



Global Counsel

The 2013 German election

A Global Counsel Primer



Summary: the 2013 German election

On September 22, after four years of dominating both German and European politics, Angela Merkel will seek a renewed mandate from German voters. This will be, by any measure, one of the most important European political events of 2013. How might it change German domestic and European policy? If it returns her to office, to what extent will it free Merkel and Berlin to move differently or faster in resolving some of the flaws in the European Union and its single currency?

Merkel's prospects for returning to the Berlin Chancellery are good. She looks likely to buck the recent trend in Europe of incumbents not being re-elected. Despite a strong performance in the campaign's only televised debate, the SPD's Peer Steinbrück has run a faltering campaign and Merkel consistently outscores Steinbrück by margins of two to one as the voters' preference for Chancellor. Merkel can be expected to lead Germany in almost any scenario. The question is obviously what kind of Germany she will be leading, and with whom.

The basic message of this primer is that the election itself needs to be seen as part of a bigger picture of change in Germany. Today the country is routinely described as the strongest in Europe, yet only a decade its economy was stalled. In 2003 Germany had experienced five years of economic stagnation and had a double digit unemployment rate. The country had high labour costs and low business profitability; the country's manufacturing sector was losing its 'edge'. The way Germany tackled its problems and regained its economic 'edge' strongly shapes the country's sense today of its own strengths and weaknesses, its options and its obligations. This primer focuses on that deeper

thread in the German political economy, because the politics and policy of the last decade are key to understanding much of what we see today.

Namely: a dominant centre right, confidently pinching the policies of the centre left. A centre-left weakened, split with the creation of the leftist Die Linke, and spooked by self-doubt over its labour market reform record in government both as a dominant party and as junior coalition partner with the conservative CDU in 2005. And on Europe, a political culture struggling to balance its own sense of European vocation and obligation with a nagging concern that rescuing the Eurozone will damage German economic strength, tie the country tighter to a stalling European 'South' (that to some eyes stretches as far north as the Seine) and carry a high price in German taxpayers' money.

Here are five things to ponder as you watch events unfold over the next three weeks:

- This election will almost certainly see the return of Angela Merkel as Chancellor, but not result in a parliamentary majority for her party. Merkel's coalition partner will be key to the final complexion of the government and its agenda. With the CDU's traditional pro-business liberal FDP partner falling sharply in the polls and struggling to clear the 5% threshold for seats in parliament, the CDU may face the prospect of a coalition with either the Greens or and Grand coalition with the centre left SPD. On balance, the Greens have probably moved too far left in recent years to make a Black/Green coalition likely, but it is not impossible. For market watchers a period of uncertainty following the vote is very likely,

although this is not unusual and the consensual German system will suppress any serious sense of unpredictability. Nevertheless, the bund price will no doubt reflect the market's sense of expectation to some degree.

- Is a second Grand Coalition in a decade really conceivable? Yes. The SPD look back on the experience of 2005 with considerable angst. Its Chancellor candidate, Peer Steinbrück, has personally ruled out serving in one. But more than half of German voters favour this outcome and the SPD would find it very hard to resist the call. More importantly, the numbers may make the main alternatives untenable. A CDU pact with the SPD may involve less policy compromise than it suggests at first. Merkel's strategic brilliance at the head of the CDU has been to secure its reputation for economic competence and then move sharply onto the traditional territory of the centre left. She has championed Germany's post-nuclear future and stolen a lot of the SPD's traditional ideological clothes on social justice and a (non-statutory) minimum wage.
 - In policy terms, how much change may be coming? Depending on the final composition of the coalition we expect small rises in income tax, possible cuts in business tax and new tax breaks for R&D. We expect a widening of the sectors covered by the German minimum wage and gender quotas for German boards. We expect to see German energy policy continue to de-emphasise subsidy and a continued exemption from environmental legislation for Germany's energy intensive businesses and exporters.
- On fiscal policy, we do not expect much change. All the major parties have committed to meeting Germany's European fiscal and debt targets. A Grand Coalition may slow the pace of current CDU debt-reduction plans moderately, but not in a way that significantly changes the country's fiscal stance.
- On Europe, by tacit agreement of the main parties, this election will not address growing German anxieties about the EU and will certainly not seek to resolve them. Under the strong elite consensus on Germany's European obligations there is a growing groundswell of concern that Germany is being asked to pay (or promise to pay) too much to secure the European single currency. Many external observers have assumed that Merkel's cautious approach to committing Germany to greater economic, fiscal or banking system integration in Europe is simply electoral calculus and a renewed mandate will see a change in German conduct in Brussels. We are more sceptical. Berlin's doubts about the legal bases and the political sustainability of pooling debt and bank liability in Brussels are not an electoral smokescreen. They reflect a deep and growing ambivalence that has yet to be resolved. Our analysis here focuses on these sources of ambivalence and what they mean for Germany and Europe.

To what extent will this election free Merkel and Berlin to move differently or faster in resolving some of the flaws in the European Union and its single currency?

The long run-up to the 2013 German election

Germany is routinely described as the engine of the European economy, but the last twenty years have been a mixed experience for the EU's largest state. It is easy to forget that a decade ago the mood in Germany was of economic and even social crisis. The Germany economy had stalled and unemployment was as high as it had been in the post-war period. How German political culture addressed that crisis is key to understanding German political calculations in 2013.

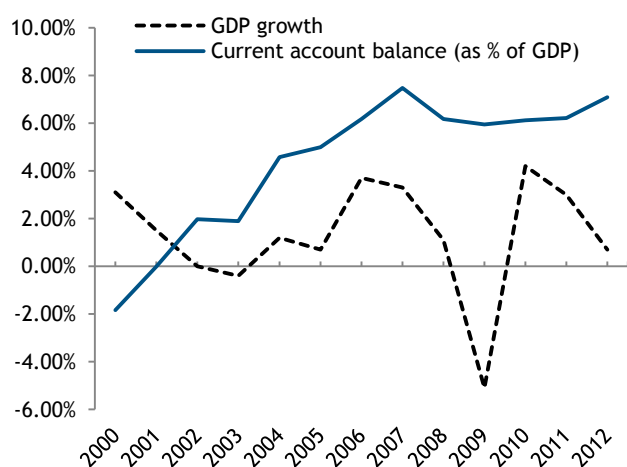


Fig 1: German GDP annual change and current account surplus (% GDP)
Source: OECD

The German economy and the euro

German GDP fell steadily from 1995 to 2000 and stagnated through the first years of the 2000s. By 2005, unemployment was at 12%. With the creation of the European single currency area, German savings were exported to the booming construction and property markets of the European periphery. This pushed down net

investment rates in Germany to the lowest in Europe. This in turn was almost certainly a source of sluggish growth.

