

Reflections

Monday, September 27, 2021

Tug-of-war for Greens and FDP to win post of chancellor

As expected, the election in Germany – the largest economy in the European Union and Sweden's largest trading partner – was a success for the Social Democrats (SPD) and the Greens, but their margins shrank during the final campaign surge. It will thus be tricky once again to put together a coalition with a parliamentary majority. The party that will lead the government and appoint Angela Merkel's successor as federal chancellor will need the support of two other parties to secure a majority. After major losses by the leftist party Die Linke, either the Christian Democrats (CDU/CSU) or the SPD must work together with the Greens and liberals (FDP) to achieve a majority in the federal Parliament. Since the Greens have more in common with the SPD, and the FDP more in common with the CDU/CSU, the outcome is uncertain. But since the SPD won the most votes, its candidate Olaf Scholz is most likely to take over as chancellor, though it will take time to put a new government in place. With the FDP as part of such a governing coalition, major changes in economic policy are unlikely. In the following 11 questions and answers, we navigate through some key points about Sunday's election.

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1. Who were the winners and losers in this election?

Over the past year we have seen major shifts in German voter support, driven in part by the political blunders of various party leaders. Since the summer, the Social Democrats (SPD) have gained ground, but by less than voter surveys indicated a few weeks ago. Increased support for the Greens will give that party a key role in putting together a majority government, since a continued grand coalition between the CDU/CSU and the SPD appears unlikely. Despite a minor rebound in the final campaign surge, the CDU/CSU suffered a stinging election loss – 9 percentage points – for the worst election outcome in party history. The leftist party Die Linke also suffered a major decline in support, falling to just below the 5 per cent minimum to gain seats in the federal Parliament (Bundestag) and thus forfeiting any role in the coalition-building process.

Historical election results and preliminary 2021 outcome

Per cent of votes

	2013	2017	2021*
Parties			
CDU/CSU (Christian Democrats)	41.5	33.0	24.1
SPD (Social Democrats)	25.7	20.5	25.7
Die Grünen (The Greens)	8.4	8.9	14.8
FDP (Liberals)	4.8	10.8	11.5
Die Linke (The Left)	8.6	9.2	4.9
AfD (Alternative for Germany)	4.7	12.6	10.3
Others	6.3	5.0	8.7

Source: Statistics Sweden, SEB; * According to preliminary election figures

2. What have been the main issues in the campaign?

Climate and environmental issues have naturally received heavy attention, especially after this summer's flood disasters. For a long time, the Greens seemed positioned to benefit even more from the fact that environmental issues have become more important than migration issues in the eyes of voters. The party has also projected

itself as a general force for political renewal. But a series of mistakes and "affairs" caused the Greens, especially party leader Annalena Baerbock, to lose momentum in the election campaign.

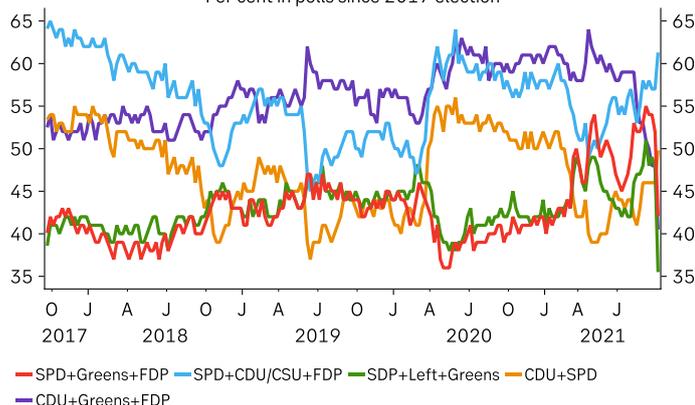
With Angela Merkel now stepping down after 16 years as chancellor, the question of who enjoys the greatest public confidence as a potential leader of the country has become increasingly important. The role of the chancellor as a source of national cohesion is also especially vital. The office has demonstrated impressive continuity; Merkel is now close to surpassing Helmut Kohl's record-long tenure as leader of Germany. If we also include Konrad Adenauer's long period as chancellor in the earliest years of West Germany, these three CDU leaders have held office for 46 of the Federal Republic's 72-year history. Partly due to the campaign mistakes of his main competitors – Baerbock and CDU leader Armin Laschet – SPD leader Olaf Scholz has successfully presented himself as the person who stands for the greatest continuity, having served as Merkel's finance minister and vice chancellor. The general leftward shift in international politics has probably favoured the SPD. In an evenly balanced political situation, Scholz's experience and role as the candidate of the biggest party may be crucial in the negotiations on a new governing coalition.

