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Approaching a Traffic Light in Germany

Germany's parliamentary elections in late September were momentous for several reasons. Perhaps most important, the elections set the stage for a new leader to take power as Chancellor Angela Merkel decided not to stand for another term after leading Germany since 2005. However, even though the retiring Merkel is likely to see her left-of-center rivals take control of the country, the coalition they're forming may leave Germany's key economic and financial policies relatively unchanged, with big implications not only for Germany itself but also for the broader European Union.

In this report, we parse Germany's party structure and discuss how past coalitions have run their economic and financial policies. We next focus on how those economic and financial policies have played out in Germany and beyond during the 16 years of Merkel's rule, and why the current coalition talks may leave many of those key policies in place. We conclude with a discussion of the investment ramifications if that turns out to be the case.

Germany's Main Political Parties

The German constitution provides for a parliamentary form of government in which executive power is vested in a "chancellor" chosen by majority vote of the nation's legislative body, the Bundestag. Rather than voting for the chancellor, voters choose only their legislators, who then have the responsibility to select the chancellor.

Under Germany's electoral system, many parties typically win seats in parliament and participate in the horse-trading required to form a government. Currently, [Germany's largest parties with representation in parliament include:](#)

CDU/CSU. Germany's center-right Christian Democratic Union (CDU) is especially popular with older, rural, culturally conservative voters who support private enterprise and small government. It typically governs in partnership with its Bavarian sister-party, the Christian Social Union (CSU). The CDU/CSU has led German governments for more than 50 of the 76 years since World War II, including the last 16 years under Merkel. This year, the CDU/CSU candidate for chancellor was Armin Laschet, currently minister-president of the state of North Rhine-Westphalia. His platform called for tax cuts, deregulation, and trade policies that would further support German exports.

SPD. The Social Democratic Party (SPD, using German spelling) is Germany's main center-left party. It is especially popular with older, lower-income, working-class voters in the country's industrial centers. The SPD has led German governments in 21 of the years since World War II, and it was part of a ruling coalition in 12 more years. In this year's elections, the SPD candidate for chancellor was current Finance Minister Olaf Scholz. His platform focused on implementing social justice policies such as a higher minimum wage and increased taxes on the affluent.

Greens. Germany's Green Party is leftist, but perhaps less than the label might imply. The party is now dominated by its "realist" wing, which is more willing to compromise in order to have a say on policy. Its uncompromisingly leftist "fundamentalist" wing has steadily lost influence in recent years. The Greens are popular with younger, higher-educated, higher-income voters focused on environmental issues and social justice goals. The Greens' only experience in power was from 1998 to 2005 as a coalition partner with the ruling SPD. In this year's elections, its candidate for chancellor was Bundestag member Annalena Baerbock. Her platform focused on an infrastructure and clean energy program to be financed mostly by new debt, as well as new social benefits and tougher pushback against Russian and Chinese human rights abuses.

FDP. The Free Democrat Party (FDP) is a right-wing party that is most popular with well-educated, self-employed business owners and professionals such as lawyers and physicians. Although it has never led a government, it has been a coalition partner for either the CDU/CSU or the SPD in more than 40 of the years since World War II. Its candidate for chancellor this year was Bundestag member Christian Lindner, who campaigned on a platform of restricting government power, cutting taxes, protecting property rights, fighting climate change by encouraging investment in new technologies, protecting civil rights, and pushing back against Russian and Chinese human rights abuses.

Left Party. Founded in 2007, the Left Party has inherited the mantle of Germany's previous hard-left parties. It is most popular with former Communists in eastern Germany and younger protest voters who oppose the country's traditional parties. It has never served in a German government.

Indeed, it has alienated many voters because of its perceived radicalism. It has also lost many supporters who prefer to express their opposition to the establishment by supporting far-right populists.

AfD. Founded in 2013 as a Eurosceptic party, the Alternative for Germany (AfD) Party is a right-wing nationalist party that has poached voters from across the political spectrum, although most of its supporters are men from Germany's middle- and lower-income classes. Its platform is anti-EU, anti-immigration, and pro-German, in the sense of upholding traditional German culture. Its membership includes many extremists, which has capped its appeal despite its growth in recent years.

German Coalitions Over Time

Since World War II, no German party has ever won a majority of seats in the Bundestag. [All of the country's postwar governments have therefore relied on coalitions to stay in power.](#) As discussed above, the center-right CDU/CSU has been the coalition leader in most of the postwar years; the center-left SPD has led all other coalition governments. Importantly, no German coalition has been composed of more than two parties since 1957. Overall, this system has served Germany well, allowing it to not only recover from the economic and social damages of the war, but ultimately to regain its position as a global manufacturing powerhouse with a rich and stable society and to reunify after the fall of the Berlin Wall in 1989.

