

Macro Watch

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Preview German elections: 'Grand coalition' most likely result

- On February 23, parliamentary elections will be held in Germany. According to polls, CDU/CSU (Union) and AfD are set to gain seats, while SPD, the Greens, and Die Linke, as well as FDP, are expected to lose seats. Union leads the polls, with AfD in second place. However, a coalition between these parties is not feasible. Most parties, including Union, reject governing with AfD due to this party's extreme views.
- The most likely coalition is Union with SPD, as CSU leader Markus Söder does not want to partner with the Greens. Given the strained relationship between Union and SPD, the likelihood of significant reforms is low. Nevertheless, the chance of easing the so-called debt brake is high in a renewed 'Grand Coalition'. SPD has long favoured this, and given statements by Union leader Friedrich Merz, Union now supports it as well.
- Easing the debt brake would allow for additional investments by the German government. These are urgently needed as the German economy is eager for improvements in physical and digital infrastructure. Easing the debt brake also opens the door to implementing proposals from the Draghi report, which calls for further European integration and higher investments in energy transition, innovation, and defence.
- Ideally, the extra financial room created by easing the debt brake would be used to modernize the economy. However, innovative ideas are lacking in the various party programs. While there is talk of reducing bureaucracy, there lacks a concrete vision. Should the new coalition also prove unstable, there is a danger that economic uncertainty will persist, that AfD's support will continue to grow, and that it will be difficult to exclude AfD in the next elections.

This is the first piece on the German elections in a series of pieces until the Bundestag elections in February. In the this first piece we will dive into the polls and possible coalitions outcomes. In the second piece we will discuss the state of the economy and the Bund Market. After the elections we will publish an analysis of the election results and its future implications.

Reason for and importance of these early elections

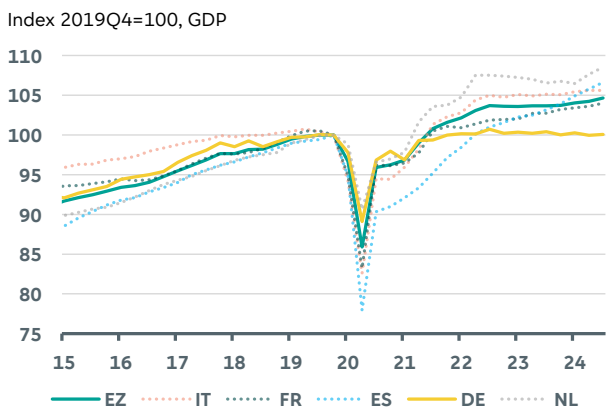
The German elections have been moved up from September 2025 to February this year. The shift is due to the fall of the government in November after Chancellor Olaf Scholz dismissed his Finance Minister Christian Lindner. SPD's Scholz accused FDP's Lindner of betrayal, claiming he deliberately aimed for the government's collapse. A major point of contention among the three coalition partners was public finances and whether the government should adhere to the so-called debt brake, which enforces budget discipline by law. FDP wanted to maintain it, while SPD and the Greens sought easing due to higher defence spending, support for Ukraine, and the ambition to modernize the economy.

The elections take place against the backdrop of a weak economy that has shrunk for two consecutive years and faces rising unemployment. The threat of higher U.S. import tariffs also clouds the outlook for this year. The problem is that the contraction is not cyclical but structural. The industry, traditionally the pillar of the economy, suffers from high energy costs, deterring investments. Additionally, the U.S. government is luring European companies to the U.S. with the Inflation Reduction Act. Furthermore, competitiveness is under pressure as major

companies falter. For instance, car manufacturers have long underestimated the importance of electric vehicles. Germany invests too little in digitization, resulting in slow internet and stagnant productivity growth. Moreover, worsening PISA scores indicate problems in education, while aging continues, with more experienced workers retiring.

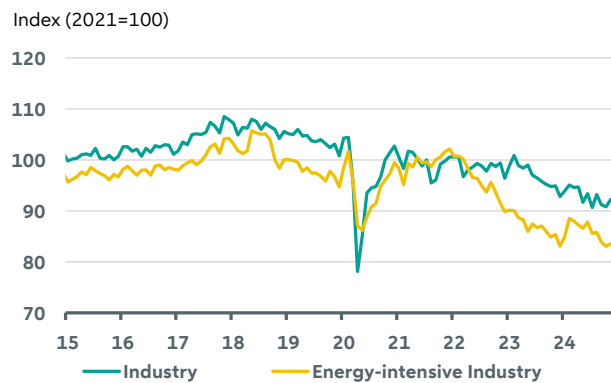
A further problem for Germany is that old certainties have vanished. Since Trump's election, security under the familiar NATO umbrella is no longer a given. Due to Russia's invasion of Ukraine, Ostpolitik, once the cornerstone of German foreign policy, has been discarded. Cooperation with Russia, a strategic partner through the supply of cheap oil and gas, is no longer an option. Lastly, China has transformed from a buyer of German products to a formidable competitor, initially in wind turbines and solar panels, now also in electric cars.

