections that the CDU/CSU will receive around 40% of the seats mean that a coalition will need to be formed. At the present juncture, it is unclear which coalition configuration Ms Merkel will lead. Martin Schulz's Social Democrats are expected to obtain around 25% of the seats. Polls show a very close contest between the remaining four significant national parties: The Greens (Bündnis 90/Die Grünen), the centre-right FDP, the Left Party (Die Linke) and the extreme-right Alternative für Deutschland (AfD), all of whom currently poll at around or just under 10%, well above the 5% threshold required to enter Parliament under the German electoral system.

Figure 1: Voting intentions, poll of polls



Source: Various polling companies, as of 11 September 2017

Figure 2: Likely coalition configurations and % of seats



Source: Financial Times, Wahlrecht.de

Four coalitions are possible

In Scope's assessment, there are four potential coalition scenarios that could emerge, all led by Ms Merkel's CDU/CSU grouping. These are:

i) A repeat of the current Grand Coalition with the SPD;

ii) A Jamaica Coalition[1] including the CDU/CSU with the FDP and the Greens;

iii) A CDU/CSU coalition with the FDP;

iv) A CDU/CSU coalition with the Greens.

Under the expected voting results, only CDU/CSU-led coalitions have a realistic chance for a stable majority, but all potential coalition options are not straightforward, as two of the three possible partners remain mindful of electoral consequences suffered after having joined Merkel governments since 2005. A repeat of the Grand Coalition between the two largest parties faces 'coalition fatigue', which has made a repeat undesirable among a majority of the SPD's wider membership. This could force the SPD's leadership to make a renewal of the Grand Coalition contingent on meaningful concessions. A Jamaica Coalition including the CDU/CSU, the FDP and the Greens would receive an adequate majority, but differences on a number of key policy areas between members of such a coalition remain significant. The CDU/CSU and FDP option is currently polling at just below 50%; however, given the reallocation of seats from those parties not meeting the 5% threshold, a razor-thin majority could still be achieved.

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

Similarly, a slim majority with only the CDU/CSU and the Greens is possible if one or both parties achieve stronger results on election day than present polling indicates.

Finally, while the radical-right AfD is likely to enter Parliament for the first time, Scope does not expect this to materially reshape government policies. The recent decline in public support for the AfD, moreover, indicates some momentary easing in a previous trend of rising support for radical, anti-establishment elements in Europe. The election of more moderate elements has been already seen in Austria, the Netherlands and France over the past year. With the AfD excluded from all plausible coalition scenarios, obstacles to Ms Merkel's euro-area reform plans are more likely to come from within her own CDU/CSU Union or the FDP.

Policy implications for Germany

Next government should represent relative continuity

In Scope's view, the outcome of the German elections will not affect Germany's sovereign ratings[2]. Scope expects that any coalition government led by CDU/CSU would represent a degree of continuity in Germany's economic policy framework with only modest changes reflecting some degree of compromise with the negotiating parties involved.

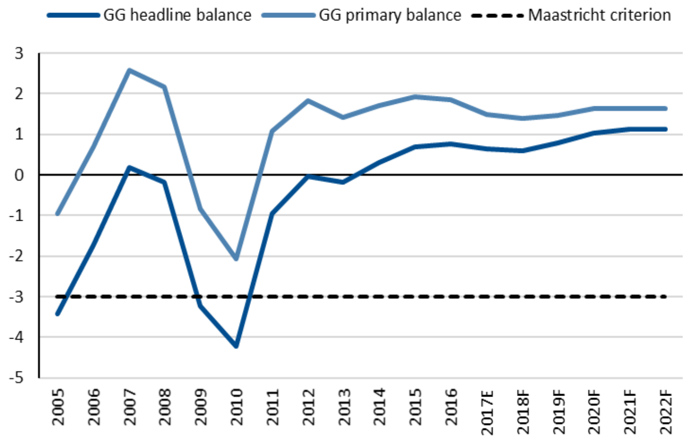
German public finances should remain strong

