PREVIEW: German Federal Election on Sunday, 23rd February

SUMMARY

- The election on Sunday, February 23rd is expected to result in another coalition government but one that is headed by CDU/CSU with Merz as the Chancellor. The most likely outcome is a 'Grand' coalition headed by CDU/CSU with SPD as the junior partner, which would be seen as pro-growth and theoretically received favourably. However, focus then turns to whether two or more of Die Linke, FDP and BSW meet the constitutional criteria to enter the Bundestag. If they do, then the prospect of debt-brake reform is much less likely (this is also the case in the scenario of particularly strong performance of AfD, at the expense of Greens) as a two-thirds majority of seats is required for constitutional change.
- If debt brake reform is possible, then Bunds will likely come under pressure with the most bearish scenario in the case of a 'Kenya' coalition (CDU/CSU, SPD and Greens) given the similarities in views on the debt brake between the SPD and Greens.
- For the Euro and stocks the reaction will be favourable in the case of a pro-growth coalition, though the magnitude of this will be dependent on the exact configuration, whether constitutional reform of the debt break is possible, how far the government is willing to push this, plans for the proceeds and what combination of expansionary measures are drawn from the respective manifestos of involved parties i.e. how pro-growth it is.
- Overall, the knee-jerk reaction will be drawn from the strength of CDU/CSU, how close a grand coalition is to a majority and then if the two-thirds seat threshold for constitutional reform is possible or not. For this, look to see if Die Linke, FDP and/or BSW meet the threshold for Bundestag entry. Particularly, if FDP enters the Bundestag as they align more closely with CDU/CSU on areas such as the debt break and could be the preferred third party in a coalition from Merz's perspective; their inclusion would limit the likelihood of debt brake reform given their opposition to it (a stance which effectively collapsed the traffic-light coalition) and the slim prospect of such a coalition hitting the two-thirds threshold. A CDU/CSU, SPD & FDP government would be a 'Germany' coalition.
- Voting is open from 07:00GMT to 17:00GMT on Sunday, February 23rd. The first exit polls should drop just after 17:00GMT. Thereafter, districts will begin to posit initial results around 30-60 minutes later. Typically, this provides an idea as to the broad composition of the Bundestag and possible coalitions, but the seat distribution is unlikely to be clear until the early hours of Monday.

CURRENT GOVERNMENT/COALITION

- Prior to its collapse, Germany was governed via the Traffic-Light coalition of SPD, Green and FDP. The coalition had been fractured for a period of time but formally collapsed when Finance Minister Lindner (FDP) refused to support Chancellor Scholz's (SPD) debt brake loosening proposal. As it stands, Chancellor Scholz heads up a minority SPD-Green government which has 324 members and as such is 41 short of a majority under the current 730 member Bundestag.
- Under German law, an election was not required until end-August 2025 at the earliest, with 26th October 2025 the last possible date for one. However, Chancellor Scholz submitted and lost a confidence motion on December 11th after the traffic light coalition collapsed in early-November.

FORMAT

- Germany has a proportional system where voters have two votes. The first, is used to direct a candidate in their constituency while the second is for the party's broader electoral list. As part of this, Germany has an electoral threshold whereby parties must obtain 5% of the second vote nationwide in order to enter the Bundestag. Alternatively, a basic-mandate clause enables entry if a party secures victory in three or more constituencies; note, this mandate was suspended in 2023 to reduce the size of the Bundestag, but has been provisionally reintroduced for 2025.
- The Bundestag currently has 730 members, but as of the new government this will be reduced to 630 members with 316 required for a majority, this could theoretically be achieved by one party directly or more likely via a coalition.

MAIN PARTIES (in order of current Bundestag seats)

SPD

- The Social Democratic Party of Germany (SPD) is run by Saskia Esken and Larks Klingbeil and is the party of current Chancellor Scholz.
- Currently holds 207 seats in the Bundestag.
- Seen as being centre-left on the political spectrum.

