

Sunday Wrap

Happy Sunday,

How much do elections matter for policies and markets? It's a question I have been pondering as the attention on next Sunday's German election has heated up among investors across the world. One would hope that the answer is "a good deal", and I do think that's the case in Germany next weekend, but consider this:

When Joe Biden unseated Donald Trump in November, the vast majority of us Europeans were relieved because of the change he had promised - and which he began delivering right out of the starting blocks: Biden recommitted the US to the Atlantic alliance, he brought the US back to the Paris Accord, he opened talks with Iran with a view to re-enter the Iran nuclear deal and he announced a number of impressive fiscal plans, aimed at strengthening the US economy and thereby the world.

Yet, a different sort of reality now seems to be emerging: The fiscal plans include surprisingly modest ambitions on climate change. The travel ban on Europeans has not been lifted even after Europe lifted its ban on Americans, and in spite of the much higher vaccination numbers and lower infection rates in Europe than in the US. The US-led exit from Afghanistan lacked any pretense of, let alone attempt at, coordination with allies. And this past week, the US and UK agreed on a deal with Australia to provide technology for nuclear submarines, replacing with a stroke of a pen the existing Australian-French submarine contract (and pushing back by maybe ten years the date of the first submarine to be delivered). No surprise that most Europeans are now scratching their heads over what actually changed in US policies towards the world, apart from the rhetoric around the delivery.

If the US election led to a degree of false hopes in Europe, no such illusion applies to today's election to the Russian Duma, of course. The outcome of that election is as predictable as they come, and I don't think anyone has any hope that it'll have any impact at all on Russian domestic policies to address its substandard growth rates or recent years' disruptive foreign "spoiler" policies.

So how about the German election next Sunday? The chancellor will, of course, change since Angela Merkel - exceptional in democracies and dictatorships alike - has decided to step aside after 16 years at the helm. And if the opinion polls are anything to go by, the composition of the Bundestag will change some. But will German domestic, European and foreign policies change as well - or will it all be a case of "everything has changed but nothing has changed"?

In today's note, I'll argue that significant changes are likely to come in German policies as a result of the election, but it'll be the reverse of what we have seen in the US: The style of the next chancellor will not be materially different from the outgoing one, and there'll be few - if any - big statements of change, promises or visions. Yet, there'll be potentially substantial shifts in policy nonetheless, particularly with respect to public investment as well as towards Europe.

The agenda:

- The election practicalities and what it'll take to change the constitutional debt brake.
- The latest polls and what they tell us about the next government coalition.
- What it'll mean for key policies.
- I'll summarize what I see as Angela Merkel's legacy, highlighting where the next government will remain in her footsteps and where it'll likely deviate.

1. Election practicalities.

Germany goes to the ballot box next Sunday to elect a new Bundestag. In Berlin and Mecklenburg-Western Pomerania (that's the Northeastern state on the beautiful Baltic coast, in which Angela Merkel was elected for all these years), there'll also be elections for the state assemblies.

In the federal election, each citizen has two votes. The first vote is cast for a specific candidate, and the candidate with the most votes, whatever the relative share, is elected a member of the Bundestag. The second vote is cast for a political party (no requirement of political consistency between the two votes), which will then allocate its total party votes in each state to its candidates on the party list, in the order of their place on that list. In case of more party delegates being elected directly via the first vote than the party itself gets votes for, the so-called "excess mandates" are triggered: All other parties will then receive additional seats proportionally to maintain their shares of the second vote. As a result, the total number of elected delegates to, and the composition of, the Bundestag are effectively determined by the second vote.

Members of the upper house, the Bundesrat, are not elected directly. The governments of each of the 16 states appoint 3-6 delegates, depending on size, who all must vote uniformly in accordance with the decision of the state government they represent. Since all 16 states are ruled by coalitions, this means – practically - that in cases where a state government cannot agree on a common position on the issue in front of the Bundesrat, the delegates of that state will abstain. As a result, given the existing composition of state governments, no single party can strategically block Bundestag decisions when they come to the Bundesrat, as has been the case in the past. The two state elections next Sunday in Berlin and Mecklenburg-Western Pomerania – both of which are governed by left-leaning coalitions and are polled to continue to be so - will not change this state of affairs in the Bundesrat.