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, likely to fall below the Maastricht criterion of 60% of GDP by end-2020. Scope does not anticipate any major shift in the direction of fiscal policy after the election, as all parties likely to enter government are committed to the prudent management of public finances, despite some modest fiscal loosening likely to materialise. The scale of any such loosening depends on which coalition is built: the CDU/CSU has called for tax cuts worth EUR 15bn (0.5% of GDP) while the FDP has proposed cuts of twice this amount; the SPD wants an EUR 10bn tax cut but offset by increases in the top income tax rates and higher inheritance taxes. Scope does not expect the scale of fiscal loosening to amount to more than 1% of GDP, ensuring compliance with the balanced budget rule. The resilience of Germany's public finances is moreover bolstered by a constitutional 'debt brake' amendment.

In Scope's view, a balanced approach between tax rate cuts for lower- and middle-income households and greater public infrastructure investment is probable across the various coalition possibilities. An increase in public investment in transport infrastructure, research and development, as well as in renewable 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 in the face of demographic and other challenges, whilst simultaneously contributing to regional and global rebalancing. Budget dynamics will also be affected by any decisions surrounding the raising of Germany's defence spending to 2% of GDP by 2024. Scope expects Germany's public finances to remain resilient, with the budget also buoyed by robust GDP growth and the low interest rate environment.

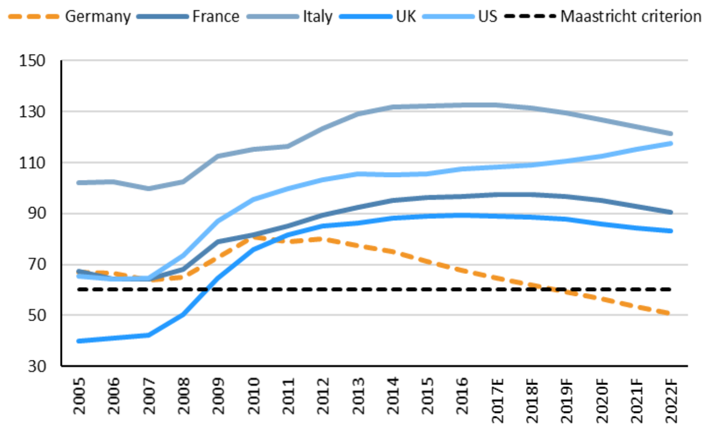
[2] On 30 June 2017, Scope confirmed Germany's AAA ratings with a Stable Outlook. The ratings are underpinned by the solid performance of its highly diversified economy, which has helped to keep public-finance ratios under control and place the debt ratio on a sound downward trajectory. Furthermore, fiscal policies aimed at balancing government budgets have generated an important consolidation track record. On the other hand, the country faces challenges stemming from demographic trends and contingent liabilities. The Stable Outlook reflects Scope's view that the economy will remain resilient and that the challenges faced by the sovereign are manageable.

Figure 3: General government balances, % of GDP



Source: IMF

Figure 4: Debt-to-GDP ratios



Source: IMF

Policy implications for Europe

Appetite for European integration stronger under a new Grand Coalition

The German election will have important implications for the European agenda. Although all the established parties are pro-Europe and endorse reform in the euro area, electoral programmes do differ significantly in the scope and direction of such reform. 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. FDP leader Christian 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 euro area budget have created concern that a coalition involving the FDP may weaken chances of reforms resting on greater solidarity within Europe.

Franco-German alignment will be key to driving reform momentum

While the debate on 'deepening the EMU' has been ongoing[3], the leadership of the euro area's two largest economies – Germany and France – recently gave vocal public support for further concrete steps towards integration. French President Emmanuel Macron has spoken of a common euro-area treasury and budget of several hundred billion euros to cushion asymmetric shocks in individual member states, along with a European finance minister and parliament. At the same time, German Finance Minister Wolfgang Schäuble's comments to transform the ESM into a European Monetary Fund have gained the endorsement of Chancellor Merkel.

