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# GLOBAL MACRO RESEARCH — THE END OF THE MERKEL ERA

GERMAN ELECTIONS: PEER STEINBRÜCK AND GARETH COLESMITH

OCTOBER 2021



# EXECUTIVE SUMMARY

After an inconclusive result, negotiations to form a coalition government have started. There appear to be two potential groupings that would work, but the requirement to form a three-party coalition gives the smaller parties significant leverage. Ultimately, this should also lead to an effective transfer of power from the chancellor and back to Parliament, a potential positive for the democratic process. Whatever the result of negotiations, the basic principles of German politics will not change. The German people will want open markets, a social market economy, coalitions in Europe, a transatlantic friendship and to be seen as having a high level of continuity and reliability.

The main political parties in Germany

Abbreviation	Name	Politics
SPD	The Social Democratic Party of Germany	Centre-left
CDU/CSU	Christian Democratic Union of Germany/ Christian Social Union in Bavaria	Centre-right
Greens (Grüne)	Alliance 90/The Greens	Centre-left
FDP	Free Democratic Party	Classical-liberal / Centre-right
AfD	Alternative for Germany	Right/Far-right
The left	The left	Left/Far-left

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- There are two likely coalitions, both are centrist
- Ministerial roles are likely to be a key negotiating point
- A three party coalition is likely to return power to parliament, a positive for democracy
- Pension reforms are needed, but will likely prove difficult given cultural aversion to risk

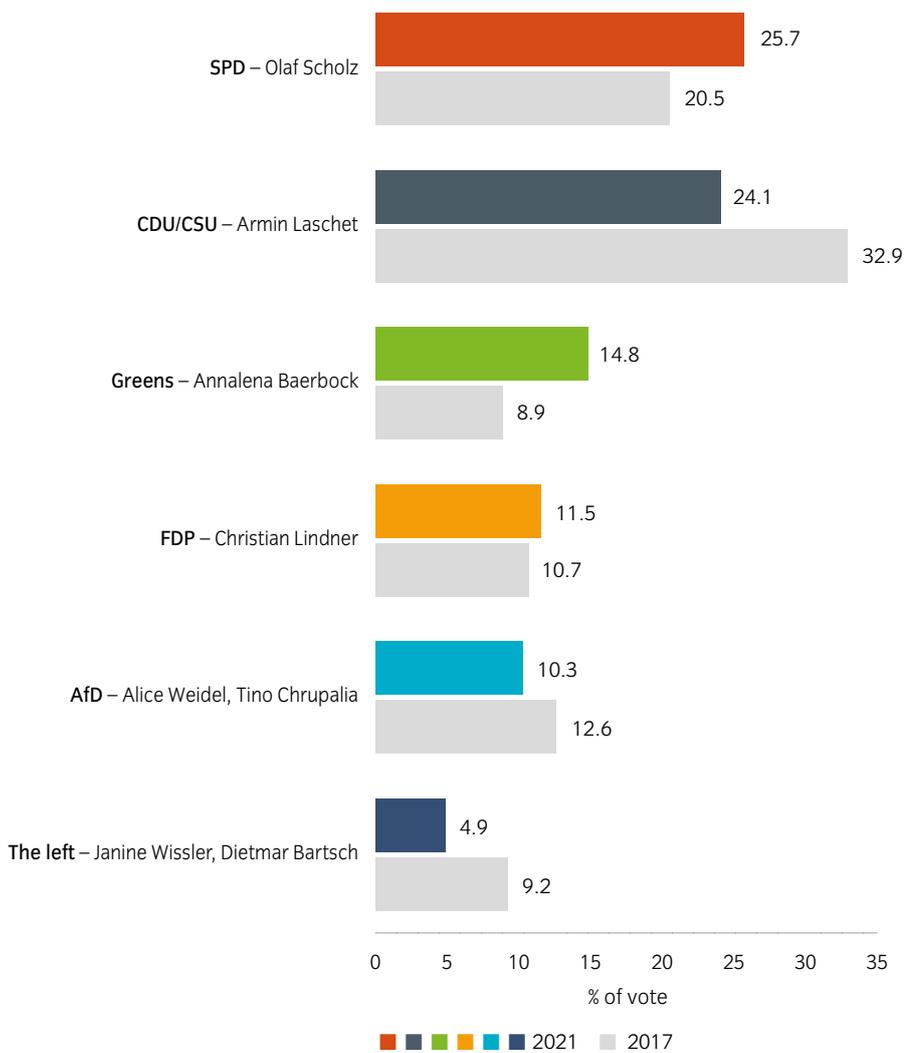
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- We are in a very unusual economic cycle
- Eurozone GDP may never return to its prepandemic trend
- Inflation has accelerated, but remains below trend, contrary to the US
- In the long-term, a centrist government is likely to lead to further slow steps towards integration

