

Angela Merkel won fourth term as German Chancellor; likelihood of protracted coalition talks ahead

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- September 24th federal election outcome.** As expected, Angela Merkel won her fourth term as German Chancellor on Sunday's September 24th federal election. The Conservative Christian democratic political alliance, consisting of Angela Merkel's centre-right Christian Democratic Union (CDU) and the Bavarian sister-party Christian Social Union (CSU) remained the strongest party, but it got only 33.0% of the total vote, its second lowest electoral showing since 1948, compared to 41.5% in the 2013 election, and less than c. 36% implied by a number of pre-election opinion polls. The Social Democratic Party SPD – the current coalition partner – came second with 20.5%, its worst post-World War II performance, a disappointing result for party leader Martin Shultz who immediately announced the party's intention to go into opposition in an attempt to rebuild its credibility and has no intention to renew the so-called grand coalition with Merkel's CDU/CSU. Public support for the CDU/CSU and the SPD has come down to c. 54% from around 90% in the 1970s. On the contrary, the far-right populist Alternative für Deutschland AfD performed better than the majority of pre-election polls suggested, purportedly capitalizing on the resentment of Angela Merkel's handling of the 2015-2016 refugee crisis. AfD secured 12.6%, well above the parliamentary threshold of 5% becoming the first far-right party making it into Bundestag in more than half a century. The liberal Free Democratic Party (FDP) came fourth and managed to re-enter into Bundestag with 10.7%, after falling below the 5% threshold in 2013 for the first time since 1949. The leftist party Die Linke and the centre-left Green party followed suit with 9.2% and 8.9%, respectively. All in all, six political parties are poised to enter the Bundestag, the most since 1953, compared to four in the 2013 ballot. Voter turnout increased to 75.9%, compared to 71.5% in 2013, and an historic low of 70.8% in 2009.
- Coalition scenarios.** Assuming that the SPD leader sticks to his intention to go into opposition and taking into account that a coalition between the CDU/CSU and the FDP would fall short of a required parliamentary majority, the sole viable coalition scenario would be a three party alliance, the so-called 'Jamaica' coalition involving the CDU/CSU, the FDP and the Greens (the colour of the parties involved resemble those of the Jamaican flag). Theoretically, the fact that six parties will be represented in the parliament increases the number of options for coalitions, but in practice most coalition scenarios have already been rejected due to fundamental differences between political parties or because party heads have already expressed their unwillingness to join specific coalitions. Bear in mind that major political parties have already ruled out collaboration with the AfD as a possible coalition partner.

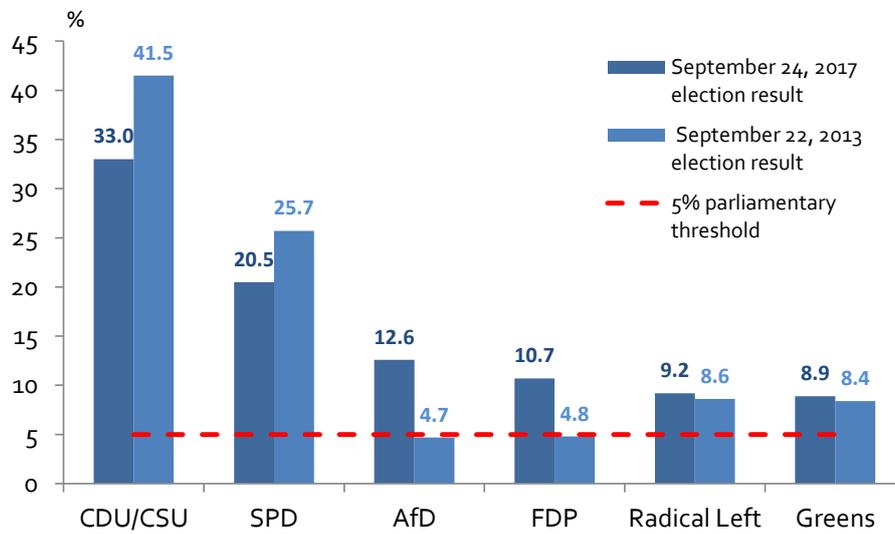
According to the final results with all the 299 constituencies declared, the election outcome translates into 246 seats for CDU/CSU in the Bundestag (vs. 311 seats in 2013), 80 seats for the FDP (vs. 0 seats in 2013) and 67 seats for the Greens (vs. 63 seats in 2013) with all three parties together having a majority of 393 seats, 38 above the required majority.

- **Lengthy coalition talks ahead.** A ‘Jamaica’ collation is already in place in Schleswig-Holstein but has never been implemented at a national level before. This suggests that negotiations are likely to prove difficult and lengthy. While all the three political parties have proposed income tax cuts (CDU: €15bn or 0.5% of 2016 GDP, FDP: €30bn and the Greens: tax cuts for lower incomes), fundamental differences on key policy issues prevail including immigration, defense, labor market, industry, and internal security politics. Indicatively, the FDP has rejected the Greens’ liberal policies on immigration, while both the CSU and the business friendly FDP have criticized strongly the Greens’ pro-environmental approach for a halt in the production of cars with internal combustion engines as of 2030. Furthermore, the Greens oppose a proposal by the CDU and the FDP for an increase in defense spending. EU policy is another source of dispute between the three political parties, including the establishment of a euro area finance ministry — as proposed by French President Emmanuel Macron — and the upgrade of the European Stability Mechanism (ESM) into a European Monetary Fund to make it easier to provide financial assistance to ailing euro area countries. Whereas the Green Party favors more euro area integration, the FDP is against fiscal risk-sharing and has called for the ESM to be scaled down. That said, it will probably take time for the political parties to reach consensus and for a government agenda to be hammered out. The Bundestag has to convene within 30 days after the federal election, i.e., until October 23rd, but coalition talks will likely extend beyond that date, with some press reports suggesting that it could take until the end of the year or even longer.

If coalition talks come to a deadlock and the SPD sticks to its pledge to stay into opposition, the prospect of a minority government of CDU/CSU and the FDP given the ideological similarities of their manifestos cannot be ruled out entirely. Alternatively, the German President could ask Angela Merkel to act as a caretaker government. But, should this be the case, given the lack of democratic legitimacy, the prospect of fresh elections being called would seem as the most likely scenario.

- **Knee-jerk market reaction to the German election outcome.** In a knee-jerk reaction to the German election outcome, the majority of the European equity markets were slightly weaker in mid-trade on Monday and euro area periphery sovereign debt spreads undertook some widening. Angela Merkel’s relatively weaker mandate and the entry of a far-right party into Bundestag for the first time since World War II have heightened political risks in the euro area’s biggest economy. In the meantime, investors are concerned over potential implications for the euro area in view of Angela Merkel’s relatively weaker mandate and the FDP’s opposition to any further euro area integration. In FX markets, the EUR lost some ground marking a multi-session low of 1.1863 against the USD, having retreated from last week’s 1.2030 peak and a fresh year-to-date high of 1.2092 recorded earlier this month. With investors focusing on the euro area’s improving economic fundamentals and the prospect of an ECB tapering announcement at the October 26th monetary policy meeting, any further EUR/USD weakness near-term is likely to prove limited. Looking further ahead, much will depend on the outcome of the coalition talks and whether market participants start adjusting their expectations of the Fed hiking rates, in line with the FOMC median of dots suggesting an additional 25bps hike by the end of this year and an additional 75bps of rate tightening cumulatively by the end of 2018.

Figure 1 - September 24, 2017 & September 22, 2013 federal election results



Source: Wiki, Bloomberg, Eurobank Economic Research

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