Certainly, any progress in these areas will depend on a push from a Franco-German political alignment, where a continued Merkel/Macron leadership structure after this month's election would present a significant opportunity to further the agenda. However, Scope notes that these proposals are still at an inchoate stage and, given differences between Germany and France on the scope, governance and precise goals of such institutions, numerous political compromises would need to be struck. In this context, the exact configuration of the next German government will clearly play a crucial role and influence the debate at the European level between i) alternatives of a greater rules-based or discretionary regime as well as ii) alternatives of greater national or joint liability of member states' outstanding debts.

[3] These include the European Commission's 'Blueprint for a Deep and Genuine EMU' (2012), the so-called Four Presidents' report 'Towards a Genuine Economic and Monetary Union' (2012), the Five Presidents' report titled 'Completing Europe's Economic and Monetary Union' (2015) and the Commission's 'Reflection paper on the deepening of the economic and monetary union' (2017).

In addition, any coalition with the FDP would have to contend with the party's platform to scale back the ESM and introduce a European debt restructuring mechanism. The FDP's position against certain euro area bailouts also raises the possibility for tension within any coalition involving them should Greece require further financial assistance after its existing ESM-financed programme concludes in 2018.

No matter how the proposal for transforming the ESM into a European Monetary Fund evolves, whether by assuming control of fiscal policy monitoring (currently undertaken by the European Commission) or by becoming a form of euro area treasury, the function of a lender of last resort for euro area countries is paramount to Scope's euro area ratings. In this context, Scope will closely monitor the evolving role of the European Central Bank (ECB), and, in particular, the future application of the ECB's unconventional monetary programmes, specifically the Outright Monetary Transactions, which in principle provide a (conditional) backstop with no ex ante quantitative limits to euro-area sovereign markets. This de facto unlimited aspect stands in contrast to the ESM's present maximum lending capacity of EUR 500bn, of which EUR 376bn remain available. In addition, issues such as the completion of the Banking and Capital Markets Union, simplification of and adherence to existing fiscal rules, and coordination of economic policies will also be areas of debate shaping the outlook for the EMU.

In the special comment 'Euro area at a turning point' published on 12 May 2017[4], 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.

What could it mean for Brexit?

Germany's negotiating stance on Brexit unlikely to change

In 'Uncertainties around Brexit challenge UK credit outlook' published on 24 August 2017[5], Scope argued that the two most likely outcomes to current negotiations for the UK's (AA, Negative Outlook) exit from the European Union are a soft Brexit and a no Brexit (or reversal) scenario. This view is based in part on the assumption of an uncompromising negotiating stance from the European Union, placing the UK in the weaker negotiation position.

Some UK government ministers have commented that after elections in Germany, a more cooperative approach to negotiations may come from the new German government[6], and as a result, from European Union counterparties as a whole. This hope rests on the possibility of a new coalition government incorporating the Free Democrats, who support a 'Europe of different speeds'. However, in Scope's view, these hopes are largely misplaced: while a coalition including the FDP may be somewhat more sympathetic to UK concerns, this disparity is unlikely to result in a substantive change in Germany's approach to Brexit. The FDP's Christian Lindner has echoed this opinion in an interview[7].

Given the concurrent timing of Brexit negotiations and the debate on strengthening the EMU, these issues are likely to become interwoven. This state of affairs will provide the next German coalition with the opportunity to significantly shape both the European and the euro-area architecture.

[4] https://www.scoperatings.com/#search/research/detail/154145EN
[5] https://www.scoperatings.com/#search/research/detail/154933EN
[6] Financial Times, 24 August 2017
[7] https://www.economist.com/blogs/kaffeeklatsch/2017/08/christian-lindner-germany

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