24 February 2025

Flash: German election

A positive outcome for markets and the economy

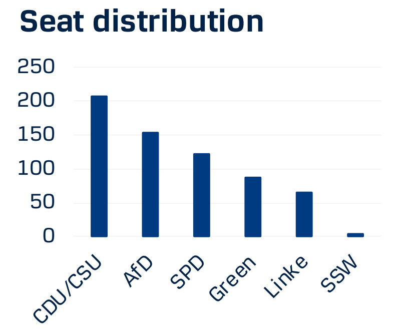
The German election makes a two-party government between the conservative CDU/CSU and the Social Democrats (SPD) the most likely result (75%), which is a positive outcome for the German economy. Markets have also reacted positively to the news by strengthening the euro by 0.6% during Asian trading hours while DAX futures have climbed 1.1%. The conservative chancellor Friedrich Merz is certain to become the next chancellor as his party emerged as the biggest one with 28.6% of the votes. A majority government with the Social Democrats is possible because two parties fell below the 5% threshold for entering the parliament, namely the FDP at 4.33% and the BSW at 4.97%. This gives 328 seats to the CDU/CSU and SPD, above the 315 needed for a majority. A two-party "Grand coalition" government is a positive outcome because decision making is easier than in a three-party government. A new government will likely take office in two months' time.

The far-right Alternative for Germany (AfD) became the second largest party with 20.8% of the votes, which is double the votes it got in the last election but at the same time in line with election polls. Being the sole party who has certainly refused to change the constitutionally enriched **"debt brake" to allow more debt we see the chance of a reform being 60%.** Such a reform requires a two-thirds majority and the CDU/CSU, SPD, Greens, and The Left have 76% of the votes. The reform will depend on the CDU as they have given mixed signals, which is the reason we estimate 70% chance of it happening (see next page for details).

In terms of defence spending and support for Ukraine, the election outcome was not the best scenario because the far-right (Afd) and the Left party combined secured 34.3% of the votes. Therefore, they will be able to block off-budget defence funds and legislation that requires two-thirds majority. Yet, with a less fragmented Parliament and a two-party government Germany's presence in the EU will likely be stronger compared to the previous government, which is positive news.

Because the majority for a "Grand coalition" is so slim (13 seats) Merz might want to include the Green party in a coalition to not be pressured by SPD the members who are the least aligned with his policies, so it is 75% certain that we get a Grand coalition and 25% chance of a "Kenya" government. Since the BSW came so close to the 5% threshold there will likely be a recount of the votes to make sure the preliminary result is correct. We must wait for that before the results are 100% final.

Election results



Source: Federal Returning Office

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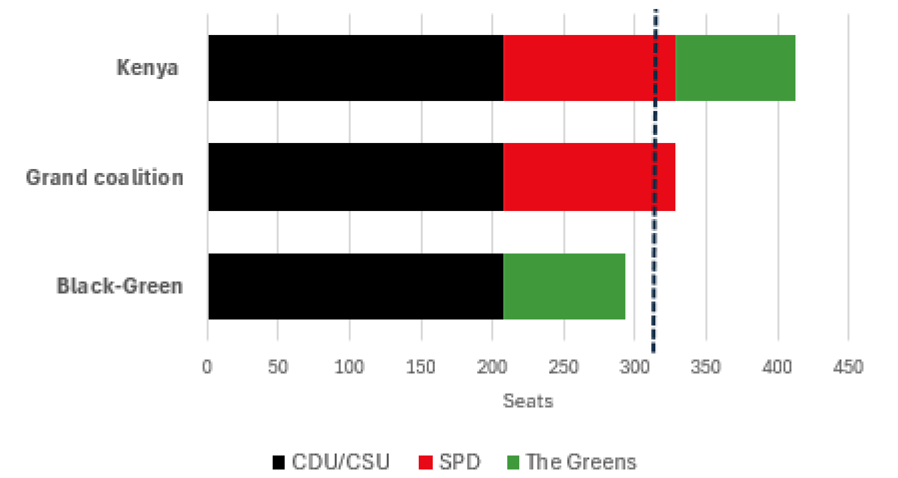
Both a Grand coalition and Kenya has a majority



Source: Federal Returning Office

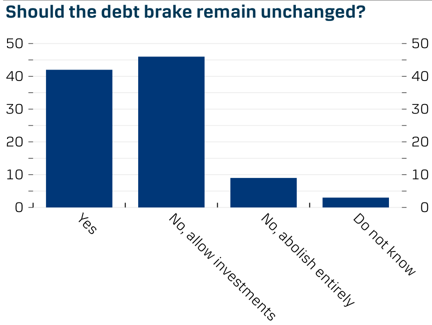
Government coalitions: Grand Coalition or Kenya?