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The picture began to change after 2002. The 1998 left-of-centre coalition of the SPD and Greens, led by Gerhard Schröder, began the radical Hartz labour market reforms, named after their author, the Government adviser Peter Hartz. These included reductions in the duration of unemployment benefit and rules to allow flexible 'mini-job' employment status to circumvent the high levels of employment protection. The combination of these Hartz changes and wage restraint along with reorganisation in many of the country's workplaces sharply held down German unit labour costs (Fig 5). At the same time, strong growth in the global economy and huge demand in economies like China for German capital goods and industrial inputs drove a sustained boom in German exports (Fig 4).

If Euro membership sucking savings out of Germany was a downside, its chief benefit lay in the way the Euro acted as a check on the currency appreciation, and loss of competitiveness, that a standalone Deutschmark would have seen as the country's exports increased and economy strengthened. The collapse of the asset price bubble of 2008 partially reversed the capital inflows that marked the previous decade as investors moved

capital to the relative safety of the Germany banking system and Germany property market. After the initial economic shock, for the first two years of the Eurozone crisis, the German economy appeared comparatively healthy.

This experience has shaped two important threads in German political debate. The first concerns Germany's self interest in the single currency and its obligations to preserve it. Weighing the costs of Germany's decade-long current account surplus after 1998 in domestic investment against the competitive benefits for exporters sustained by the single currency is not easy. The German political class as a whole however have a strong commitment to the Euro and its preservation. This commitment is obviously not purely a question of economic calculation - it is also seen as part of a wider European obligation.

Hartz and minds

The last decade has also shaped the way the German political class thinks about 'the German model'. The Hartz changes are seen as the country accepting the need for painful reform to improve competitiveness and increase employment. The export boom of the second half of the 2000s is seen as the fruit of a willingness to take tough decisions. Germany has a reputation of having a highly consensual and corporatist culture. The disruptive and painful change of the last decade has demonstrated the resilience of that culture, but it has strained it also. Living standards for most Germans have grown only modestly, welfare provisions have been cut and inequality has grown.

How the German general public weigh the costs of this 'return to competitiveness' is an important question. Ten years after the Hartz reforms their impact on the German economy

has been profound. Two thirds of the new jobs created in Germany since 2001 have been 'mini-jobs' - temporary and subject to both lower average pay and lower standards of employment protection (Fig 2). Real wages in Germany have barely risen over the last decade and the share of Germans earning less than two thirds of the average wage has risen by four percentage points: a change driven by the growing preponderance of part-time employment. The German public feels it paid a price for the country's renewed economic strength. They have suffered pain for economic gain. Unsurprisingly they are unenthusiastic about digging into their pockets to bail out struggling Eurozone economies and expect them to make the same difficult choices.

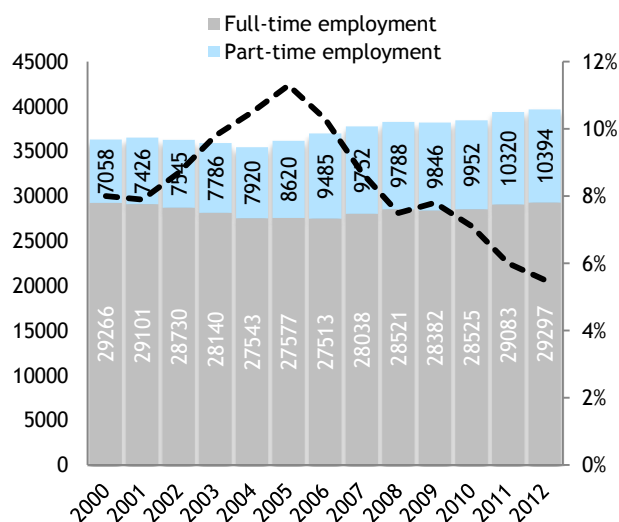


Fig 2: German Employment ('000) and unemployment (% working population) 2000-2013
Source: OECD

As the progenitor of the Hartz reforms the SPD look back on their own legacy with ambivalence. The large new temporary workforce that they have created is acknowledged both as a source of German economic flexibility, but also as having created a cohort of younger, less secure workers,

especially among women. The unpopularity of the Hartz reforms with many on the left fractured the SPD, eroded electoral support among its traditional supporters and led to the formation of the Die Linke far left party. The decision to govern with the Christian Democrats in 2005 ate away further at loyalty to the SPD.

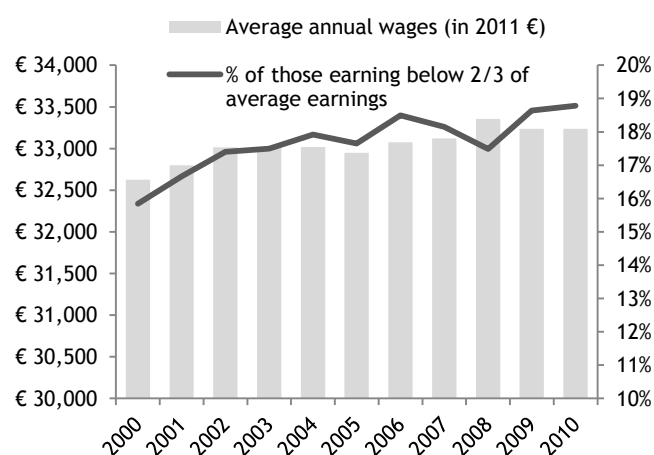


Fig 3: German Average wage and percentage population earning below 2/3 average wage 2000-2010
Source: OECD

The Merkel Ascendency

Angela Merkel emerged to dominate this shifting political landscape when the CDU capitalised on centre-left disenchantment with the SPD's economic reform agenda to win the 2005 Federal elections. Spin doctors describe her as lacking 'charisma', commentators decry her 'lack of a big picture' and the politically committed are frustrated by her apparent failure to understand the role of 'symbols' and 'passion' in German politics. But she has crafted for herself a formidable governing style rooted in an unflashy manner, modesty and instinct for voter concerns, even when they are not traditional CDU preoccupations. These have helped her establish a unique rapport with the German public.

Merkel instinctively understands the mood of economic uncertainty among many Germans, especially in a Europe where Germany is being asked to deploy (or promise to deploy) ever greater resources in defence of the Euro and the European Union. This rapport has left Merkel substantially more popular than her CDU party. It is the basic explanation for the fact that she personally so dominates a political landscape in which the CDU itself has been defeated in 11 regional elections in a row.

How does Merkel personally dominate a political landscape in which the CDU itself has been defeated in 11 regional elections in a row?

