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German election: what is at stake?

Germans head to the polls on 23 February in a federal election that carries far-reaching implications for the German economy, as well as potentially European financial markets.

The previous government, a coalition of the centre-left Social Democrats (SPD), Greens and liberal Free Democratic Party (FDP), collapsed at the beginning of November 2024, mainly due to irreconcilable differences over the budget. The FDP insisted on compliance with the "debt brake" – which caps the structural budget deficit – while Chancellor Olaf Scholz (SPD) considers higher public debt to be necessary to fund areas like defence and infrastructure spending.

Ultimately, the government's demise was hastened by a November 2023 Federal Constitutional Court ruling that significantly restricted fiscal leeway, fuelling tensions between the coalition partners.

Friedrich Merz, the leader of the conservative Christian Democratic Union of Germany (CDU) is favourite to become the next chancellor. It remains unclear which parties could join the CDU and its Bavarian sister party, CSU, in a future coalition, but they are most likely to be drawn from one or two of the parties of the previous government (SPD, Greens or FDP).

We see several main issues dominating the policy battleground.

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Immigration and the economy are key focuses

Illegal immigration has emerged as an important issue in the run up to the vote. The CDU, CSU, along with the FDP, the Alternative for Germany (AfD) and the populist left-wing Sahra Wagenknecht Alliance (BSW) advocate a tighter stance on immigration than the SPD, the Greens and the left-wing Die Linke. We believe a compromise on the issue will be needed in any future coalition.

Revitalising the German economy is the second major campaign issue. After years of stagnant or falling economic growth, the outlook for Germany's economy in 2025 is anaemic at best. Unsurprisingly, the CDU/CSU and the FDP have therefore campaigned on a programme of significantly boosting the German economy. The SPD traditionally prioritises social spending and the Greens' focus is environmental issues.

The parties most likely to form part of the coalition are united in their commitment to Western foreign and security policies – in contrast to the AfD and BSW.

We expect the following economic issues to be a particular focus of coalition negotiations:

1. **Reducing bureaucracy**. An important topic for all parties, especially the CDU/CSU and the FDP.

2. **Cutting energy costs**. Electricity and gas prices are too high for the traditionally energy-intensive German economy. Potential coalition partners agree on the need to reduce energy costs (both taxes on electricity and grid fees). The CDU/CSU, SPD and the Greens are committed to the goal of making Germany climate-neutral by 2045, while the FDP favours 2050. The AfD's plan relies on fossil fuels, particularly from Russia, and nuclear energy.

3. **Reducing taxes**. Both the CDU and the FDP want to reduce corporate tax rates (currently high compared to the G7 average) to encourage investment. In contrast, the SPD and the Greens want to focus on direct investment incentives. Tax relief for employees is also broadly planned, though the proposals differ on the scale and beneficiaries of any cuts.

4. **Addressing labour shortages**. All the main potential coalition partners agree that Germany should promote the legal migration of skilled workers.

5. **Easing the debt brake**. Under the Basic Law, the federal government's structural budget deficit may not exceed 0.35% of GDP, except in special situations, such as natural disasters. Opinions on whether the debt brake should be retained or relaxed differ across the potential coalition parties.

Debt brake: relaxation rather than abolition

The CDU/CSU, the FDP and the AfD favour retaining the debt brake. However, Mr Merz has repeatedly expressed his willingness to negotiate on the issue in return for cuts to government consumption, including social benefits and subsidies. The CDU/CSU plan to streamline security income (Bürgergeld) and provide stronger incentives to work. According to independent estimates, the CDU/CSU's plans to cut tax would significantly raise the budget deficit, likely requiring compromise on the debt brake anyway.

Both the SPD and the Greens advocate a relaxation – but not an abolition – of the debt brake, as well as the creation of a new "special fund" not subject to the debt regulation. The aim is to increase funds for spending on defence, infrastructure, education and environmental protection.

Many of Germany's leading economists and the German Bundesbank favour modifying the debt brake, and we believe a compromise on the issue is likely – even if it will not be easy to achieve. According to a proposal by the Bundesbank (that takes into account EU fiscal rules), the structural deficit could be raised, depending on the overall debt/GDP ratio, to up to 1% of GDP – or currently around EUR 30 billion.

Possible political constellations

As of 12 February, the polls indicate that CDU/CSU will emerge as the election winner with around 30% of the vote. The AfD can expect to win around 20% of the vote, with the SPD around 16% and the Greens about 14%. It remains to be seen if Die Linke, the BSW and FDP will also make it to the Bundestag for which (in most cases) 5% of the votes are required. According to the polls, all three of them are currently close to the 5% hurdle.

As the FDP, a traditional partner of the CDU/CSU, would not be strong enough to generate a majority in parliament, even if they make it into the Bundestag, the CDU/CSU would prefer the SPD as a coalition partner. Still, a coalition with the Greens cannot be ruled out. A three-way coalition between the CDU/CSU, SPD and the Greens or the FDP could also materialise depending on the final election outcome, even though such a constellation could be unstable, as proven by the demise of the previous coalition. A coalition between CDU/CSU and the AfD, BSW and/or Die Linke has been ruled out categorically by Mr Merz.

Other potential outcomes must be considered, too. First, if coalition negotiations between the CDU and the SPD, the Greens or possibly the FDP fail, a new election may be required. Second, even with a stable CDU-led government majority, the parties on the fringes of the political spectrum (the AfD and BSW), could get a blocking minority of one third of the Bundestag seats. Changes to the constitution – including the debt brake – would then be much more difficult to implement.

Market expectations: higher Bund yields and positivity for equities

We think the most likely outcome is that the CDU/CSU emerge as the election winners and form a coalition ideally with one, but possibly two of the centrist parties (SPD, Greens or FDP). We don't expect the fringe parties to gain enough votes to form a blocking minority.

US economic and policy trends remain key drivers for global financial markets. But a stable German government with a business-friendly agenda could set a positive tone for Europe again – important considering the threat of tariffs on European exports to the US.

Under this eventuality, we would expect a slight rise in Bund yields as investors contemplate what an easing of the debt brake may provide: a boost to economic growth and an increase in debt issuance. It is uncertain whether spreads on bonds from other euro zone countries relative to Bunds would tighten. Higher German bond yields will initially raise interest rates across the entire currency area and a rise in borrowing costs would provide an additional headache for countries already under pressure to reduce their budget deficits.

Equities, particularly German and European cyclical industrial stocks but also financials, could benefit from the improved growth outlook for Europe's largest economy. A positive election outcome could bring a continuation of the outperformance of European equities since the beginning of the year.

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