Therefore, if, against expectations, the federal election should result in the required two-thirds majority in the Bundestag in favor of changing the debt brake in the constitution, then the Bundesrat would be very likely to agree as well because the political leaders of the major parties would have coordinated in advance such an important decision with the state prime ministers of their party.

2. Opinion polls and what they indicate about the next government coalition - and my guess how it'll play out.

The election campaign has so far seen the following three big movements in party popularity:

First, following the Greens' decision in mid-April to nominate Annalena Baerbock as its chancellor candidate, the party saw an astronomical rise in popularity, briefly to become the most popular party, followed by a cooling off to their present roughly 16% support, which is still a nearly doubling from the last election. A number of political mistakes early on contributed to the decline from the highs. A report this past week by the Institute for Strategic Dialogue argues that it was also caused by a disproportionate amount of online abuse, disinformation and sexist attacks, compared to Armin Laschet and Olaf Scholz.

Second, the CDU has suffered a dramatic collapse in support to its weakest point in post-war history, mostly caused by a series of missteps by chancellor candidate Laschet, not least being caught on camera laughing during a solemn ceremony for the victims of flooding in his home state of North Rhein Westphalia. But the drop in the CDU's popularity also reflects its internal struggle between the centrist line developed by Merkel, and supported by Laschet, and the more conservative wing pushed by e.g. Friedrich Merz, as well as the openly hostile process to elect its new leader, followed by Laschet clinching the chancellor candidate position against the CSU's Markus Söder.

Third, the clear beneficiary of these two trends has been the SPD, which is now polling to become the biggest party in the Bundestag, driven by its chancellor candidate Olaf Scholz, who opinion polls indicate is regarded as the closest option available to continue the vastly popular Merkel's policies and style. The two (of three) TV debates between the three candidates have seen Scholz as the winner by a good margin with Baerbock doing slightly better than Laschet. The third and final debate will take place tonight but is unlikely to change the general picture.

The average of the past ten days' opinion polls suggests that SPD will receive about 25%-26% of the votes, CDU/CSU will get 21%-22% of the votes, the Greens about 16%, FDP and the AfD each roughly 11% and the Left 6%-7%. However, an

unusually high share of the population (roughly 40%) says that they are undecided – and an equally unusually high share of the population (50% in some regions) has applied for postal votes, probably because of COVID. Four years ago, 29% of votes were postal votes.

Sticking with opinion polls and after adjusting for the small parties which will fall below the 5% threshold, there'll be only one mathematically possible two-party coalition, namely another grand coalition of CDU/CSU and SPD, but this time with the SPD as the senior partner. It seems virtually impossible to imagine that the CDU/CSU would agree to become the junior coalition partner, so I'll rule that one out.

As a result, the next government almost certainly will be a coalition of either SPD, the Greens and FDP (the so-called Traffic Light coalition with 57%-58% of the votes) with Scholz as chancellor, or of CDU/CSU, the Greens and FDP coalition (the so-called Jamaica coalition with 52%-53% of the votes) with Laschet as chancellor. My (entirely non-scientific) guess is that there is a roughly two-thirds probability for the former, and a one-third probability for the latter – with a tiny carve-out for any alternative, including a “Red-Red-Green” coalition of SPD, Greens and the Left.

The one thing that seems a virtual certainty is that the Greens will be the second biggest party in the next government coalition, and (almost as certainly) that the FDP will be a part as well. The only real question is whether those two parties can agree on which party to support to take the chancellorship. On policy, the Greens should favor a coalition with SPD, while the FDP should favor a coalition with CDU/CSU. But personalities, the juggling for key positions and concerns about the narrative for the electorate (with a view to the next election) also play important roles, of course.