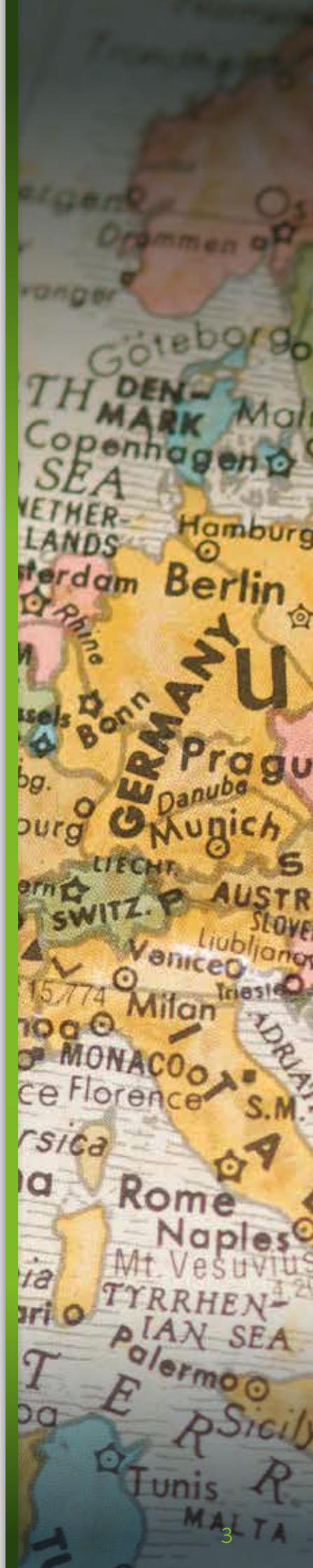
# AN INCONCLUSIVE RESULT

Held on 26 September 2021, German federal elections saw the SPD taking the largest share of votes, with the CDU/CSU facing severe losses. The loss of Angela Merkel to the CDU appears to have been a significant factor, with the SPD positioning Olaf Scholz as the most credible alternative in the post Merkel era. Both the Greens and FDP gained, while the smaller parties struggled. The parties will now negotiate to determine a coalition government before the Bundestag votes on a new chancellor.

Figure 1: Federal elections saw the two largest parties with similar shares of the vote<sup>1</sup>



<sup>1</sup> Source: Insight, data as at 30 September 2021.



# PEER STEINBRÜCK



Peer Steinbrück  
Former Federal Minister of Finance  
Germany

Peer Steinbrück, member of the Social Democratic Party (SPD), was Federal Minister of Finance (2005 to 2009) and Prime Minister of the State of North Rhine-Westphalia (2002 to 2005). In 2013, he ran for Chancellor as opposition candidate but failed to carry the election. Having resigned from his mandate in the Bundestag in September of 2016, Peer Steinbrück now engaged in the founding of the Bundeskanzler-Helmut-Schmidt-Stiftung. As economist by training, he was Head of the office of the Minister President of North Rhine-Westphalia, Johannes Rau, from 1986 to 1990. In 1993, he became Minister of Economic Affairs and Infrastructure in the state of Schleswig-Holstein. He then returned to North Rhine-Westphalia, where he became the Minister of Economic Affairs and Infrastructure in 1998 and Finance Minister in 2000.

## THERE ARE TWO LIKELY COALITION SCENARIOS

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We stand at a historic moment; the era of Merkel is drawing to a close and for the first time in its history the incumbent chancellor has not stood for re-election. Negotiations have begun and a coalition will be formed. I don't believe that a grand coalition will happen, because neither of the larger parties want to be the passenger when the other is driving. This means we are left with the two most likely scenarios – either a so-called Jamaica coalition made up of black, green and yellow<sup>2</sup>, or a so-called traffic light coalition<sup>3</sup> made up of red, green and yellow.