German growth: 5 years of stagnation



Source: Datastream

Industrial production drops, unused capacity grows



Source: Datastream

Four societal issues dominate the German elections. The primary issue is migration. A quarter of Germans now have a migration background. The question is whether Germany wants to remain an open, tolerant society. The second issue is the distribution of resources between rich and poor, and young and old. Society has become more heterogeneous, diminishing mutual solidarity and the willingness to pay taxes to support the social system. The third issue is Germany's place in the world and Europe's role. Politicians increasingly attribute self-inflicted problems to Brussels.

The fourth and final issue is the role of the state and declining trust in institutions. The latter explains the desire to adhere to the debt brake, despite doubts about its economic utility. It limits the capacity to absorb economic shocks, while monetary policy, an alternative for economic management, is in the hands of the ECB. The debt brake also leads to postponement and cancellation of public investments in physical and digital infrastructure. This is politically easier to sell than tax increases or social spending cuts. Due to low investments, the public capital stock is smaller than in other eurozone countries.

Polls indicate major shifts in voter sentiment

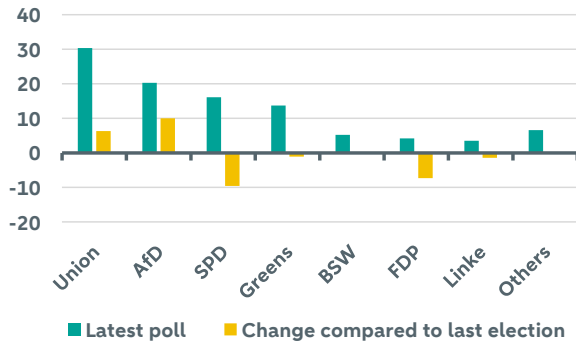
A total of fifty-six parties have registered to participate in the elections. Since not all are allowed to run and there is a 5% hurdle rate, only a fraction will enter parliament. A new party may enter the Bundestag: BSW, although it is uncertain whether this party will surpass the 5% hurdle rate. It is also unclear if FDP and Die Linke will exceed the 5% hurdle rate. Currently, eight parties have a realistic chance of gaining seats: AfD, BSW, Union, the Greens, Die Linke, FDP, and SPD.

Caution is advised when drawing conclusions about the final election outcome based on current polls, as German elections are often unpredictable. For instance, SPD unexpectedly rose in the polls during the 2021 elections without SPD candidate Scholz having to do anything. His Union opponent, Armin Laschet,

squandered his chances with an unfortunate, empathy-lacking remark about flood victims in southern Germany at the time.

Latest polls show rise in Union and AfD

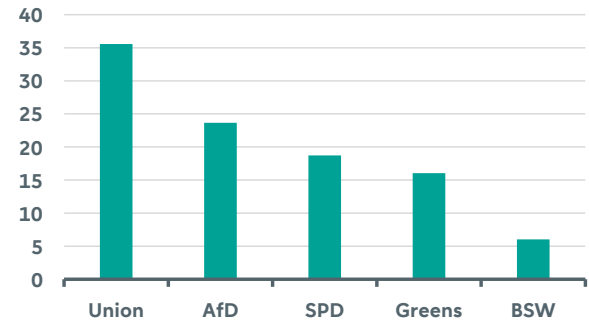
Share of votes, %-change



Source: Politpro

FDP and Die Linke may not return to the Bundestag

Percentage share of seats



Source: Politpro

Additionally, a small difference in the election result can significantly impact the final composition of parliament. Currently, it is uncertain whether three parties with a chance of a parliamentary seat will surpass the 5% hurdle rate. After an article about the government's fall in the weekly Die Zeit, FDP fell below the hurdle rate in the polls. It is also uncertain whether Die Linke, which is also losing ground, and newcomer BSW will secure enough votes to enter parliament.