In my understanding, whether Scholz or Laschet ends up leading the next government will largely depend on whether a Red-Red-Green coalition turns out to be a mathematical possibility, as the polls presently suggest will be the case (with 52%-53% of the votes); hence my 2/3 probability. It's widely known that Scholz, a committed Atlanticist and fiscal conservative, would be extremely reluctant to form a coalition with the Left, even after the Left outlined a series of major concessions. Part of his reluctance is likely driven by his determination to keep the left wing of his own SPD at bay. Nevertheless, the sheer existence of a potential Red-Red-Green coalition (and Scholz' deft refusal to rule it out) is expected to lead the FDP to switch sides and agree to a Traffic Light coalition so as to be a “safeguard on taxes and business policies”, and hence “in the national interest”, their narrative will go. As Ralph Bollmann persuasively argues in yesterday's Frankfurter Allgemeine Zeitung, the FDP is already busy preparing the ground for such a shift. His piece is here: [Die FDP und die Wirtschaft](#)

Of course, once negotiations begin, the FDP will no doubt be encouraged by the CDU to jointly offer substantial concessions to the Greens to agree to a Jamaica coalition – concessions which would have to leave more Green policy in a Jamaica coalition agreement than what SPD and the Left would put on the table for a Traffic Light coalition. Either way, as far as I can judge, the Greens will get a very large part of their policies into the next coalition, and will become powerful in the next government.

In this context, if Scholz becomes chancellor, he may feel invigorated by the impressive recovery of the SPD that he has led, but with only some 25% of the votes and two coalition partners, he will still find himself in a relatively weak position. His position will be further constrained by the very high probability of the CDU being driven into a hard (and clearly right-of-center) opposition under a new leader, probably Merz. This will surely include hard opposition to any change in the constitution on the debt brake, and noisy opposition to any gradual fiscal path back to the deficit stipulated by the debt brake.

For Laschet to become chancellor, he'll have to square the circle between, on the one hand, his own party's right wing, CSU and FDP, and, on the other hand, the substantial concessions needed to bring the Greens on board – no easy task. Part of this process might very well become a referendum among CDU members on a draft coalition agreement, the outcome of which is far from certain given the deep divisions within the party.

As a result, it'll likely be at least end-November before Germany has a new government, but more like end-December, if not even early 2022. For Germany, even a relatively long delay does not matter that much. Merkel will remain as caretaker chancellor – and if she is still there by mid-December, she'll surpass Helmut Kohl, who oversaw the unification of Germany in 1990, as the longest serving German chancellor (unless you include Otto von Bismarck, who ruled for nearly 23 years in the late 19th century and unified Germany). For Europe, the length of coalition negotiations will be more important because the window for any important decisions, including the fiscal rules, will close (temporarily) in early spring when the French election campaign heats up.

3. What to expect on the policy front.

I don't mean to ignore the many very important policy areas facing any government, but I'll focus here on the issue of the debt brake as it'll critically impact public investment, and hence Germany's commitment to climate change. In turn, it'll also impact the debate about the EU's fiscal rules as the next German government will – presumably – take its own handling of public debt rules to the European table. I'll also briefly touch on prospects of longer-term German commitment to the Europe.

Among the likely coalition partners, only the Green party advocates a change to the constitutional debt brake. This is partly to finance their call for EUR 500bn in climate change investment over the next ten years (about 1.5% of GDP per year). The SPD has been less explicit, but I understand that they would be looking for something close to 1% of GDP in green investment. A think-tank close to Laschet has called for green investment of virtually the same size as the Greens, which Laschet first endorsed, only to withdraw his support after being attacked by the right-wing of his own party, including Merz. The FDP also calls for sizable green investment, but like the CDU, to my knowledge they have not put a number on it, but rather emphasized the idea of creating incentives for the private sector to do the investments (while, ironically, criticizing the ECB for too accommodating monetary policies.)

To remind you, during the past ten years, gross public investment has declined sharply to just 3% of GDP throughout the OECD (measuring before the pandemic messed with all these ratios). In Germany it dropped to roughly 2%. In net terms, however, Germany public investment has been virtually zero for the past 10-15 years, although with a slight increase during the past couple of years. Gross fixed investment (i.e. private plus public) runs at about 20% of GDP in the OECD, including Germany. To me, this tells two stories about the future of green investment: The public sector has to do a lot more, but without the private sector it won't be enough, and for that you'll need incentives – both in the form of carrots and sticks. A new Bruegel paper, presented to the EU finance ministers, estimates a need of 2% of GDP in additional investment each year for the next decade, of which 0.5%-1.0% would need to be public investment. Here: [A green fiscal pact: climate investment in times of budget consolidation](#)

To further complicate the math of deficit reduction and additional investments in Germany, CDU and FDP advocate tax and spending cuts, while SPD and the Greens call for higher taxes (on higher income as well as a wealth tax), tax cuts for lower income groups and additional spending.