German law does not prescribe that the party with the most votes must be part of the government, and there are various historical examples where that was not the case. So, it is not a certainty that the SPD will be part of the coalition. However, I do think it will be very difficult for anyone, even within the party, to believe that the results have given the CDU a mandate for government. The Greens and the FDP will ultimately be the kingmakers. The FDP have more affinity towards a Jamaican coalition, as they would like to bring in more discipline, and this is more possible in a coalition with the CDU than the SPD. If a Jamaican coalition does occur, it is unlikely that Mr Laschet, head of the CDU, would emerge as chancellor given the level of criticism he has faced after losing so much of the popular vote.

If Mr Laschet is not to be chancellor who could it be? Markus Söder is a possibility, but as head of the CSU he could face opposition from the CDU. Friedrich Merz was one of the CDU leadership candidates, but he seems a man of the past. Ralph Brinkhaus has very strong backing within the CDU/CSU. But it is also possible that a less known name emerges. This is quite an exciting period and it will be interesting to see how the CDU is going to renew themselves, and what consequences there will be within the party as a result of this election.

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<sup>2</sup> Jamaican coalition would be made up of the CDU/CSU (black), Greens (green) and the FDP (yellow).

<sup>3</sup> Traffic light coalition would be made up of the SPD (red), Greens (green) and the FDP (yellow).

Whether or not they end up in coalition, it will be important for the CDU to choose a new leader relatively quickly. There are elections in North Rhine-Westphalia in May next year, and the CDU will want to regain some political momentum before then. North Rhine-Westphalia is the most populated state in Germany and carries a lot of weight in Germany's lower house.

Whatever the results of negotiation, the basic principles of German politics will not change. The German people will want open markets, a social market economy, coalitions in Europe, a transatlantic friendship and to be independent of disputes between the US and China. Germany will want to be seen as having a high level of continuity and reliability.

## MINISTERIAL ROLES WILL BE A KEY NEGOTIATION POINT

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In terms of key positions within the new government, whether it is in coalition with the CDU or the SPD, the FDP will have a lot of requirements and demands. They will want to prevent a tax on the wealthy, and they will want to gain ministerial posts. Mr Lindner, head of the FDP, believes that ministerial posts are the central point where policy is made, especially the finance ministry which is extremely important – so it is quite likely that negotiations will include a requirement for him to become finance minister.

The Foreign Ministry usually goes to the FDP but it seems likely that this could end up with the Greens. Annalena Baerbock or Robert Habeck, co-leaders of the Greens, could both be candidates for this role, although there are other possibilities.

Although the ministerial roles are normally divided in a particular pattern, things could be very different this time given the need to bring three parties together. The fact that the FDP and Greens could choose either the CDU or SPD as partner to form a government, gives them significant power in negotiations.

## POWER IS LIKELY TO RETURN TO PARLIAMENT

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Another major change we are likely to see is that German policy has been dominated by the chancellor and Merkel has stayed in power for much longer than the leaders of other European countries. This is now coming to an end and with three parties making up the government a lot of power will return to Parliament. This should result in a lot more discussion and debate which should be a positive. In the last few years there have been various crisis and things haven't always been fully discussed in Parliament.

The closeness of the vote could also mean we see a strong opposition as well, especially if the CDU assume that role. They will want to do everything to get back into power after the four-year parliamentary term is up.