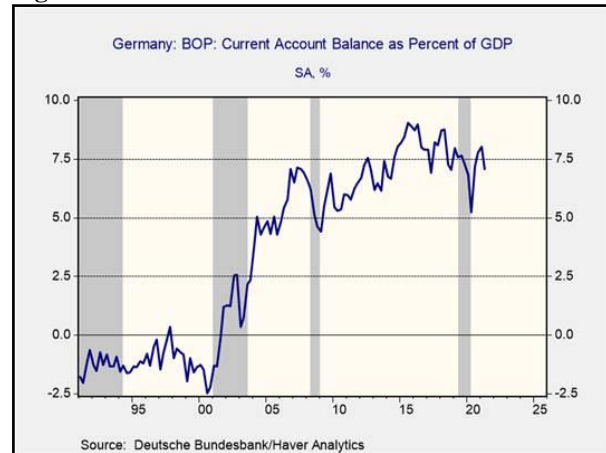
From its inception in 2005, the CDU/CSU government under Chancellor Merkel was therefore no anomaly. Despite the major political damage Merkel suffered from the European migrant crisis in 2015, she led major initiatives that enhanced Germany's political and economic power in Europe and

beyond. The following developments under Merkel were particularly important:

- Domestic.** By the time Merkel became chancellor, Germany was already benefiting mightily from the 1999 launch of the euro, which reduced the risk of currency appreciation and provided a stimulative interest-rate cut for poorer, less stable countries in Europe. German industry was also already benefiting from a previous government's labor reforms, which held down German wages and made its exports more competitive. True to CDU/CSU ideology, Merkel further boosted German competitiveness by strictly hewing to free-market policies and further entrenching German fiscal rectitude, most notably by pushing through a constitutional "debt brake" that generally limits federal government borrowing to 0.35% of the country's gross domestic product (GDP). One downside of the debt brake, however, is that it has impeded German investment in broadband and other infrastructure.
- International.** As the Global Financial Crisis of 2007-2008 spread to Europe, threatening to push highly indebted countries like Greece and Portugal into default, the Merkel government insisted on imposing strict oversight and German-like fiscal austerity on those nations in return for limited debt relief. Her ability to make those demands owed much to the fiscal hawks representing Germany at the European Central Bank (ECB), such as German central bank chief Jens Weidmann. Coupled with Merkel's competitiveness-boosting domestic policies, Germany's fiscal influence over the European Union and other EU countries helped transform Germany into an export powerhouse, with some EU countries filling a nearly

colony-like role as absorbers of German exports and investment capital. As evidence of Germany's trade success, Figure 1 shows the dramatic rise in the country's current account balance (which is driven by its trade balance) since the launch of the euro.

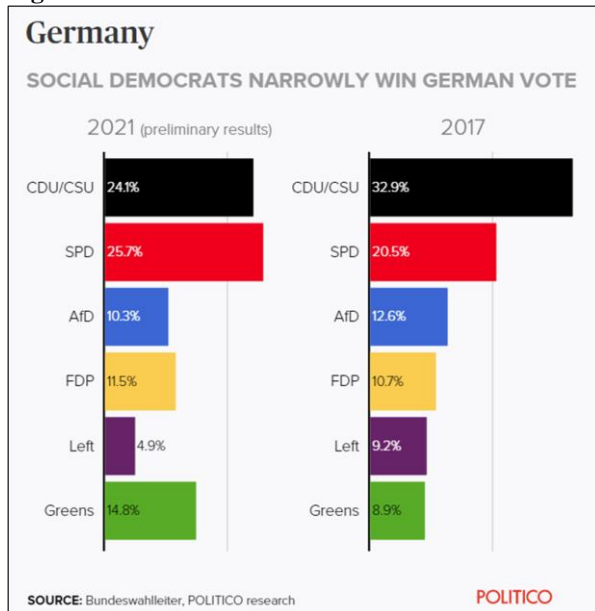
Figure 1.



Germany's Evolving New Government

Against this backdrop, the September elections were a turning point for Germany on several levels. As shown in Figure 2 on the following page, [the SPD won the election with 25.7% of the vote, followed by the CDU/SCU with 24.1%, the Greens with 14.8%, and the FDP with 11.5%](#). Figure 3, also on the following page, indicates the number of Bundestag seats won by each party and the various coalition groupings that could provide a majority. As shown by the chart, a few two-party coalitions could theoretically form a government. However, because of renewed animosity between the CDU/CSU and the SPD, most observers believe that any likely coalition would probably require at least three parties.