CDU/CSU

- The Union Parties led by Friedrich Merz and Markus Soder, though with Merz the overall leader. The two parties do not compete in any states, operating as a 'union' with the same basic political goals.
- Currently holds 197 seats in the Bundestag.
- Seen as being centre-right on the political spectrum.

Greens

- Formally Alliance 90/The Greens. Felix Banaszak and Franziska Brantner are the co-leaders with Katharina Dröge and Britta Haßelmann the parliamentary leaders while Robet Habeck (current vice-Chancellor) is their candidate for Chancellor.
- Currently holds 117 seats in the Bundestag.
- Seen as being centre/centre-left on the political spectrum.

FDP

- The Free Democratic Party. Led by Christian Lindner who was the Finance Minister under the traffic light coalition.
- Currently holds 90 seats in the Bundestag.

- Seen as being centre-left on the political spectrum.

AfD

- Alternative for Germany, led by Timo Chrupalla and Alice Weidel who are also the parliamentary leaders.
- Currently holds 77 seats in the Bundestag.
- Seen as being far-right on the political spectrum.

Die Linke

- “The Left”, led by Ines Schewedtner and Jan van Aken.
- Currently holds 28 seats in the Bundestag.
- Seen as being left on the political spectrum.

BSW

- Reason and Justice, led by Amira Mohamed Ali and Sahra Wagenknecht.
- Currently holds 10 seats in the Bundestag.
- Seen as being left/far-left on the political spectrum.

MANIFESTOS

- In brief, the plans of all major parties are heavily focussed on reforms to income tax, with differing approaches aligning with the ideologies of respective parties. Further, parties generally look for adjustments to various surcharges, ‘mini-job’ rates, pensions, capital gains and citizens insurance. Broadly, parties look to increase the basic allowance and upper levels income tax bands in addition to lifting the top rates of income tax.
- Ifo analysis on the fiscal plans of the parties estimates that, including behaviour/second-round adjustments, the measures of SPD would lead to an increased budget burden of EUR 7bln, CDU/CSU 87bln, Greens 1bln, FDP 129bln, AfD 143bln, Die Linke 2bln and BSW 181bln; note, this does not include the impact of transfers or second/third round effects from such payments. In summary, Ifo writes that the proposed measures are unlikely to be implemented in full in any coalition given the elevated fiscal requirements and contradictions amongst the views of potential coalition members. Instead, Ifo believes that staggered implementation of any major reform is the most sensible option; Die Linke policies aside, expected employment incentives and additional tax generation from associated measures can only provide very limited compensation for the considerable state revenue shortfall from a net reduced level of tax burden and/or increased government support.

DEBT BRAKE

- The debt brake currently limits Germany’s net borrowing to 0.35% of GDP and is a constitutional requirement, meaning it requires the support of two-thirds of the Bundestag to alter.
- One of the main market focus points into the election. Incumbent Scholz (SPD) has continuously reiterated a need to reform the break immediately after elections, as have the Greens. However, the CDU/CSU official position is for the debt brake to remain in place, a view shared by the FDP; though, in recent debates Merz (CDU/CSU) has acknowledged it could be altered in order to fund defence spending, though he has been more cautious about near term adjustments. Specifically, Merz said “you can discuss everything, but that certainly won’t come at the beginning”.
- Currently, polls point to CDU/CSU, SPD and the Green Party having control of just under 60% of the Bundestag, though this will likely be higher in the scenario that some of the aforementioned smaller parties do not hit the electoral threshold for seat allocation. Specifically, Goldman Sachs calculates that it is likely there will be a blocking minority against constitutional changes if two or more of the smaller parties meet the threshold and enter parliament.

POLLING

- Since the election was formally called, opinion polls have clearly and consistently had the CDU/CSU union in the lead with a margin of between 5-15pp over their next closest rival which has at almost every polling point been AfD.