Merkel's political strategy has been to turn the weakness of the SPD into a structural feature of German politics. She has cemented the CDU's reputation for economic competence and then deftly moved to deny the centre-left any potential openings by being willing to steal some of their political clothes on issues such as the minimum wage and banking reform. Tactfully avoiding hostility to the trade unions and projecting arguably more family- and women-friendly instincts than the SPD, Merkel has denied the SPD political 'space' - to the frustration of its leaders and strategists. She has performed a similar strategy with the German Greens on renewable energy and nuclear power. It is this relentless occupation of the centre ground (and stealing of the competition's policy clothes) that is the key to her success.

Germany and Europe

All of these threads come together in German policy on Europe. The reality of European decision-making is that Germany has become the one 'indispensable' nation as the Franco-

German duumvirate that has long led and powered European integration has weakened with France's deteriorating economic position. It has been Merkel who has provided the guiding hand for the Eurozone's crisis response strategy since 2010.

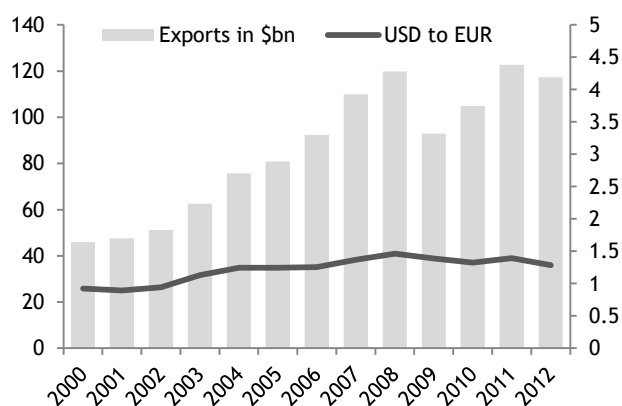


Fig 4: German exports (LH/\$bn) and USD exchange rate 2000-2012 (RH)
Source: OECD

This German leadership has determined both the nature of the response, and its speed. Under Merkel, Berlin has acquiesced in the creation of a new European 'liquidity' fund (the European Stability Mechanism) to provide lines of credit to Greece, Ireland, Portugal, Cyprus and Spain. It has allowed the first tentative steps towards pooling supervisory responsibility for the EU's largest banks and allowing the direct recapitalisation of banks with EU funds. But it has made the pooling of these liabilities contingent on submission by EU states to tougher fiscal rules and EU oversight. Where German taxpayers' money has been put on the line, Merkel has publically and visibly demanded tough concessions in return.

This is part of the delicate political balance Merkel must strike on Europe in Germany. Like most Germans of her generation she takes Germany's pro-European credentials exceptionally seriously. She sees Germany's European vocation as a powerful and important

part of its political culture. Yet she also understands that the perception that Germany is being asked to bail out other members of the Eurozone to save the single currency is putting a deep strain on this sense of Germany's European obligations. While she accepts that a greater measure of collective liability for banks as well as borrowing is probably required to stabilise the Eurozone for the long term, she is deeply pragmatic about how fast the German public can be pulled in this direction.

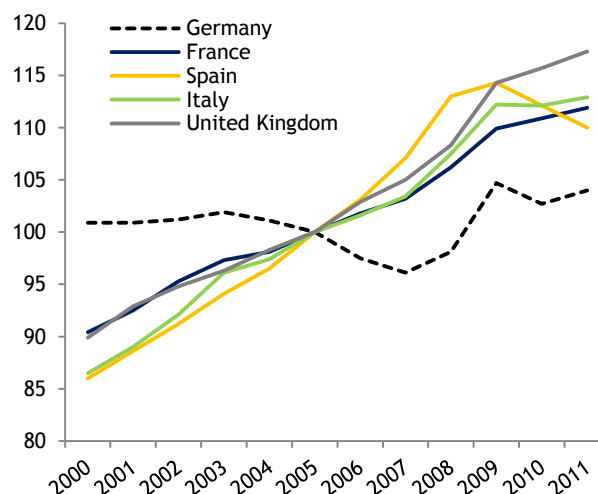


Fig 5: European unit labour costs 100=2006
Source: European Commission

Merkel has corralled the German political mainstream behind her European strategy very effectively. Both the SPD and the Greens have backed European bailouts on the terms Merkel imposed and the Bundestag has approved it all by substantial margins. Despite the debate raging among elites about the legal scope for ECB action, the European Treaty bases for banking union and the constitutionality of Germany's ESM commitments, on the whole the German political class remains broadly united on the issue of Europe. For this reason, Europe is neither likely to be a major issue in the campaign nor have a significant impact on the outcome.

Yet behind the elite consensus the wider mood in Germany on Europe is clearly evolving. The emergence in 2012 of an anti-bailout party - Alternative Für Deutschland - largely from within the ranks of the FDP and the CDU, marked the first serious fracture in the consensus. Within the CDU and the FDP in particular, there is growing concern at the perceived price Germany is being asked to pay for stabilising the single currency.

Under this enforced political consensus, the mood in Germany on Europe is clearly evolving.

Confronted with an indebted periphery and a requirement to stabilise the single currency by closing the gaps in competitiveness between Germany and its southern neighbours, Germans are uneasy. Many Germans are now actively questioning the terms of further European integration and just how much 'more' Europe they really want. They feel that they have just emerged from a decade of their own painful reform, which followed in turn on a decade of economic sacrifice to achieve German reunification after 1989. They sense that they will pick up the bill for the perceived excessive borrowing and over-spending of some Eurozone countries. When outsiders demand greater

leadership from Germany in resolving the Eurozone crisis, many Germans simply see the prospect of a third decade of economic sacrifice.

Much of this is still running beneath the surface of German politics. The preference of the main parties would be to avoid talking about Europe in this election, although the issue surfaced briefly in August when CDU Finance Minister Wolfgang Schäuble and former SPD leader Gerhard Schröder engaged in a brief war of words on further support for Greece. But the first signs of an important change in the German view of Europe are clearly present. At one level Germany is perhaps just becoming more like every other EU member state: concerned to protect its own national interest above the prerogatives of the EU. And with generational change, the country has become more comfortable in its own skin and less tied to the sense of political obligation to the EU that has characterised every German political generation since the war.

Parties and process

The 22 September election is to elect representatives to the Bundestag, the lower house of the German Parliament. The German Chancellor will be elected as the head of the largest party elected to the Bundestag. The Bundestag does not have a predefined size but fluctuates depending on the result of the election. It is composed of at least 598 representatives, but the current Bundestag has 622 members, and due to a recent electoral reform, the next Bundestag could be larger still.