- **'Grand Coalition' between CDU/CSU and SPD (probability 75%):** Such a coalition is currently the most likely and it has previously been in office from 2005 to 2009 and from 2013 to 2021. A grand coalition government is expected to pursue a pro-European and pro-business agenda. Both party programmes emphasise reviving the German economy, albeit through different means. The CDU/CSU aims to lower income and corporate taxes by nearly €100 billion annually, while the SPD proposes establishing a €100 billion public investment fund, raising the minimum wage from €12 to €15, and offering a 10% tax rebate for companies investing in Germany. Compromises between the two parties would likely involve tax cuts for middle- and low-income groups and support for businesses.
- **'Kenya' coalition between CDU/CSU, SPD, and the Greens (probability: 25%).** With three parties of significant size each it will be more difficult for government to find common ground and agree on legislation like we saw in the previous 'traffic light' coalition. Hence, it would be negative for the German economy and for the EU as the internal disagreements "trickle up" to the EU.

Abolishment of the 'debt brake' is not likely, but we see 60 % chance of reform that allows more investments

We see 60% probability of a small reform of the debt brake that will give a special treatment for investments, but we do not anticipate an abolishment. The far-right AfD and the conservative CDU/CSU support the debt brake, so achieving a two-thirds majority for an abolishment seems unlikely. The CDU party programme states, "the debts of today are the tax increases of tomorrow," and Friedrich Merz defends the debt brake. However, Merz faces pressure, particularly from state government members within his party affected by the "black zero" policy, and he has opened the door to a smaller reform if funds are invested in "pro-growth programmes". The SPD, the Greens, and the Left all wish to relax the debt break, making a two-thirds majority in favour of a smaller reform seem possible in our view. Yet, given election results the decision relies entirely on the CDU/CSU, so we estimate a 60% chance of it occurring.

Germans favour reform of debt brake



Source: DGAP, Forsa,
Note poll conducted in Jan 25

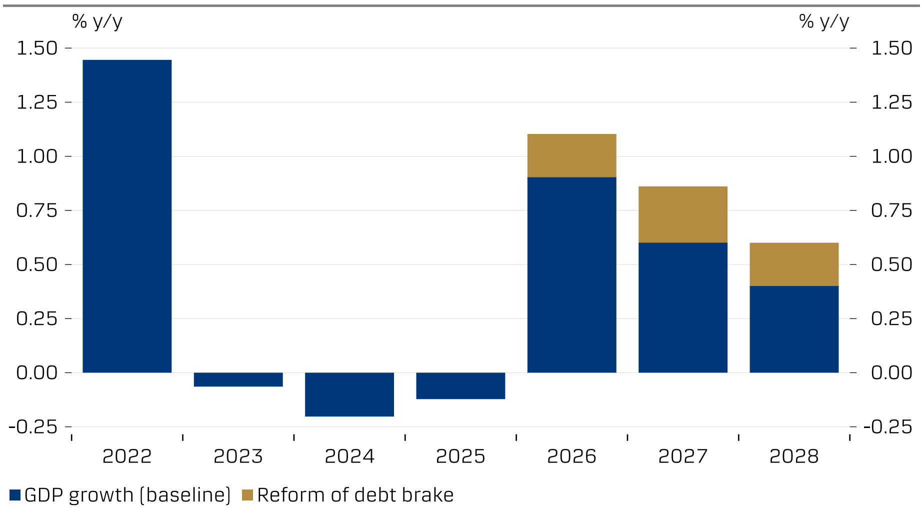
We expect a possible reform **to allow a special treatment of public investment by excluding them in the calculation of new debt and allowing the structural deficit to increase to 1.50% from 0.35%.** Polls also show that a majority of Germans want this type of reform.