As of the 14th-17th February polling period for the most recent YouGov, INSA and Forsa polls:

- CDU/CSU: 27-30%
- AfD: 20-22%
- SPD: 15-17%
- Green: 12-13%
- Die Linke: 6-9%
- BSW: 4-5%
- FDP: 4-5%

COALITION OPTIONS

- Given CDU/CSU is polling in the lead and other parties have committed to a “firewall” to prevent AfD from entering a coalition/government, this preview will focus on options for a CDU/CSU led coalition.
- Historically, the preferred option among voters is for a “Grand Coalition” (Black-Red) led by CDU/CSU with SPD as the junior partner, such a coalition would likely see Merz appointed as Chancellor. As it stands, it does not appear as if current Chancellor Scholz (SPD) would have a role in the cabinet, Scholz and Merz have described the prospect of them both being in the same cabinet as “unlikely”. The easiest path for this coalition would be if one or a combination of Die Linke, BSW and FDP do not hit the 5% hurdle, with the omission of FDP and the Left meaning that a “grand coalition” of CDU/CSU and SPD could obtain the 50% threshold. Otherwise, a third partner could be needed with the Green Party the likely target, resulting in a ‘Kenya’ coalition, particularly given some of the similarities between them and SPD on the debt brake. CDU/CSU may wish to have FDP as the third member of a coalition if one is required, though it remains to be seen if FDP will feature in the Bundestag and even if they do the likelihood of this resulting in a two-thirds majority is, based on current polls, very slim.
- Goldman Sachs attached, as of 14th February, around a 50% chance of a grand coalition and then, if two or more of the smaller parties enters parliament, a 35% chance of a three-way Kenya coalition. Failing this, the desk assigns around equal odds of a CDU/CSU-Green (Black-Green) or CDU/CSU, SPD & FDP (Germany) coalition.
- If a coalition between CDU/CSU and parliamentary group(s) cannot be formed then it is theoretically possible that AfD could attempt to

form a coalition, though as other parties have committed to not joining with them they, barring a significant surge on polling day, should not be able to reach a majority. Note, AfD received heightened press attention and possibly some modest polling strength in recent weeks with support coming from Hungary's Orban, Elon Musk and more generally within Germany following the asylum-seeker-related incident in Munich and supportive remarks from US VP Vance, amongst others.

DEBATES

- There have been two TV debates this cycle, with the head-to-head between current Chancellor Scholz and frontrunner Merz regarded as being a relatively even contest. Unsurprisingly, Scholz talked up the success points of his leadership while Merz focussed on more recent economic woes and political focus points such as immigration; economic proposals were covered, but nothing fundamentally new featured aside from Merz acknowledging that under his leadership the debt break could potentially be altered, though this would not occur in the near-term. Broadly, commentators are of the view that the debate did not feature anything that would stand in the way of a return to a 'grand coalition'.
- More recently, a broader debate with the above officials alongside Habeck (Greens) and Weidel (AfD) was particularly heated and focussed on US President Trump, defence spending and the far-right. AfD's Weidel came under the most scrutiny with all parties going to lengths to confront the official who has received support from US VP Vance in recent sessions; the overarching message was that the firewall is intact and the parties will not be seeking support from AfD for any coalition.
- Overall, it does not appear as if either TV debate has significantly changed the narrative. Following the conclusion of the second and final debate, ING estimates that over 25% of voters are yet to decide who they will vote for. A narrative that is particularly interesting if tactical voting comes into play, given the constitutional rules around minimum vote share and both Die Linke and BSW polling within error margins of that 5% mark.

ECONOMIC IMPLICATIONS & REACTION

ECONOMY

- Heavily dependent on the prospect of reform to the debt brake. In the scenario of policy gridlock where the hurdle for constitutional reform is not met or the coalition cannot agree on required reforms, something Goldman Sachs ascribes a 35% probability to, then the desk does not expect any meaningful growth effect to emerge from the likely limited policy changes.
- Goldman Sachs' base case, 50% probability, is for limited debt brake reform via the implementation of a tiering rule and various other tax and labour reforms. Within this, they expect military spending to lift to 2.5% of GDP by 2028. Under this outcome growth is seen increasing by an average of 0.2pp until 2027, and the deficit +0.3pp of GDP.
- The more substantial scenario, 15% probability, is for a more significant reform of the debt break and a larger off-budget defence fund to bring such spending to 3.0% of GDP by 2028. Measures which would increase growth by 0.5pp on average until 2027, and the deficit to 0.9pp.