The Bundestag is elected using a ‘mixed-member proportional’ (MMP) electoral system. This means that German voters cast two ballots. With the first vote, they elect their local representative by the first-past-the-post system, as in the United Kingdom or the US, with the candidate with most votes winning the seat. Half of representatives are elected in this manner. The second vote is for a regional party list, to reflect the general level of support for a party across a region. This ensures that the parties’ share of seats in the Bundestag matches their national share of the vote.

It is the second vote (*Zweitstimme*) that is decisive and determines the overall composition of the Bundestag, because it captures the scale of national support for a party, irrespective of its local concentration. To be guaranteed representation, parties must reach a 5% minimum share of the national vote. Only the CDU, the SPD, Die Linke, and more recently the Greens, have been elected in recent elections to first-past-the-post constituency seats. The FDP’s representatives come exclusively from the party lists.

Coalition building

A German government must face a vote of investiture in the Bundestag in a secret vote

before it can be sworn in. This small but crucial step makes minority governments in Germany impossible. Instead, the largest party must try to build a governing coalition capable of passing an investiture vote through the possession of a numerical majority in the lower chamber.

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Since the 1980s, the German party system has grown increasingly more fragmented but also more bipolar, particularly at the federal level. The centre-right pole, formed by the CDU/CSU and the FDP, and the centre-left pole, formed by the SPD and the Green Party dominate the political landscape. There is, however, an asymmetry between the two poles that gives an advantage to the centre-right. On the centre left, the far left Die Linke party polls sufficient votes to electorally weaken the SPD but its radicalism and its origins in the Communist Party make it an unacceptable coalition partner at Federal level for the SPD and Greens.

Governments can be expected to form first on the basis of these two basic political blocs - indeed they can be expected to have run closely aligned political campaigns. Only in the event that neither of these left/right groupings achieve a numerical majority can more ‘heterodox’ alliances be expected. The most recent of these was the CDU/SPD ‘Grand Coalition’ of 2005-2009 in which the centre right and centre left governed together. These more politically unconventional alliances are much more common at the level of the German



Länder (regions). Over the last five years, German regional government has seen SPD/CDU and CDU/Green coalitions. These tie-ups are often seen as a testing ground for possible alliances at the national level.

In any national coalition the post of Chancellor is always held by the senior partner, and that of Vice-Chancellor by the junior partner. The number of cabinet posts that the junior partner obtains will depend on its relative strength vis-à-vis the senior partner and the junior partner will often seek to specialise in a number of policy areas. For example, between 1982 and 1998 the FDP held the Ministries of Foreign Affairs, Justice, and Economics in CDU-led governments. In the Red-Green governments of 1999-2005, the Greens took on Foreign Affairs, Food and Agriculture, and Environment. In the present CDU-FDP coalition, the excellent FDP results in 2008 meant it was able to hold an unprecedented five posts: Foreign Affairs, Justice, Economics, Health and Development.

The Bundesrat

Unlike many Parliamentary systems, the national election will not determine the composition of the German second chamber, the Bundesrat. Rather, the Bundesrat is the legislative body that reflects the profound importance of federalism in the German political economy and which represents the sixteen Länder. All legislative initiatives by the federal government must first be presented to the Bundesrat, who may present an objection, and its approval is required for legislation affecting the power of the Länder, as well as constitutional changes.

Rather unusually compared to most other upper houses, the Bundesrat is not elected directly. Its members are representative of the respective state governments, and delegates (between 3 and 6 per state, depending on population) must vote *en bloc* on proposals. A state governed by a coalition may not present delegates whose voting on a proposal is split. Therefore, only states whose governing coalition matches the Bundestag's are technically part of the government. Those that only include opposition parties are part of the opposition and those that include both government and opposition parties are neutral and will usually abstain on legislative proposals.

Even if Merkel's government is re-elected in September, she will still have to face a hostile Bundesrat.

The September 22 election will have no effect on the makeup of this chamber. Its disposition results rather from the shifting landscape of regional government in Germany. The current governing CDU-FDP coalition lost its majority in the Bundesrat in 2010, and following a string of regional election defeats, the opposition SPD-Greens have had a majority in the Bundesrat since their Lower Saxony victory in January 2013, giving them the power to block some government proposals and initiate legislation of their own. Even if Merkel's government is re-elected in September, she will still have to face a hostile Bundesrat.

Box 1: The main German political parties

Christian Democratic Union (CDU)



The Christian Democratic Union (CDU), supported by the Bavarian Christian Social Union (CSU), dominates the German centre-right. The CDU are the quintessential Christian Democratic party in the continental European tradition: socially conservative, fiscally conservative and pro-business in a market economy buttressed with strong social institutions.

The CDU is pro-European and Atlanticist and sits with the European People's Party group in the European Parliament.

The CDU has held power for 44 out of 64 years since the creation of the Federal Republic in 1950. Angela Merkel has led the CDU since 2000 and has been German Chancellor since 2005. She served as Minister for the Environment from 1994 to 1998, and for Women and Youth from 1991 to 1994 under the government of Helmut Kohl.

The Free Democratic Party (FDP)



A small pro-business centrist party, the Free Democratic Party (FDP) was Germany's third largest party throughout the post-war period. It was the uncontested kingmaker, having entered into coalitions with both the CDU and the SPD. However, since the 1980s it has lost this dominance and shifted rightwards ideologically. It has now oriented itself towards long-term cooperation with the CDU, and is to the liberal right of the CDU on most

questions of economic and fiscal policy.

Perceived increasingly by the electorate as a hard-line free-market party, its platform is based on lower taxes, and it has at times opposed Chancellor Merkel's more generous spending plans, including in areas such as subsidies for low carbon energy. Although the FDP obtained a record-high of 14.6% in the 2009 elections, the party's fortunes are in decline and it has failed to meet the 5% threshold in a number of recent regional elections. The party will be lucky to meet the 5% threshold in September.

Although not party leader, Rainer Brüderle will be the face of the FDP campaign, and has been chairman of the FDP parliamentary faction since 2011. Brüderle was Minister for Economics under Angela Merkel from 2009 to 2011

The Social Democratic Party (SPD)



The Social Democratic Party (SPD) is the primary party of the German left and the mainstream opposition to the CDU. It is a social democratic party, committed to a social market economy and a strong welfare state, and is strongly pro-European. Since the late 1990s the centrist Seeheimer Kreis wing of the SPD has been instrumental in pulling the party towards a greater degree of economic liberalism and was the key driver of the SPD's Agenda

2010 labour market reform agenda. The SPD sits with the Party of European Socialists in the European Parliament.