3. What are the most likely governing coalitions?

The new German political landscape opens the way to several alternatives. It is not self-evident that the biggest party should lead the government, or even be part of it. But after several grand coalitions between the CDU/CSU and SPD, there is a widespread desire for change. In its 2017-2021 term of office, such a grand coalition emerged once again as an emergency solution after other constellations failed. Until now, the CDU/CSU has always dominated the coalitions that it joined as the largest party and has been rewarded with the post of chancellor. It is thus unlikely that the CDU/CSU is interested in a supporting role in government after their sharp decline in the 2021 election. The most likely result is therefore

that the SPD and the Greens will form the core of the next government. But they will also need the support of the liberals (FDP), who have more in common with the CDU/CSU. For example the FDP has a stricter view of fiscal manoeuvring room, both in Germany and at the EU level. This may pose obstacles to the investments in social welfare and the environment that the SPD and the Greens have pledged in their election campaigns. Although the CDU/CSU is battered following its election losses, it has signalled an interest in leading a coalition with the FDP and Greens. These parties work together at the state level, but it would be harder for them to reach a deal at the federal level. Both of the major parties therefore face problems in putting together a majority including the Greens and FDP, but the election outcome still gives the SPD the best chance.

Greens and FDP key to German coalition-building
Per cent in polls since 2017 election



Source: Wahrecht.de, Macrobond, SEB

4. How will economic policy be generally affected?

One clear pattern during the post-war period is that German government policies have been characterised by very great continuity. Ideological differences between the two biggest parties – the CDU/CSU and SPD – have been relatively small in terms of economic policy. The CDU/CSU has been rather firmly anchored in the pragmatic middle ground and has often been unsympathetic towards neoliberal experiments carried out in English-speaking countries and elsewhere. During the previous two periods of SPD-led governments, economic policy was also fairly centrist. For example, during the Willy Brandt/Helmut Schmidt era (1969-1982), the Bundesbank's tough fight against inflation, including acceptance of slightly higher unemployment, began to deviate clearly from other countries' fruitless attempts to achieve more ambitious "full employment" goals with the help of fiscal fine tuning. The shift compared to earlier CDU-led governments instead mainly concerned tentative efforts to create ties between West and East Germany. During Gerhard Schröder's period as chancellor in 1998-2005, the German labour market underwent the so-called Hartz Reforms. This brought an end to the stagnation that had followed German reunification and the country's competitiveness problems after the introduction of the euro. Unemployment fell sharply, but at the same time the reforms led to widening economic gaps.

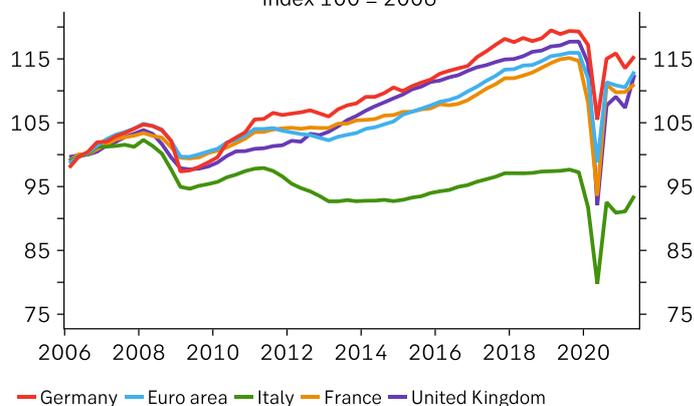
This time around, the general debate climate in the Western world – with a focus on economic gaps – is probably one reason why the SPD is tacking a bit further left than usual. For instance, the party has announced that it would like to reintroduce some form of wealth tax and increase the inheritance tax. Meanwhile the Greens want to raise taxes on the highest incomes. The SPD and Greens can probably agree on economic policy without any divisive battles. But with the FDP as the third coalition partner, we do not believe that government policy will move sharply to the left. The same is true if the CDU/CSU manages to put together a majority. In that case, the Greens would instead guarantee that policy will remain middle-of-the-road.