EURO

- Barclays' takes the view that fiscal expansion needs to be at the upper-end of pledges, referencing at least 2% of GDP from CDU/CSU and "ideally" with an investment fund of the type proposed by SPD, in order for a meaningful re-assessment of the blocs growth outlook and by association the EUR.

BONDS

- The necessity of measures to stimulate the German economy means that pressure to increase borrowing will increase, and more so if the pathway for debt brake reform is open. As such, the bias for Bunds is negative on results night with the magnitude of pressure dependent on the type of coalition: a Grand Coalition that hits the threshold would likely see some pressure, but limited given CDU/CSU's relatively cautious approach to reform; a Kenya outcome would, given Greens and SPD both favouring reform, likely be the most bearish for Bunds and particularly so if less than two of the three smaller parties enter parliament. Bearish action for Bunds would likely see the continued narrowing of spreads against swaps and the periphery.
- On the flip side, Barclays outlines a bullish scenario for Bunds where two of the three smaller parties enters parliament and AfD outperforms (essentially blocking debt brake reform), such a scenario could see spreads, i.e. Bund-BTP, widen.
- EGBs entered the election week under marked pressure as France convened an emergency meeting to discuss potential defence spending increases in relation to Ukraine and to appease the US' calls for higher spending levels. A narrative which, given the funding implications, weighed on European debt. In terms of issuance to fund such spending details are currently light but remarks from the Spanish Finance Minister Cuerpo have garnered attention as he said that common debt for public goods, i.e. defence, is a "no brainer". Specifically, Cuerpo referenced continuation of the post-COVID Next Generation EU scheme which was funded via joint borrowing across the bloc.

STOCKS

- Equities could see a favourable response to a Grand Coalition, given the pro-growth approach of parties manifestos, with Barclays noting the expected policies could "help to lift investor sentiment towards both the large cap cyclical laggards and mid caps". Further, they see upside for both domestic names and foreign stocks with high German exposure, as while sentiment around Germany has improved marginally the "basket performance has lagged, which we think offers catch-up potential".
- Within this, markets will be attentive to details on incentives for EVs; of note for, Volkswagen (VOW3 GY), BMW (BMW GY) and Mercedes-Benz (MBG GY) among others. Defence spending pledges, for the likes of Rheinmetall (RHM GY); Housing/Rental market reform/support, for Deutsche Wohnen (DWNI GY); Steel/Material/Chemical names on support for the sectors and/or the approach to Trump's tariffs, for the likes of BASF (BAS GY), Salzgitter (SZG GY) and ThyssenKrupp (TKA GY).

RESULTS DAY & BEYOND

- The immediate results will give us an indication as to whether a blocking minority against constitutional reform is present, if there is then the odds of any but particularly substantial debt brake changes are drastically cut. For this, we look to see if two or more of Die Linke, BSW and FDP hit the threshold and enter parliament, if they do then a blocking minority is possible.
- Thereafter, we look to see if CDU/CSU and SPD together hit the majority threshold and, if so, the two-thirds level for constitutional reform. The Grand coalition likely sets the stage for some limited debt brake reform in the relatively near-term, as a compromise between the two parties. In the likely scenario of the support of a third party being required for the two-thirds threshold, then the odds of more substantial debt brake reform increase if Greens (Kenya coalition) are selected given their views align more closely to SPD.
- The overall outcome may well be heavily influenced by the strength of AfD on results day though, given the firewall and barring a substantial and surprise surge in support on polling day, AfD is not expected to be part of any government.
- In the days/weeks after, and depending on the Bundestag's composition, market attention will be on the final coalition, whether

constitutional reform is possible and what appetite for/consensus around it there is in addition to what mixture of policies the final coalition ends up drawing from the parties within it i.e. how pro-growth they are.