The SPD is chaired by Sigmar Gabriel, but its Chancellor Candidate is Peer Steinbrück. Steinbrück was Minister of Finance from 2005 to 2009 under Angela Merkel during the CDU-SPD

grand coalition government. Prior to that he was Minister-President of North Rhine-Westphalia, Germany's largest state, from 2002 to 2005. Despite his wealth of experience, Steinbrück has run a faltering campaign, perceived as uncharismatic and lacking Angela Merkel's assured popular touch.

The Greens (Die Grünen)



The Green Party entered the Bundestag for the first time in 1983 and briefly overtook the FDP as the third-largest party in 1994. It was part of a coalition government with the SPD from 1998 to 2005, with its leader Joschka Fischer taking the post of Foreign Minister. Over the last decade the party has increasingly moved towards the liberal and post-ideological centre ground. Aside from its traditional young urban base, the party now has an element of conservative middle class support and it has attracted an element of left-liberal support formerly loyal to the FDP but unsympathetic with its evolution to a harder line free market view. The Greens sit with the GUE/NGL party in the European Parliament.

The faces of the Greens' campaign are Katrin Göring-Eckardt and Jürgen Trittin. Trittin is Chairman of the Green parliamentary group in the Bundestag, and was Minister for the Environment in the Schröder government from 1998 to 2005. Göring-Eckardt has been one of the Bundestag's Vice-Presidents since 2005. With a projected decrease in both Die Linke and the FDP's voting share, the Green Party is almost certainly going to jump from fifth to third-largest party in the Bundestag.

The Left (Die Linke)

DIE LINKE. Die Linke is the political heir of East Germany's ruling party, the Socialist Unity Party, and its support comes mostly from the former GDR. The party is positioned on the hard left and is uncompromisingly ideological (it advocates a 100% tax on incomes above €500,000). It has never been invited to enter national government, though it has allied with the SPD in some Eastern German states.

Die Linke's support in West Germany has grown over the last ten years as it has tapped into a mood of disenchantment with globalisation and European economic integration and liberalisation on the left fringes of the SPD. It has been the fourth-largest party since 2005, but recent polling suggests the party's support is once again retreating to its heartlands in the East. The faces of the Die Linke campaign are party co-Chairs Katja Kipping and Bernd Riexinger.

The Pirate Party (Piraten)

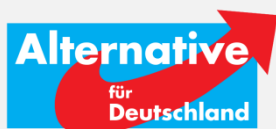


The Pirate party was founded in 2006 and achieved a surprise electoral success for the first time in 2011, when it gained 15 seats in the Berlin regional parliament, and was able to gain representation in other Lands in 2011 and 2012. The party defines itself as a champion of the digital revolution and the potential of an 'information society' - advocating limited regulation of the internet alongside an evolving platform of social liberalism.

After a brief surge (when it briefly overtook the Greens) the party's polling has slumped - its lack of a coherent political platform, infighting within the party, and lacklustre parliamentary performance in the Landers where it is present have led to a significant decrease in

popularity, and the party is unlikely to enter the Bundestag in September.

Alternative for Germany (Alternative für Deutschland)



Alternative für Deutschland (AfD) is the latest arrival on the German political scene, and was only formally established in April 2013. It defines itself as euro-sceptic, but unlike parties like the UK Independence Party, it favours the European Union while criticising the *euro* and in particular the bailout of southern European countries.

its main policy is the gradual return to national currencies. Its economic instincts are broadly free-market liberal: its manifesto includes a pledge for the abolition of energy surcharges to fund renewables.

Led by economics professor Bernd Lucke it has attracted significant media attention since its founding, and will field candidates in all constituencies and the 16 German states. While its poll ratings currently place it at around 3%, which would not give it seats in the Bundestag, polls also suggest that its voter *potential* is much higher. AfD draws support from across the political spectrum, but with a support base that strongly overlaps with the CDU and in particular the FDP (it gained its first representative by the defection of a FDP state assembly member), its key impact in this election may be in denting the overall support for the current coalition.

The possible outcomes

No single party will win the German election. So the result will hinge on the performance of individual parties and the coalition options that they present. German voter preference is for Merkel to continue as Chancellor, but it is far from clear that the existing CDU-CSU-FDP coalition will win a majority. The likely outcome is that the CDU/CSU will be largest block as it is currently polling at 40% plus, several points up from 2009. This will leave it looking for a coalition partner capable for bridging the gap to a 50% majority in the Bundestag.

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The CDU's current FDP coalition partner has seen its support slump. In the most recent regional election this January, Lower Saxony, the FDP's vote fell to barely 5% compared to the 14% share in 2009. Even this meagre vote share was only secured by tactical support from CDU voters. If it scrapes over the 5% margin on September 22 it is unlikely to be by much. A performance similar to that in Lower Saxony would not give the current Black/Yellow coalition sufficient seats to govern.

The Greens should be expected to continue to perform strongly. At one point shortly after the Fukushima nuclear accident in 2011 the Greens overtook the centre-left SPD into second place. They have fallen back substantially since but are still positioning themselves to some degree as a potential coalition partner for both major parties.

If the FDP perform badly, Merkel may seek a Black/Green coalition with the Greens.

Most observers feel this would be a difficult sell to both parties, but the exit from nuclear and the country's 'Energiewende' transition to renewable energy have demonstrated Merkel's 'green' credentials and such a coalition cannot be ruled out. Moreover there is an element of conservative middle class support for the Greens - think farmers making a tidy living off wind turbines, rather than urban post-materialists - that would perhaps be comfortable enough with the idea. It is also possible that the Greens could join the CDU/CSU and FDP in a so-called 'Jamaica coalition', although this would involve reconciling some very divergent views on issues such as energy subsidies.

Merkel's main challenger, the SPD, has seen its vote share fluctuate since 2009. Support for the far-left Linke party has shrunk in the west of the country, but the Party retains sufficient support to badly split the left wing vote and as a Party with former Communists in membership is regarded as beyond the pale as a potential coalition partner at Federal level for the SPD. At 25% the SPD is polling well behind the CDU, and its candidate for Chancellor, Peer Steinbrück, has run a stumbling campaign. Steinbrück has been boxed in by Merkel's dominance on the economic issues that are his own natural key strength and matched or outflanked even on the social justice issues that are the SPD's historic touchstones.

The SPD's preferred governing coalition partner are the Greens, but at this point the SPD and Greens together look to be polling significantly short of the numbers needed for a majority.

This leaves the option of a return to a Merkel-led "Grand Coalition" of the CDU/CSU and SPD. The current SPD leader Peer Steinbrück has ruled out serving in such a coalition and describes the SPD as having been "traumatised" by its last experience of Grand Coalition with Merkel. But, as politically unattractive a prospect as it would be, the rest of the SPD's leadership will realise that if the arithmetic on polling day makes it look to be the most

effective way for Germany to have stable government, the country's voters are likely to expect the party to serve and will punish it if it doesn't.