5. More aggressive stimulus in Germany and the EU?

The increased voter support for the SPD and Greens nevertheless suggests that Germany will pursue somewhat more expansionary policies, including investments in social welfare systems and the environment, partly funded by higher taxes. But the country's fiscal policy framework, which stipulates that the federal deficit must not exceed 0.35 per cent of GDP over an economic cycle, poses obstacles. Such regulations have been put on hold until 2023 due to the pandemic, but the Greens – and probably also the SPD – would probably consider bending the rules further. Here too, the FDP's hard line could be expected to slow such developments. Yet it is likely that green projects and certain other investments may be viewed as necessary efforts to meet the challenge of cutting emissions and making the economy environmentally safer. Such arguments for extending the pause on normal fiscal rules for another while would be hard for the FDP to oppose, although the party will probably block some ideas, reforms and tax hikes.

At the EU level, too, fiscal policy rules have been put on hold during the pandemic. The message from Brussels, the European Central Bank (ECB) and other international organisations has been to be careful not to withdraw stimulus measures prematurely. Fiscal policies in the EU will inevitably tighten in the future as crisis responses fade, but based on the experience of the 2010-2012 euro crisis, the authorities will exert less pressure on EU countries to lower their budget deficits quickly. A red-green German government will contribute to a gentler approach by EU member states. Meanwhile attitudes towards the EU may be important in the negotiations to form a new government. The FDP's restrictive attitude and caution about letting the EU take over more areas of responsibility have previously made it difficult to persuade them to join coalitions.

GDP during Merkel's period as chancellor
Index 100 = 2006



Source: U.K. Office for National Statistics (ONS), French National Institute of Statistics & Economic Studies

6. How is the German economy doing?

The German economy has performed relatively well during Merkel's tenure as chancellor. However, some of its success can be attributed to changes like the Hartz reforms, which were implemented under previous governments. Germany occupies the top spot if we look at GDP growth since 2006 in the four largest euro area countries, and although manufacturer faces headwinds due to post-pandemic problems, the economic outlook appears promising. The challenge for the next government will be to further improve and adapt the economy. In their recent reviews of the German economy, the International Monetary Fund (IMF) and the Organisation for Economic Cooperation and Development (OECD) have addressed such matters as the need for investments in digitisation and infrastructure, training to reduce bottlenecks and research and development to boost productivity. Germany's export dependence is one reason for its cautious approach towards disturbing relations with countries like Russia and China; The Greens have pursued more heated rhetoric towards these countries, both on environmental and

human rights issues. It remains to be seen whether the party will stick to these positions even if it joins the government.

7. Will this new political situation affect the ECB?

The economic recovery is progressing, but the euro area is generally lagging behind the United States and the Nordic countries. The ECB has just reformulated its inflation target, underscoring the need for long-term stimulus. A more expansionary German fiscal policy could marginally ease the burden on the ECB, thereby reducing the need for ultra-loose monetary policy. But in general, the election outcome is unlikely to have any major impact on ECB policy in the near future. German opposition to excessive central bank expansion has mostly been in the form of various types of legal proceedings, focusing on links to the German constitution. In addition, the export-oriented German economy is dependent on the rest of the euro area getting back on its feet. It is thus in Germany's interest to avoid the internal conflicts that characterised the euro crisis. Continued low ECB interest rates and quantitative easing are thus important.

8. How will financial markets be affected?

Although a regime change now seems likely in Germany, we find no strong reasons for market turbulence. The initial market reaction also seems to reflect some relief that Die Linke's major downturn has decreased the risk of a sharp left turn in economic policy. In countries with stable fundamentals, it also normally takes very severe political uncertainty to trigger any major financial market movements. In the last German election in 2017, the situation was more uncertain, with Donald Trump having taken office as US president and the Brexit referendum relatively recent. But even though the formation of a German government took time, markets were not especially worried. Looking ahead, one question may be how markets will react if economic policy proves more expansionary than now appears likely. For Germany, with its negative government bond yields and low public debt compared to other euro zone countries, such trends should not be cause for concern. Other countries are more in the firing line on such issues. In general, these issues are closely linked to ECB monetary policy and bond purchases. The ECB is likely to be cautious about phasing out its quantitative easing (QE) programme in a way that creates market concern. Looking at the foreign exchange market, we believe the euro will weaken against the US dollar in 2022, but this is due to expectations of wider yield spreads, not to the political situation in Germany and other euro area countries.