There are three ways out of this mathematical dilemma:

First, you can change the constitution to either abandon the debt brake or carve out space for, e.g., climate change investment, and maybe the associated cost of the change.

Second, you can create an extra-budgetary fund or a SPV-like construction in which the government injects debt-financed capital for such dedicated investments, possibly geared with private capital. Or, case-by-case, the government can inject capital in, e.g., the Bundesbahn and the like with instructions to invest in the green transformation. By injecting (debt-financed) capital in SPV or the like, the government's net debt does not change, and the debt brake is therefore not triggered (but depending on its construction, they may trigger concerns from the European Commission about state aid.)

Third, you can "revisit" the numbers which drive the operational aspects fiscal policy of the debt brake in a way that finds room for more investment. This has been proposed by Philippa Sigl-Glöckner et al of the Dezernat Zukunft think-tank. In a new paper, they have pointed out that a more realistic estimate of German potential growth would raise what the constitution refers to the "normal" situation over time, and that would create sizable space, within the existing debt brake, for, e.g., additional investment. Their paper is here in German; an English version is forthcoming: [Wird die Konjunkturkomponente der Schuldenbremse in ihrer heutigen Ausgestaltung ihrer Aufgabe noch gerecht? Analyse und ein Reformvorschlag](#). A broader paper, in English, on a new fiscal policy by Sigl-Glöckner et al from earlier this summer, which includes the (appropriate) call for an adjustment of the calculation of potential output is here: [A new fiscal policy for Germany](#)

Without a doubt, changing the constitution would be the honest and most transparent way of dealing with the dilemma, but my guess is that it'll remain politically impossible to do, particularly under a Scholz government with a hostile CDU in opposition, blocking (along with the AfD) the government from reaching the necessary two-thirds majority. Ironically, a Laschet government heavily influenced by the Greens (and with a curtailed right-wing of CDU) might just be able to get it done, because the SPD-in-opposition would have a harder time voting against it.

Either way, my money is on a significant lift in German public investment in the years to come, maybe of close to 1% of GDP, even if – most likely – it'll come via somewhat opaque fiscal engineering.

While not first-best, it'll still be good for Germany (and Europe), but it'll significantly weaken Germany's stance in the upcoming negotiations on the return of – and in what shape - the EU's fiscal rules. The ironic good news here is then that the handful of small countries, including the Netherlands and Austria, which have publicly called for a return of the rules as they are, would lose the chance of getting a heavyweight on their side of the table. I'll be back another day with much more on the EU's fiscal rules.

Beyond the relatively immediate issue of fiscal rules, I'll suggest that the next German government will, on balance, turn more committed to Europe and further integration than in the past, mostly because of the likely substantial increase in influence by the Green party.

4. Merkel's legacy: What stays and what goes.

Plenty has been written about Angela Merkel and her legacy by people much better placed than I am to understand the full picture. The best I have read on what formed Merkel's thinking and values is the chapter on Merkel in Cerstin Gammelín's new book on the "underrated East Germans" ("Die Unterschätzten"). The best English-language portrait of Merkel and her political legacy is – in my opinion - Jeremy Cliffe's *The Fateful Chancellor* in *The New Statesman*. Both are highly recommended.

Here I'll address three areas with a view to suggest where the next government will stay in her footsteps and where it'll divert from recent years' path:

First, the widely-held claim that Merkel has been "a manager without a vision" overlooks a profound and perfectly valid view of life: It seems to me that Merkel quite simply acknowledges that the future is so uncertain that all you really can do is to manage, and shape, events as they emerge. In his piece on Merkel, Jeremy Cliffe quotes historian Timothy Garton Ash's reference to Bismarck's apparent dictum: "The statesman's task is to hear God's footsteps marching through history, and to try to catch on to the coat-tails as he marches past." The fall of communism and of the Berlin Wall, and hence the disappearance of the country in which Merkel grew up, provide a good example of the unpredictability of life. It has no doubt shaped her outlook and *modus operandi*.