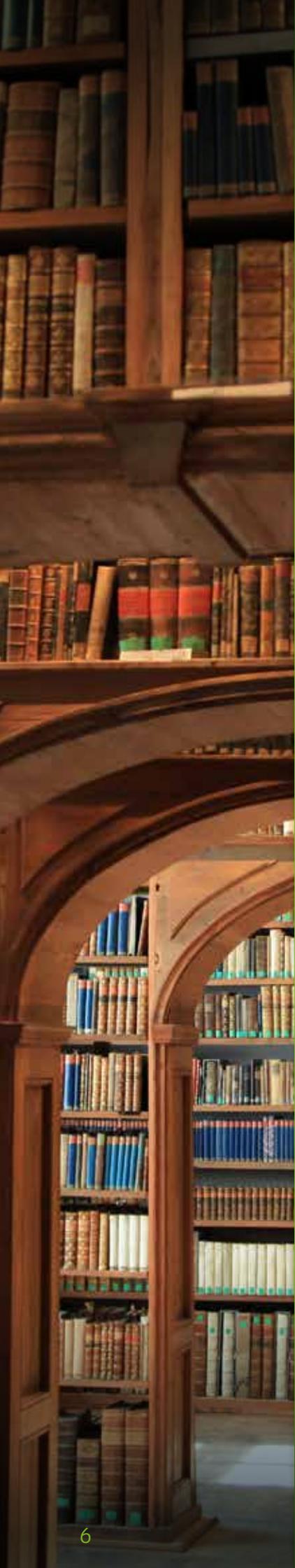
## REFORMING THE GERMAN PENSION SYSTEM

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Pensions didn't play a major part of the election debates; the focus was on issues that affect much of the rest of the world such as decarbonisation and climate change. But Germany has an aging population, and there is an important question mark over how the country finances its pension system. Politically, there have historically been two red lines. No one wanted to increase the retirement age and no one wanted to increase contributions. These need to be addressed, along with other issues such as greater participation of women in the pension system, and greater inclusion of migrants in both the pension system and the labour market.

In future, the German pension system needs to have four pillars. It has to have a publicly financed statutory pension at its core. This should then be increased with a move towards a Swedish or Austrian model, where an additional pension payment is made based on contributions to the tax system over your life. Company pension schemes have to be promoted more, and lastly property needs to play a greater role. If property were more affordable, something that could possibly be managed via new builds, then it would





encourage people to invest more in property. In Germany the statutory pension will always be the strongest pillar, but the other three pillars need to grow in importance and could be helped if there is greater union of capital markets within the eurozone.

There is also the issue of pension guarantees in Germany, where companies have to guarantee a minimum return of zero so that members are not exposed to any losses. There has been a social model introduced over the last two or three years where employers can fund a pension without guarantees, but it requires a social partner such as a trade union to agree to this. As there is very little upside for the trade unions to agree, development has been very slow. I think for this system to gain momentum there need to be more concessions to the trade unions to accept investment which is risk-based. Ultimately there are many deep historical reasons why Germans don't like risk. This may change with younger generations. In Sweden and the Netherlands there was significant volatility in pension assets during the 2008 global financial crisis, but people just accepted this volatility as part of long-term investment and went onto to make strong gains. Time is a huge advantage for a pension investor unless you are close to retirement.

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There is an old saying that if you flirt with inflation then you are going to marry inflation.

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### IS THE LEVEL OF RETURNS PROBLEMATIC FOR PENSIONERS?

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There is an old saying that if you flirt with inflation then you are going to marry inflation. Mario Draghi started to flirt with inflation and perhaps now is the time to get married to it. Collective wage-bargaining this autumn will be very important to the inflation outlook in Germany. Unions will be arguing that the acceleration in inflation has eroded the purchasing power of their members and if they succeed then it could create an inflationary spiral. The inflationary pressures we have seen suggest that inflation outlook may be worse than the European Central Bank (ECB) are daring to suggest – the amount of liquidity being poured into economies, rising raw material prices, supply chain problems, shipping rates – inflation is not a singular development.

Germans feels very anxious about inflation rates above 4% and the ECB will take this into consideration if that occurs. It used to be the case that whatever it takes was right, but now I think the risks are maybe too high. But some Southern European countries and parts of the European banking system continue to be dependent on cheap financing even after so many years. This has created a phenomenon of fiscal dominance, where the liquidity pump of the ECB erodes its independence. There is already some tension in the ECB Governing Council, with the President of the German Federal Bank critical of the prolonged low level of rates.

However, with people having become so used to low interest rates it's going to be a very slow process to meaningfully change things.

# GARETH COLESMITH

## AN ASSESSMENT OF THE ECONOMIC BACKDROP



Gareth ColeSmith  
Head of Global Rates and Macro Research, Fixed Income  
Insight Investment

As Insight's Head of Global Rates and Macro Research, Gareth has oversight of Insight-managed government bond portfolios, in particular global, UK and inflation-linked portfolios as well as direct responsibility for managing European government bond portfolios. In addition, he was responsible for setting up the macro research function, which aims to consolidate and improve on our internal macro, economics and politics research, to the benefit of the whole investment team.