9. What are the election's international consequences?

German-French relations will become even more important in the future, now that the United Kingdom has left the EU. European cooperation with the US will probably be more predictable now that Trump has left the White House, but in many respects Joe Biden's administration looks set to continue with an "America first"-oriented strategy. This underscores the need for the EU to show a united front, even in fields where there have previously been differences of opinion. The recent dispute over the sale of French submarines to Australia is one such example. In the past, Germany often had a cautious and sometimes mediating role when France ended up in conflict with the US. In the future Germany will probably have to adopt a firmer position. Among other things, Germany may have to increase its spending on areas related to defence and foreign policy. In recent decades, German-French cooperation has not been particularly sensitive to whether the countries were led by representatives of different political colours. On the contrary, it has actually been easier to reach a broad consensus on strategic issues when this has been the case. Nor does President Emmanuel Macron's central position in French politics suggest that the outcome of the election itself will be so important for French-German relations.

Since all major parties in Germany have a fundamentally EU-friendly attitude, the election outcome is unlikely to result in any major policy

shifts, but Angela Merkel's long-term dominance in German politics still raises some questions. Under Merkel, Germany has tried to hold the EU and its core values together when it has been subjected to such strains as the euro crisis, Brexit and the emergence of increasingly authoritarian member countries. But Merkel has been criticised as being too reactive on EU issues. This is undoubtedly related to Germany's tendency to avoid being too assertive on the international stage. A more proactive leader might be beneficial to the EU but might also generate more uncertainty. With Green participation in the government, Germany will probably become more outspoken on environmental issues and perhaps also on human rights. This may lead to more tense relations with countries like Russia and China. During her years as chancellor, Merkel has helped ease tensions between Western countries and Russia because of her good personal relationships with Russian leaders, especially President Vladimir Putin.

10. How will the election outcome affect Sweden?

Because Germany is Sweden's most important trading partner, we have reasons to follow developments there especially closely. It is difficult to foresee major economic consequences from the election. But Germany is also the large country that most closely resembles our own in terms of party structure and electoral system, which makes German elections particularly interesting. Since the allocation of Bundestag seats mainly takes place through a proportional electoral system, more compromises are required between parties in order to create stable majorities than in countries like France and the UK. Today the similarities between Germany and Sweden are probably also greater than usual. For example, the role of the FDP greatly resembles that of Sweden's Centre Party. Meanwhile it is hard to avoid the impression that the tone of the conversation between parties and their willingness to compromise are generally more constructive in Germany than in Sweden. Another interesting similarity at the moment is that the current Minister of Finance seems likely to become head of government in both countries, which is very unusual in European politics.

11. How will Sweden's long-term EU role be affected?

With the British having now left the EU, it is especially important for Sweden to have a constructive relationship with Germany. One potentially important issue for Sweden is German wage formation. Around 2015, Germany introduced statutory minimum wages, and during the election campaign the SPD and others have pushed for these to be raised relatively much. Germany's change of government is taking place in a situation where the Swedish model of wage formation, which is entirely handled by labour and employer organisations, is also under pressure from the EU. As part of its "Social Pillar", the European Commission is pursuing a policy of common legislation. Aside from the generally strong position of labour and employer organisations in the Nordic region, Sweden would be hit particularly hard because relatively high statutory minimum wages are likely to exacerbate the problems of integrating immigrants into the labour market.

The creation of a common EU front in international politics may also be potentially difficult for Sweden and other neutral countries. If US decreases its involvement in Europe, this may lead EU to create certain parallel structures with NATO. The problems of an EU in which it is hard to persuade all member countries to move in the same direction have occasionally led to discussions about choosing between a more unified EU or a multi-speed EU. Since Sweden is already not part of the euro area, it might end up being an outsider in two respects if EU actions make it hard to maintain freedom from military alliances. There is a risk that countries which choose to refrain from deeper cooperation in important fields will lose influence. This may be especially clear in Sweden's case, now that the UK is no longer available as an ally on matters of EU cooperation.