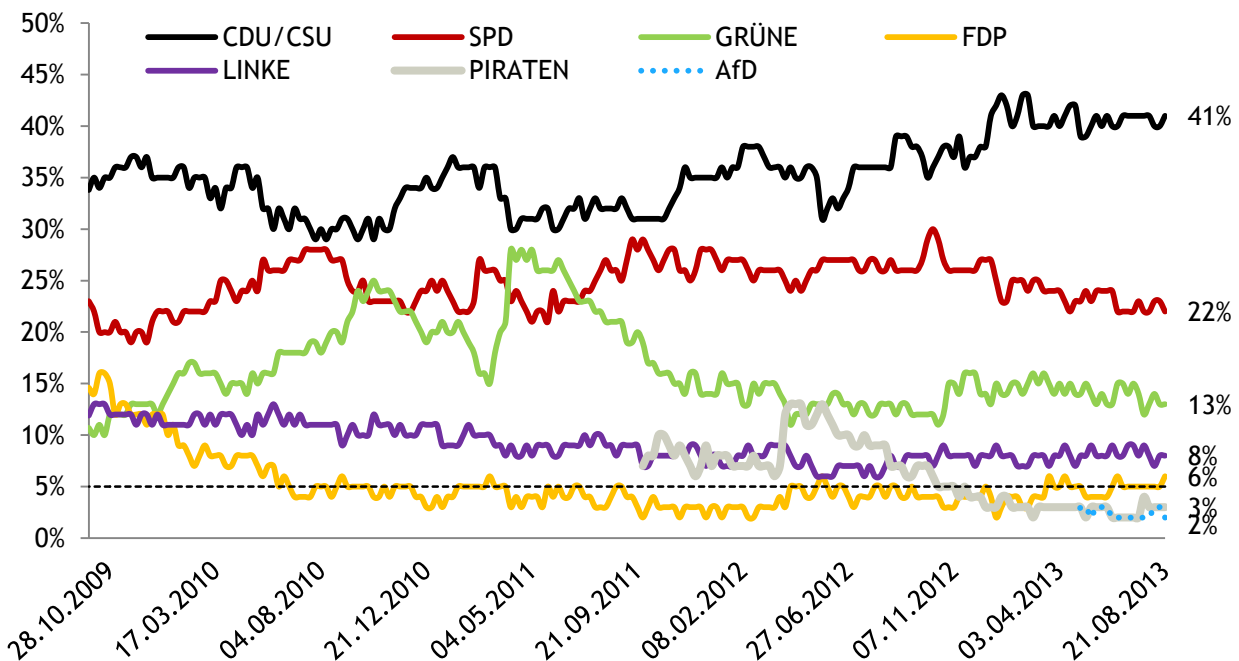


Fig 6: Polling main German political parties 2010-Present (see also August 2013 averages in Fig 7)
Source: FORSA

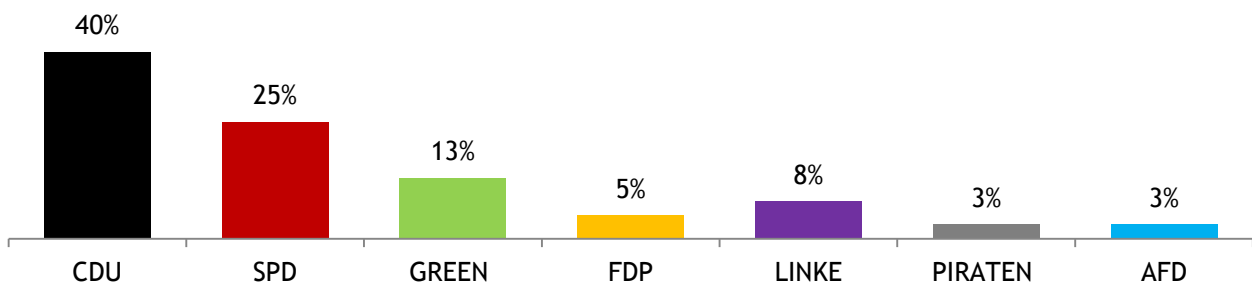
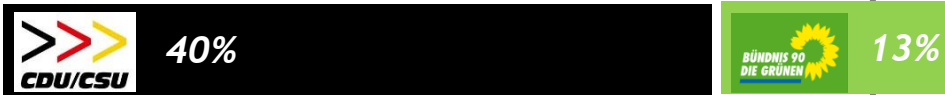


Fig 7: Average party support, all published polls, August 2013
Source: All published polls, August 2013



If both coalition parties poll at the top of their recent ranges the current Black/Gold coalition could be returned on a very narrow majority. The FDP would be dramatically reduced in stature as a coalition partner and as a shaper of policy, although as the CDU's preferred route to power they would still drive a hard bargain.



A weak performance by the FDP - including a possible failure to reach the 5% threshold - would leave the CDU/CSU seeking alternative coalition partners. A possible strategy would be an alliance with the Greens, who are likely to poll well. This would be uncomfortable for some on both sides, but Merkel has burnished her green energy credentials and the Greens are no longer the party of post-materialists they were in the early 1990s. The Greens might balk at a grouping that included the CDUs traditional FDP allies - who have typically taken a highly critical view of green energy subsidies.



If the CDU/CSU were unable to form a coalition, the SPD in principle could seek to build an alternative alliance. At current levels of support, even a Red/Green/Yellow coalition would fall far short of the numbers required to form a government. A more ideologically compatible Red/Green coalition looks even less likely.



The final option for Merkel and the CDU/CSU would be to invite the SPD to serve in a repeat of the 2005 Grand Coalition. SPD leader Steinbrück has ruled out such an option, but under public and media pressure others in his party would find it hard to resist. The 2005 coalition was a traumatic experience for the junior SPD partner and it is not a prospect they would relish again.



After a brief surge into double-digit support in the middle of 2012, the Pirate Party will be lucky to reach the 5% threshold. They will not join any coalition.



Die Linke will win seats in the Bundestag, but they also will not join any coalition.



Alternative für Deutschland are unlikely to win any seats in the Bundestag, but they may pull crucial votes from the FDP and the CDU.

German election issues for business

Income and other taxation

The largest differences between the centre-right and the centre-left are in taxation plans, where the centre-left's emphasis on redistribution and wealth taxation clashes with the FDP proposal to put a constitutional limit on income tax at 50%. The CDU has proposed relatively little on tax reform, except to index income tax bands to inflation to prevent 'cold progression' where taxpayers move into higher bands as real incomes rise faster than tax rate bands.