### EITHER COALITION WOULD BE A CENTRIST COALITION

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From an economic backdrop it is important to remember that regardless of which coalition is struck, it will undoubtedly be a centrist coalition, which means the main themes of German policymaking are not going to change. Both the AfD and Left parties lost votes and seats – and that's important for both Germany and Europe.

From a eurozone perspective there are both short and long-term issues at stake. In the short term, it's all about fiscal policy, and how quickly countries return to the stability and growth pact. Longer term, being able to trust the governments of other member states is key to driving reforms that create a more resilient system.

### A VERY UNUSUAL ECONOMIC CYCLE

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Looking at GDP levels, this has been a very unusual downturn, followed by a very unusual recovery. In a normal economic downturn, the economy gradually slows, then gradually rebounds in response to monetary and fiscal stimulus. In this downturn, governments deliberately shut down parts of the economy in response to the pandemic, and in doing so they created a sharp contraction in GDP (see Figure 2), with a decline of close to 15% for the eurozone as a whole. As these sectors reopened, so activity recovered at a more rapid pace than would normally be expected.

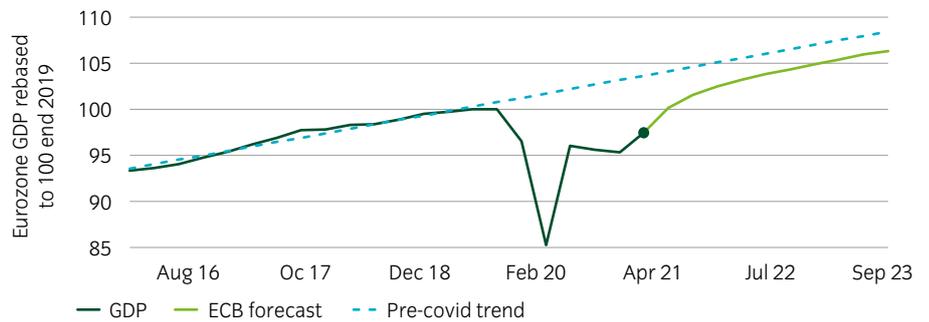
However, what is important is the shape of the recovery relative to the pre-pandemic trend. Right now, eurozone GDP is still around 2.5% below the level at the end of 2019, and it may return to that level soon. But, if we take ECB staff forecasts, the level of GDP may never





return to its pre-pandemic trend, and even by 2023 would still be around 2% below where it would have been had the crisis not happened. That matters.

Figure 2: The level of eurozone GDP may never return to its pre-pandemic trend<sup>4</sup>

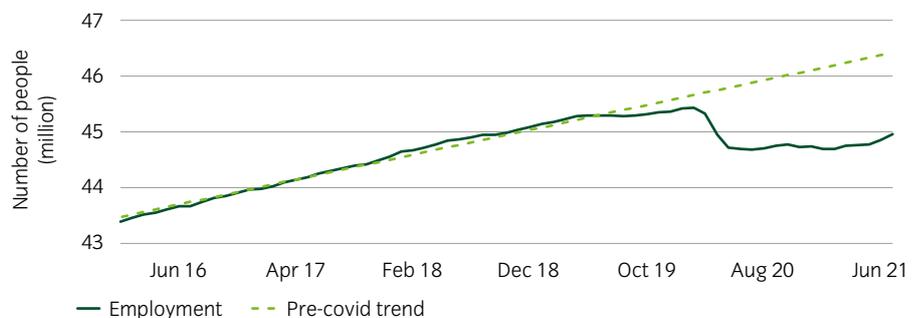


In the United States, the level of GDP has already returned to end-2019 levels and is expected to return to its pre-pandemic trend by the end of 2021. China has already returned to its pre-pandemic trend. The difference between these countries and the eurozone has been the scale of the fiscal response. In an extreme environment, they have kept fiscal stimulus in place until the recovery is complete.