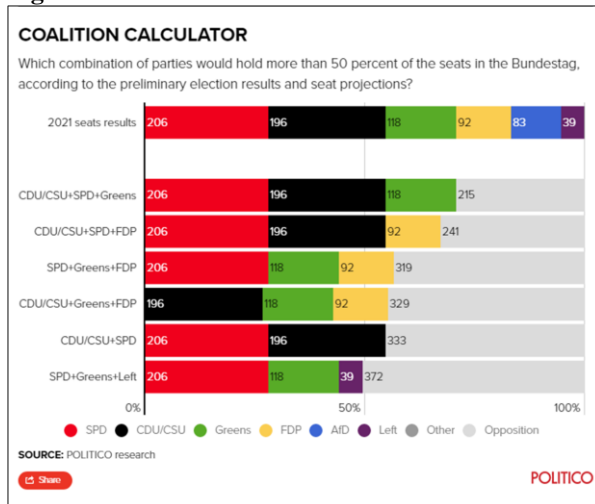
Figure 2.



being termed a “Traffic Light Coalition,” based on the parties’ colors (red for the SPD, green for the greens, and yellow for the FDP, as seen in Figures 1 and 2).

The SPD-Greens-FDP talks are continuing, and a wide range of policies and personnel decisions are still under negotiation, including the all-important decision of who would lead a Traffic Light government. Given the preponderant vote for the SPD compared with the Greens and the FDP, we suspect that current [Finance Minister Scholz is most likely to become the new chancellor](#). However, we think investors should also pay close attention to the evolving discussions over who will be Germany’s new finance minister and who will be the new head of Germany’s central bank, the Bundesbank. Current prospects for those positions appear to be as follows:

Figure 3.



- Finance Ministry.** Both the Greens and the FDP are reportedly fighting for the finance ministry, but as of this writing, it appears the FDP has the inside track for the position. [For example, a triparty statement on their initial negotiations states that a Traffic Light coalition would govern “within the framework of the constitutional debt brake.”](#) The statement also makes no mention of any relaxation of the EU’s fiscal limits. [This is important because a finance minister from the conservative FDP, perhaps party leader Lindner, would like to maintain many of the Merkel government’s shackles on taxes, spending, and debt both at home and in Europe generally.](#) That would likely impede many goals embraced by the SPD and the Greens, like massive new public investment in infrastructure and clean energy, or further issuance of joint EU bonds. Not only would that spark intra-coalition tensions and leave the new government unstable, but it could

Looking at this landscape, the Greens and FDP realized that their best bet for entering into power would be to present themselves as a joint coalition partner for one of the major parties. [Therefore, they first negotiated among themselves to agree on a set of policies and personnel appointments they could both support.](#) They then conducted “interviews” with the SPD and the CDU/CSU to see which they would rather join in government. [As widely expected, they ultimately chose to enter into formal negotiations with the SPD in what is](#)

also prolong the political and economic imbalances within the EU.

- ***Bundesbank Chairman.*** With the [unexpected resignation of Bundesbank chief Weidmann in mid-October](#), the new German government [will need to name a replacement](#). Compared with the finance minister issue, there has been much less press reporting on any talks regarding the Bundesbank. However, given that two of the three Traffic Light parties are left-of-center, the SPD or the Greens would likely get the Bundesbank appointment as compensation if the FDP gets the finance ministry. [The Greens may be especially interested in the Bundesbank as a way to increase the party's wider international reputation and press its environmental agenda on a wider stage.](#)

Ramifications

The September defeat of the CDU/CSU almost certainly reflects more than just “Merkel fatigue.” It also appears to reflect a generational shift, with younger German voters demanding increased public involvement in the economy in order to make Germany more technologically advanced and greener. Those younger voters are also more internationalist and supportive of better relations with the EU. Therefore, even if the FDP does end up with the finance ministry in Germany’s new government, a Chancellor Scholz would probably be able to keep economic policy looser and less restrictive than the most stringent policies under Merkel. Indeed, it’s

notable that when Merkel needed to form a coalition with the SPD and named Scholz as her finance minister in 2013, he was able to substantially ease German policies. For example, Scholz was instrumental in boosting fiscal spending and temporarily relaxing the debt brake in order to deal with the coronavirus. He also helped ensure that Germany would support the EU’s new €750 billion pandemic relief fund and its funding mechanism relying on joint EU debt issuance.

If the SPD, Greens, and FDP successfully conclude their negotiations and form a new Traffic Light government in the coming weeks, we suspect the ramifications will generally be positive for investors. We believe German economic policy would remain centrist on balance, with new environmental regulations and spending programs championed by the SPD and the Greens held in check by the more conservative FDP. Meanwhile, the FDP’s fiscal austerity would be largely counterbalanced by the fiscal stimulus espoused by its partners. We suspect that the resulting modest amount of stimulus could help boost growth in Germany and the broader EU, so it would likely be positive for European equities. At the same time, continued fiscal discipline would likely help support European fixed income and the value of the euro itself.

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