Indeed, the dislike of grand visions has been a recurrent theme of German chancellors and is unlikely to change in the foreseeable future, even though Scholz' and Laschet' roots in Hamburg and Aachen, respectively, gave them front line positions to observe and benefit from European integration – while watching the historical event of German reunification from the comfortable side of history.

Importantly, however, Merkel's dislike of grand speeches did not stand in the way of big - indeed visionary - decisions when "God marched by", or when the world threw her a curveball. For example, the 2011 Fukushima nuclear disaster in Japan triggered the German *Energie Wende*, which included the end of German nuclear power plants. (Personally, I'm not sure that was the right decision in light of today's climate debate). In 2015, when human disaster in the Middle East caused millions of people to flee their homes, Merkel opened the German borders to a million people, dismissing the critics with her "Wir schaffen das". A few years later, someone close to her explained it to me as one of her easiest decisions, driven simply by her Christian beliefs. (My view is that it was one of the finest moments of any politician in many years). And early last year, as the pandemic swept into Europe, Merkel agreed with Macron on a EUR 500bn common European debt issuance (later boosted to EUR 750bn) to help the hardest hit countries, sweeping aside the traditional German reluctance (and that's put politely) to European common debt in size - and this by a chancellor who never really had the EU in her DNA. (My view is that this was a game-changer in European integration.)

Second, Merkel – and Germany – is widely criticized, particularly in the Anglo-Saxon world, for a foreign policy which is seen as excessively driven by commercial interests, particularly when it comes to China and Russia. Yet, such criticism overlooks the possibility of a credible alternative to confrontation.

When Willy Brandt launched his "Ostpolitik" towards the Soviet Union towards the end of the 1960s, it was widely dismissed among the Western allies, but there is little doubt today that the engagement that grew out of that policy helped inform the general population in the Soviet Union and Eastern Europe about life in the West, which clearly contributed to the end of communism and the Cold War. Merkel's policy towards China and Russia is almost certainly informed by that experience. Whether it'll be successful – and lasting - remains to be seen, but to dismiss it as driven solely by commercial interests would be a misunderstanding.

This policy of commercial engagement as a way of exercising soft power is unlikely to change materially in the next German government, although the Greens have been explicit about a desire to have foreign policy being directed toward more human rights concerns. This may lead to more noise in this direction if Baerbock (or another Green) becomes the next foreign minister, but with foreign policy, particularly towards China and Russia, increasingly directed from the chancellery, I doubt that we'll see a measurable change in actual policies.

Third, German economic policies have fallen short of what they could – and should – have been during these past 16 years. Indeed, much of Germany's economic success during the Merkel years is the result of the wide-reaching labor market reforms under her predecessor, Gerhard Schröder, as well as of European integration.

I have two key concerns about the Merkel era's economic policies: First, the lack of German public investment during the past many years has, as the only major OECD country, led to a decline in the German public sector capital stock in even nominal terms. Investment was sacrificed to other priorities, including pension increases, while constrained by the misinformed political obsession with the Schwarze Null and the constitutional Debt Brake on fiscal policy. As a result, German potential growth is now considerably lower than it should have been.

Second, the very limited reform of the German financial system, particularly of banking and its protected state-underwritten savings banks, has not only limited German growth, but has also blocked critically needed European financial sector reform and integration.

These misguided policies were not designed by Merkel, of course, but rather the product of complicated coalition agreements and vested interests, reflecting deep divisions on these issues inside her own political party and across the political spectrum. But in my book, it was a battle she should have taken, just like the confrontation she took at the critical moment when her finance minister, Wolfgang Schäuble, wanted to push Greece out of the eurozone.

As I discussed above, policies in these two areas, particularly with respect to public investment and Europe (and hopefully the financial sector) are likely to change under the next government. The extent and exact shapes will depend on which coalition rules Germany.

And on that note, I wish you a good Sunday afternoon from the great city of London. In a couple of days, I'll be back in my beloved Kiez in Berlin's Mitte.

Best

Erik

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