### WHAT DOES THIS MEAN FOR GERMANY?

Looking specifically at Germany, even though you had a well-established Kurzarbeit, or furlough, system to keep people employed you still had a reasonably large fall in jobs as a result of the pandemic and employment hasn't fully recovered. There are around half a million Germans who are now unemployed that were employed at the end of 2019. Relative the previous trend, there are around 1.4 million fewer people employed than would have been the case had the pandemic not occurred.

Figure 3: German employment is now well below its pre-pandemic trend<sup>5</sup>



### INFLATION: STICKY OR TRANSITORY?

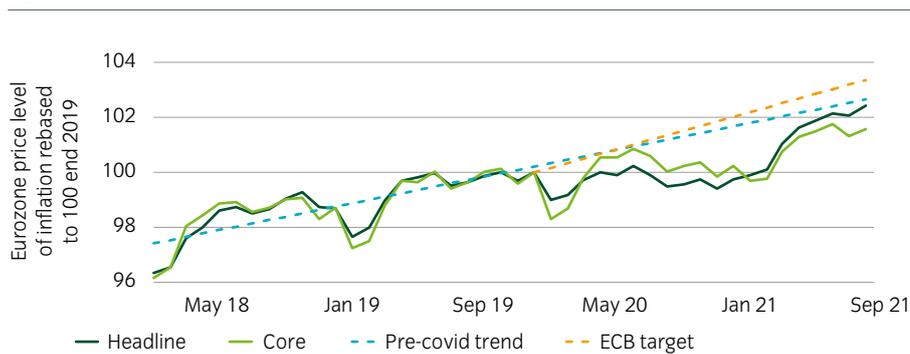
Inflation is obviously an important topic in Germany for historical reasons and if inflation in the eurozone were to remain above 3% then the ECB would react, as it would be concerned that rising inflation expectations would keep inflation elevated for a longer period. But the question is whether inflation is sticky or is it transitory.

Looking at a chart of price levels it is possible to look at the level of inflation relative to its trend and the level of prices being targeted by the ECB. Critically, although price levels have moved upwards, they have still not recovered to either their previous trend or the ECB's 2% annualised target.

<sup>4</sup> Source: Eurostat, ECB as at 21 September 2021.

<sup>5</sup> Source: Deutsche Bundesbank as at 21 September 2021.

Figure 4: Price levels in the eurozone have risen, but remain below trend<sup>6</sup>



In the US, where the Federal Reserve is more concerned about inflation, things are very different. Prices have already risen above their previous trend, and the Fed has achieved its average inflation target. For the ECB, there is no reason to be overly concerned right now, but that could change. If wages start to spiral it would suggest higher long-term inflation which would require a response, but there is nothing in the data to suggest that at the moment. If inflationary proves to be transitory, then the ECB will be correct to keep policy at stimulative levels.

## THE LONG-TERM IMPACT ON THE EUROZONE

Chancellor Merkel has had to deal with a number of crises over her 16 years in power, and has been very effective, but what she has perhaps lacked is the longer-term vision in taking bold steps to build a more resilient system. There have been grand plans such as banking union and capital markets union, but they are still not finished. Instead, the eurozone has been left with a system of periodic crises and policies to muddle through.

When a crisis hits, the level of trust between EU member states is critical to the policies that can be enacted. A centrist government in Germany, along with centrist governments elsewhere in Europe, is likely to lead to further steps towards integration. For example, the European Recovery Fund was an integration step that came about in response to the coronavirus crisis. This was in contrast to the previous crisis where a lack of trust between member states resulted in Greece's sovereign default.

Although further steps towards integration are probable, federalisation is still a long way away. In Switzerland it took 500 years to change from a confederation to a full federation. Conversely, a breakup scenario now seems unlikely as the costs are very high, but it's not impossible, which is why it's important to spend time analysing political tail risks. If pro-breakup politicians come to power, things could fall apart very quickly if a crisis hits.

Under the current political backdrop across the eurozone, the risk of these extreme scenarios has declined. The most likely scenario is periodic crisis, and centrist politicians trust each other enough to ultimately exchange fiscal solidarity for structural reforms that lead to gradual, slow integration. Leadership will be key, having the vision to build a more resilient system out of crisis, and I trust that whatever the outcome of the negotiations the German coalition leaders and the next chancellor and finance minister will have the vision to do that.

<sup>6</sup> Source: Eurostat as at 21 September 2021.



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