The SPD and Greens have, however, put forward a number of more radical proposals including a permanent wealth tax, increasing land tax for business, and the Greens' proposal for a one off 1.5% tax on net wealth in excess of €1 million. On income tax, the centre-left parties are proposing narrower bands that would move the 42% rate up to 49% for those earning over €100,000 (SPD) or €80,000 (Greens). The Greens are also proposing the introduction of a 45% tax rate for those earning between €60,000 and €80,000. A SPD/Green coalition could therefore see significant changes to the taxation system. Should the CDU and the SPD seek to form a Grand Coalition, taxation reform would probably be the area in which differences proved particularly difficult to overcome, and in which dramatic changes would be unlikely.

The German fiscal position

The consolidation of the German fiscal position remains a high priority for the CDU/CSU, the FDP, SPD and the Greens. Regardless of the election result German commitment to reducing its deficit and bringing the debt burden down - both of which aims are now imposed through the *Schuldenbremse* debt brake provision in the German Constitution - will remain intact.

The outcome may however affect the *pace* at which the deficit and debt burden are addressed. The FDP remain the most aggressive on deficit reduction, with the Greens the most sanguine at the prospect of a prolonged period of deficit spending. Both the SPD and the CDU advocate improving the German fiscal position, with the CDU manifesto explicitly setting out their commitment to balanced budgets and a reduction of the debt ratio to under the EU Fiscal Pact limit of 60%. This commitment may even circumscribe some of their more ambitious plans, as most of the spending commitments have been made contingent on the public finances being able to bear them without the introduction of new taxes.

Across the German political spectrum, discipline and fiscal probity remain the watchwords.

Like their counterparts across the European centre-left the SPD have campaigned on a platform of caveated austerity. The policy of a coalition of the centre-left involving the SPD and the Greens would substantively be broadly similar to that of the CDU, but with greater emphasis on growth, job creation, and wealth redistribution. However, the measures employed to effect this would be incremental, largely fiscally neutral and by no means constitute a 'stimulus package'. Across the German political spectrum, discipline and fiscal probity remain the watchwords.

Corporation tax

Considering that any coalition will include either the CDU - which has explicitly ruled out raising corporation tax - or the SPD as senior partners - which has not campaigned on it -

raising corporation tax is unlikely to be on the agenda for any government post-September. The CDU, FDP and SPD remain highly sensitive to alienating Germany's politically powerful and symbolic Mittelstand SME sector. Whilst the Green party would be more likely to consider higher corporation taxation, its 'price' for entering in any coalition agreement would be likely to focus on issues of social justice and a more progressive income tax rather than business taxation.

Of the parties conceivably likely to find themselves in government, the FDP has by far the most aggressive position on corporation tax: it advocates abolishing it altogether. It is however unlikely that this position would be supported by the CDU if the current coalition were to continue. Other proposals for cutting business taxes have however focussed on improving tax breaks for research and development funding and which would likely be addressed by any new government, supported as it is by both the CDU and the SPD.

The 'Energiewende'

All of the four major parties (CDU/CSU, SPD, Greens, FDP) support the low carbon *Energiewende* ('energy turn') and the phasing out of German nuclear power. But there is also a growing consensus that the rising cost of renewable energy and impacts of the *Energiewende* on international competitiveness need to be addressed. Proposals on how to do this focus on the existing exemptions from the renewable energy levy (EEG) and the electricity tax for energy-intensive companies.

The FDP are by far the most hawkish on reducing the support levels for renewable energy, and argue for the continuation of both exemptions for business from the EEG and reduction in the electricity tax, in effect placing the burden on renewable generators themselves. They also argue for a move to

direct marketing for new renewables plants instead of fixed feed-in-tariffs.

The CDU for its part has committed to a reassessment of the *Energiewende* - both to slow down the expansion of renewable energy and to move towards market-orientation for the EEG. Furthermore, the CDU is committed only to retaining exemptions from the EEG for companies which are subject to international competition - although it is unclear how strictly this criterion would be interpreted.

Whilst all four of the major parties support the low carbon *Energiewende*, they also all accept that the rising costs will have to be addressed.

A Grand Coalition would almost certainly see action on addressing the costs of the *Energiewende*, however the SPD would be less aggressive in seeking to reduce them, as it retains more ambitious plans for the extent and pace of the *Energiewende* than the CDU. The SPD have supported reducing the electricity tax within a framework of reform of the EEG, although the exact plans are unclear.

An SPD coalition with the Green party would also weaken plans to address the costs of the *Energiewende*. However, it is a demonstration of the political concern over impact on business that even the Green party - whose manifesto commits to a 100% share of renewable energy in electricity production by 2030 - would retain subsidies for energy-intensive companies subject to international competition provided they could demonstrate efficiency measures.

The SPD and the Green party would look to consolidate responsibility for the *Energiewende* in a separate Energy Ministry - it is currently shared between the Environment and Economics

Ministries, which has been the source of some conflict in the current coalition. The FDP also propose change, but would seek to consolidate the responsibility within the Economics Ministry which they currently hold.

Positions towards shale gas fracking run on a spectrum from the Greens, who would ban it outright, to the CDU and FDP who explicitly would not object to hydraulic fracking were it proven to be safe. The SPD have for now committed to upholding a moratorium until more information about the impact of fracking becomes available. Given the strong environmental movement in German politics, those in favour of fracking look set to continue to encounter stiff resistance after September

Banking and finance

Both the SPD and the CDU are contesting this election on a platform of greater regulatory restraint on banking and finance. Merkel has consistently outflanked the SPD by calling for both structural reform of German banks and the imposition of a Financial Transactions Tax (FTT) in both Germany and Europe. On structural reform the current coalition has proposed and will implement a German version of the US 'Volcker rule' banning deposit taking banks trading on their own account or conducting computer-driven high frequency trading. The coalition has also championed a European Financial Transaction Tax based on a levy on trades of some combination of equities, debt securities and certain derivatives.

Both measures can be expected to go ahead under any realistic coalition arrangement. However a CDU-FDP coalition could be expected to quietly drop any political resistance to dramatically reducing the scope of a European FTT after the election - Berlin is concerned that the current European Commission proposals would raise the costs of holding and trading European sovereign debt.

Minimum wage

The minimum wage in some form or another enjoys strong support in Germany, with some polling suggesting that as many as three quarters of Germans are in favour of a statutory minimum. The strength of support is such that even the pro-business FDP have now agreed to accept minimum wage agreements in certain sectors, despite strong opposition from inside the party. The position of the CDU is similar, which indicates that a continuation of the current coalition would likely see government support for minimum wages, although not on a statutory basis and only in sectors not currently covered by collective bargaining agreements.

