

# Germany heads to the polls for a crucial election



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Germany will hold federal elections on Sunday 23. This is a key election, particularly in the current context of sluggish growth in Europe's largest economy and the significant geopolitical challenges facing the European Union.

Polls suggest there should be little surprise about the election's winner: the centre-right CDU/CSU, with Friedrich Merz likely to become the next Chancellor. However, uncertainties remain about the future composition of Parliament, which could have major implications for the next government, the German economy, and Europe as a whole.

Below is our preview of what is at stake in this election for investors, what to look at when the first results come out, and the implications for Germany and Europe's future.

### A key economic issue at stake: fiscal policy and a potential reform of the constitutional debt brake:

- ▶ Since 2009, German public finances have been framed by a constitutional debt brake that limits annual structural public deficits to 0.35% of GDP. This rule has helped stabilise German public debt, reducing it from 80% of GDP in 2010 to 63% in 2024. In comparison, without a similar debt brake, France's public debt-to-GDP ratio surged from 85% to 112% over the same period.
- ▶ While effective in controlling public debt, the debt brake has become increasingly inconvenient in recent years due to Germany's prolonged economic slump, triggered by a combination of external shocks, such as the cutoff of cheap Russian gas supply, lower demand for German industrial goods from China, and automaker challenges due to the transition to EVs.
- ▶ Fiscal support could have mitigated the negative impact of these shocks on economic activity, but the debt brake acted in this case as a straitjacket, preventing the government from stepping in to support an ailing economy.
- ▶ The CDU/CSU, likely to lead the next government, has opposed a reform of the debt brake so far but may be open to some easing once in power. The SPD and the Greens, likely coalition partners, are in favour of reforming the debt brake to boost public investment in infrastructure, education, and energy supply.
- ▶ A CDU/CSU-led coalition with the SPD and/or the Greens could therefore push for a reform allowing more public spending in these areas, provided it remains within the boundaries of sound public finance management (the CDU/CSU agenda includes cuts to unemployment benefits and subsidies).
- ▶ Public investment could also be financed via off-budget funds dedicated to defence or infrastructure spending.
- ▶ Targeted increases in public investment could support a rebound in German economic growth after two years of GDP contraction. Though the impact on GDP growth may not fully materialise before 2026, it could already help stimulate business and household sentiment in the second half of this year.
- ▶ However, both a reform of the constitutional debt brake and the creation of off-budget funds require a two-thirds majority in Parliament.

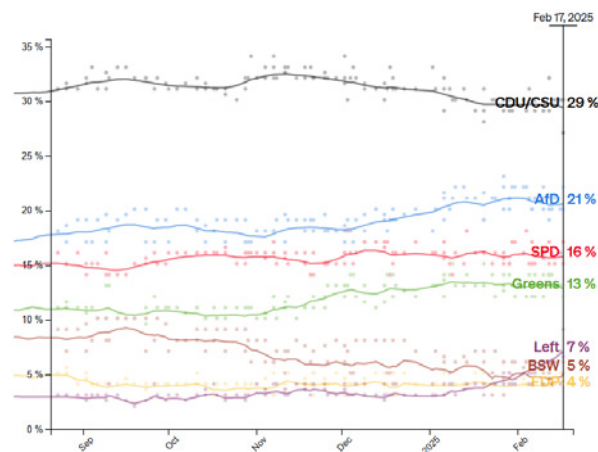
- ▶ As all fringe parties and the fiscally conservative FDP oppose a reform to the debt brake, one key question in the election outcome will be whether these parties can form a combined blocking minority (over one-third of the Bundestag seats). If so, the prospect for significant fiscal stimulus could be questioned, which would be a negative signal for Germany's growth prospects.

### What to look for in the elections' results?

#### ▶ The score of the BSW and FDP parties, and the aggregate weight of parties opposed to fiscal easing

- ▶ The German electoral system requires a party to gather at least 5% of the votes to enter the Bundestag.
- ▶ Based on the latest polls, beside the three mainstream parties (CDU/CSU, SPD, Greens), two fringe parties are set to have a representation in the Bundestag: the AfD (21% of voting intentions in the polls) and The Left party (7%). Two other parties are currently around or just below the 5% threshold in the latest polls (leftist party BSW 5% and fiscally conservative FDP 4%).
- ▶ Whether the BSW and/or FDP parties reach the 5% threshold in the election and can enter the Parliament or not will be key for the prospect of a debt brake reform. If they do enter the Bundestag, the likelihood of having an aggregate one-third blocking minority in the Bundestag will be significant, lowering prospects of future fiscal support to the economy.

#### ➔ Watch for the results of those four parties that will oppose the future government, and for their aggregate weight in the Bundestag:



#### ▶ The relative weights of the three large mainstream parties

- ▶ The CDU/CSU party is widely expected to win the elections (29% in latest polls) and lead the next government with Friedrich Merz as next Chancellor.
- ▶ However, Friedrich Merz will have to build a coalition and negotiate with the SPD, and possibly the Greens, to form a government. The negotiations for a coalition government will start after the elections and the scores of the potential partners will shape the balance of powers within the coalition.
- ▶ A strong result by the CDU/CSU and a two-parties coalition with the SPD or the Greens would give the

leading party a strong hand in implementing some of the key economic reforms of its agenda, such as tax cuts and public spendings' reductions. A reform of the debt brake could still be contemplated, but with a limited increase in public deficits.

- › Conversely, a three-parties coalition with better-than-expected results by the SPD and the Greens would give them more weight in the future government and likely lead to more profligate fiscal policies to fund their agenda of infrastructure investment, childcare facilities and social housing.

➔ **Watch for the scores of the CDU/CSU, the SPD and The Greens compared to the recent polls, to gauge the composition of the next governing coalition and the strength of the CDU/CSU leadership in it.**

▶ **The answers to those two questions will be crucial for the outlook of Germany**

- › A stable coalition with a clear CDU/CSU leadership, combined with no blocking minority for opposition parties, would allow the next government to deploy a comprehensive agenda of tax and public spendings cuts, combined with targeted public investments in key areas such as defence or infrastructures.
- › Conversely, a coalition led by the CDU/CSU, but with strong representation for the SPD and the Greens, would pave the way for less tax cuts than expected and more public spendings, assuming the debt brake is reformed.
- › A one-third blocking minority by opposition parties would further constrain the future government in combining the necessary increase in defence spendings with measures designed to support domestic activity.

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▶ **The outcome of the German elections is also crucial for Europe at large**

- › In a period of intense economic and geopolitical challenges, Europe badly needs leadership and initiative from its largest economy. Talks to form a coalition usually last several weeks or months in Germany after an election, but the sooner a new government will be formed, the faster Germany will be able to lead Europe's efforts to address its geopolitical and economic challenges.

- › If the elections produce a fragmented Bundestag with several fringe parties being represented, it will significantly hamper the capacity of the next government to take the bold decisions required by the economic situation in Germany and the geopolitical challenges facing Europe (Ukraine, US tariffs...). Political instability in Germany, combined with a fragile political situation in France, would create a potential leadership vacuum in Europe at a time when leadership is most needed.

- › Not only does Europe need to agree on views and actions around Ukraine and the responses to potential US tariffs, but also on the huge internal economic challenges pointed out by Mario Draghi last year. The former ECB president reiterated this week his alarm call for urgent European action, and this requires Germany's participation and leadership. ECB President Christine Lagarde and European Commission Ursula von der Leyen had also issued a joint call for profound changes earlier this month. Europe has no choice but to act and take bold and likely difficult decisions. For that, it needs an operational and solid government in Germany. This is what is at stake in Sunday's elections.

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