GDP growth to rise by around 0.2 percentage points in each of the coming years following the potential 'debt brake' reform

If the new government reforms the debt brake to allow the structural deficit to rise to 1.5% of GDP from 0.35% by permitting an additional 1.15% in investments, how much will growth increase? We anticipate that a reform would affect growth from next year and thus maintain our estimate that the German economy will stagnate in 2025, with GDP growth at -0.1% year-on-year. From 2026, we expect growth to be stimulated as the government can increase the structural deficit. The current budget targets a structural deficit of 1.0% of GDP in 2026, allowing the government to raise the deficit by 0.50 percentage points (EUR 22 bn) to 1.5% of GDP. In 2027 the deficit could be raised by 0.25 p.p and in 2027 by 0.50 p.p of GDP (see chart on next page).

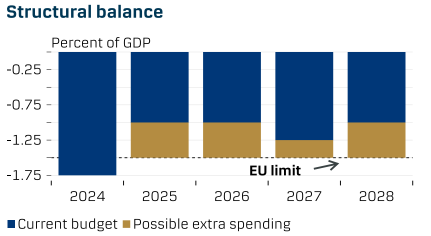
Assuming the increased spending are used on investments that has a certain lag before they are implemented, we estimate that the potential reform of the debt brake would increase **growth from our forecasted 0.90% year-on-year to 1.1% year-on-year in 2026. In the subsequent years, the investments could boost growth by 0.25 percentage points in 2027 and 0.20 percentage points in 2028, raising it to 0.9% y/y and 0.6% y/y respectively in our forecast.** If the reform is not made, we expect the coalition to use targeted off-budget funds e.g. on infrastructure and digitalisation to boost the economy, with similar effects on growth in the short run. Off-budget funds would be less positive compared to a reform in the longer horizon as fiscal policy would remain very constrained especially when repayments come.

Expected growth impact of 'debt brake' reform



Source: Danske Bank

EU fiscal rules make limits room for new spending despite reform of debt brake



Source: German Ministry for Finance, Danske Bank

Box: The German debt brake

The German fiscal 'debt brake' emerged as a political response to rising government debt during the global financial crisis. Established in 2009 to maintain sustainable public finances, it was enshrined in the Constitution, requiring a two-thirds majority in parliament to amend the law. The debt brake restricts the government deficit, adjusted for interest rates and cyclical effects, to -0.35% of GDP. This allows for a larger deficit during economic downturns, but it must be offset when the economy recovers. State governments must maintain a balanced "black zero" budget. An escape clause permits the Bundestag to temporarily suspend the debt brake with a simple majority in the event of a natural disaster or other extraordinary emergencies beyond the state's control.

Source: Danske Bank

Appendix

Overview of selected party programmes

	CDU/CSU	SPD	Greens	AfD
Economic /fiscal	• End solidary surcharge "soli" tax	• €100 bn investments fund	• Investments in infrastructure, energy systems, and industry	• Fiscal hawks
	• Reduce VAT in hospitality from 19% to 7%	• Raise minimum wage to €15 from €12 per hour	• German fund' to unlock investments	• More trade with Russia and resume energy imports
	• Lower corporate tax to 25%	• "Made in Germany" premium, giving 10% tax rebate on certain company investment	• Maintain flat rate public transport ticket of EUR 49	• EU/euro area exit
	• No increase in retirement age	• Tax cuts for most earners	• Reduce electricity taxes and grid fees	
	• "Active pension" to allow pensioners to earn €2000 eur per month tax free	• Tax increase on wealthy, reintroduce wealth tax on ultra-rich, and raise in inheritance taxes	• End produciton of combustion engine vehicles faster	
		• Higher tax on capital income and financial transactions	• 10% state aid premium for industry investments	
			• Support for purchase of electric vehicles	
			• Climate bonus for low and middle income households	
Debt brake	• Supports the debt brake	• Relax debt brake	• Reform of debt brake	• No reform of debt brake
	• "The debts of today are the tax increases of tomorrow"	• More capital to state owned corporations		
	• But willing to reform if money is used on pro-growth investments			
Defence	• 2% of GDP spending	• 2% of GDP defence and off-budget fund	• 3.5% of GDP	• No European defence integration, national sovereignity, lift sanctions on Russia
	• CSU wants well above 3%			

Source: Danske Bank, party election programmes

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None

Date of first publication

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