Both the SPD and the CDU are contesting this election on a platform of greater regulatory restraint on banking and finance.

CDU opposition to statutory minimum wages would probably rule them out in a Grand Coalition deal, but such a government would be likely to introduce a wider extension of sectors covered by the minimum wage, and the minimum level at which it was set could move closer to the SPD's preferred €8.50 an hour. The SPD and Greens both take the position of support for a statutory across-the-board minimum wage at €8.50 an hour.

Mini-jobs

The issue of mini-jobs - low paid, short term and typically part time jobs which are exempt from certain social security contributions and taxation - is one of the key points of differentiation between the German centre-right and centre-left. In part this is due to the differing interpretations of the impact of the mini-jobs, seen either as a key factor in Germany's resilience through the crisis and its



relatively low unemployment rate, or as a pernicious undermining of labour protection and a driver of Germany's widening inequality gap, which is the second highest in Europe.

The centre-left and the Green party in particular, seek greater regulation and restrictions on mini-jobs. The SPD also seek to further regulate the mini-job sector, which in part is a product of the party's ambivalence towards its own legacy of labour market reform under Gerhard Schröder, which included the introduction of the mini-job as part of the Hartz II package. The centre-right however is far more positive on maintaining the flexibility of the labour market and there is even some support within the FDP for further deregulation in longer-term employment contracts, although this would be unlikely to form part of a coalition agreement with the CDU.

Gender and inter-generational equality

Proposals to introduce gender quotas for executives have found support in both the CDU and SPD. The CDU has committed to introducing a quota of 30% for women in managerial and executive positions, although continuing coalition with the FDP, who are strongly opposed to such quotas, may see this plan weakened or shelved.

A Grand Coalition, or a coalition on the left could well also see the introduction of gender quotas for boards as the SPD have also proposed a 40% quota for women on supervisory and executive boards. The SPD have also proposed legislation on equality of income for women, although it is unclear whether this would survive coalition with the CDU. The SPD have also put forward a proposal for generational contracts, similar to those seen in France, which encourage employment of younger people and provides support for training.

Germany and Europe

For many international observers of this German election the big questions that hang over it concern Germany's conduct in Europe and its evolving view of its place in the European Union. Although the issue of further support for Greece intruded briefly into the election campaign (when CDU Finance Minister Wolfgang Schäuble let slip in a moment of characteristic candour that further support was inevitable), Europe has been largely absent from this campaign.

The consensus that Merkel has built over the last three years across the political mainstream on Germany's underwriting of a Eurozone rescue has largely neutered the European issue in electoral terms. The German political elite on the whole continue to accept that Germany has unique European 'obligations' that must be discharged without excessive complaint. So when former SPD Chancellor Gerhard Schröder was wheeled out to criticise Merkel in the wake of Schäuble's comments he attacked her lack of candidness on her European policy, not her European policy itself. Nevertheless, under this elite consensus things are clearly changing. Here are three things to consider on Germany and Europe.

First, in many respects German politics on Europe may simply be becoming like political attitudes to the EU everywhere else in Europe. After five decades, the idea that Germany owes a special debt to European integration is simply losing its force. Merkel obviously understands the central role Germany would inevitably play in a more fiscally integrated Eurozone and European Banking Union. But she also clearly knows that she cannot appear dismissive of German interests over those of the wider EU. It was always striking that Germany was the last of the large European political markets to see open criticism of the fundamental direction of

European policy break into the mainstream. But it has happened with Alternative für Deutschland, and there are plenty of sympathisers with the AfD argument across the political spectrum, especially on the centre-right.

Merkel will not interpret a new mandate as a license to widen or deepen Germany's explicit or implicit underwriting of the rest of the Eurozone or the EU's banking union.

Second, this should give anyone who thinks that this election will change European policy in the Chancellery food for thought. German popular patience with the idea of 'paying' to drive and secure European integration is eroding. Our case here has been that this is closely tied to popular perceptions of what Germany itself has undertaken over the last twenty years to reunite East and West Germany and to regain a new measure of wage and industrial competitiveness after 2003. The demands that Merkel intuits that her voters want placed on Eurozone states receiving European assistance are a version of the tough demands Germans believe they have spent the last decade imposing on themselves. But even they will not be enough to remove German doubts about the way the Eurozone is evolving.

So Merkel will not interpret a new mandate as a license to widen or deepen Germany's explicit or implicit underwriting of the rest of the Eurozone or the EU's banking union. Indeed she is a canny enough politician to recognise that at her current popularity levels she will be constantly fighting against the public disenchantment that inevitably undermines a leader so dominant in their domestic politics. If

the Eurozone struggles back to sustained growth, the ECB pulls off its Asset Quality Review in Spring 2014 without destabilising market views of the banking system and no other crisis intervenes, Merkel will see no reason for big new Eurozone initiatives other than possibly doing more on youth unemployment and continuing to apply pressure on the back markers to pursue structural reform in their domestic economies and be more fiscally disciplined.

A canny British leader sensitive to this bigger picture could secure German support for significant concessions to the British desire to protect its interests vis-à-vis those of the Eurozone. Provided they in turn supported a German vision of fiscal management and economic competitiveness in the Eurozone and wider EU.

Third, Merkel's search for allies in this attempt to control the pace and scope of European political and economic integration would typically have directed her towards London as a counterbalance to Paris. France is both more demanding of implicit German guarantees and a lot more hostile to German views of fiscal constraint and structural reform. Although Berlin has cultivated Warsaw as an alternative counterweight to Paris within the Eurozone

(which Poland is outside of, but intends to join), the view in Berlin is that London would be the better long term bet for shaping an EU that reflects German instincts and interests.

The fact that London has chosen this moment to retreat into an uncertain and angry debate about its future in the EU - and done so in a way that might have been calculated to irritate its EU partners - is a source of both frustration and anxiety in Berlin. Ironically, it suggests that in the next political cycle a canny British leader sensitive to this bigger picture could secure German support for significant concessions to the British desire to protect its interests vis-à-vis those of the Eurozone. Provided they in turn supported a German vision of fiscal management and economic competitiveness in the Eurozone and wider EU. How and whether this happens will be one of the most interesting parts of the European dynamic over the next five years.

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38 Wigmore Street
London
SW1U 2HA
info@global-counsel.co.uk
+44 (0)207 656 7600

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Stephen Adams (s.adams@global-counsel.co.uk)
Geoffrey Norris (g.norris@global-counsel.co.uk)

www.global-counsel.co.uk