Box: The German electoral system in short

The Federal Republic of Germany is a constitutional republic, where federal legislative power is vested in Bundestag (parliament) and Bundersrat (the representative body of the Länder, Germany's regional states). Every four years, Germans go vote to elect the members of the Bundestag. In theory, there are 598 seats up for election to the Bundestag, but the final number of seats can be larger (see below). The head of government, the Chancellor (Bundeskanzler/in) needs to gain an absolute majority in parliament to govern. However, it is rather uncommon that one party receive half of the seats. That is why coalitions are often needed to obtain a majority. When the Germans head to the polls, they will receive a ballot with two choices: - One is for the district representative: The first vote or "Erststimme" is for the voters to select their favourite candidate to represent their district in the Bundestag. This could be compared to the US voting system where Americans vote for a congressperson in their district. There are 299 districts in Germany which make about half of the Bundestag. As such, German states with larger populations have more constituencies and get to send more representatives than the smaller ones. - One for a party. The second vote or "Zweitstimme." goes to a political party instead of a single candidate. This is to fill the other half to the 598 seats in Germany's Bundestag and determines the percentage each political party gets in the Bundestag. This voting system allows voters to split their vote amongst different parties. For example, a German can vote for his or her local Union candidate in the first vote and vote for the FDP party in the second vote, to support a Union and FDP coalition. However, this strategy often leads to so-called 'overhand seats'.

'Overhand seats'

Sometimes the number of seats exceed 598 because a party can receive more direct Bundestag seats through the first vote than they do for the party vote. Since each candidate that wins a district is guaranteed a seat, those extra seats or 'overhand seats', are there to make sure that every candidate who was directly elected gets a seat while the political parties are still proportionally represented in Bundestag. It is first and foremost the Union which fields many popular and ultimately successful candidates. Due to this, there are currently 733 seats in the Bundestag.

The 5 percent hurdle

For a party to enter the Bundestag, it must win at least 5 percent of the second vote. This system was put in place to prevent smaller splinter parties from entering parliament. Currently, there are six parties represented in the Bundestag: Union (the Union), SPD, the liberal FDP, the Left party (die Linke), the Greens and the far-right party AfD.

According to the latest results, Union leads with a polling share ranging from 26% to 31%, followed by AfD (18% to 22%). Both parties are set to gain compared to the previous elections. All other parties currently in parliament are losing ground: SPD (14% to 19%), the Greens (12% to 16%), FDP (4% to 7%), and Die Linke (3% to 5%). Newcomer BSW scores 4% to 7% in the polls.

Possible coalitions

None of the parties can secure an absolute majority, meaning a coalition will need to be formed, as is customary in post-war Germany. The exact composition of this coalition is still unclear. Although party views differ, most parties agree on one thing: they do not want to govern with AfD due to the party's radical views that contradict the rule of law and democracy.

Based on current polls, a repeat of the 'Grand Coalition' between Union and SPD is most likely. A combination of Union and the Greens would also yield a majority on paper. However, CSU leader Markus Söder has indicated a preference not to partner with the Greens, although he may set aside his reservations if FDP joins.

The 'Grand Coalition' could also theoretically be supplemented by FDP, whose party program most closely aligns with that of Union. However, this is not very likely. Firstly, because FDP must first surpass the electoral hurdle. Secondly, because Olaf Scholz may be reluctant to join another cabinet with Christian Lindner. Conversely, Union may not be enthusiastic about expanding the 'Grand Coalition' with Die Linke or BSW.

What to expect?

Given the programs, 1) Union and FDP, 2) SPD and the Greens, and 3) AfD and BSW are most closely aligned. However, none of these combinations can secure a majority based on the polls, making a repeat of the 'Grand Coalition', as we have noticed, the most likely outcome. The advantage is that this coalition can rely on a comfortable majority in parliament, allowing measures to be passed relatively smoothly.

One measure on the agenda for the next government is adjusting the debt brake. Union was not in favour, but this stance is shifting. SPD's desire for adjustment has also increased. In a 'Grand Coalition,' there is room to soften the sharpest edges, for example, by incorporating exceptions for investments, defence, or climate policy. More room for this helps address economic issues and provides opportunities to play a constructive role in Europe and initiate Mario Draghi's policy agenda. Improving European security and strengthening common defence are high priorities.

Box The debt brake's pros, cons and its potential adjustments

The debt brake has been under scrutiny lately. The debt brake, which was introduced in 2009 to restore Germany's public finances, limits the federal government's deficit to 0.35% of GDP and stops German regions from running budget deficits. During a cyclical downturn additional debt can be incurred, which must be repaid when the economic situation improves. The debt brake is fixed in Germany's constitution. A permanent change or abolishing the debt brake altogether requires a two-third majority of the votes in the Bundestag. A temporary suspension is possible in an emergency situation. Establishing such a situation requires a simple majority in the Bundestag. In 2020 for instance, the debt brake was suspended to deal with the costs of the pandemic. However, in 2023 the Constitutional Court, on request of the Union, ruled the government's decision in 2021 to reallocate EUR 60 billion of unused money to the Climate and Transformation Fund, unconstitutional. This triggered intense debate. Proponents claim that the debt brake represents a commitment to responsible governance, thus fostering economic stability, encouraging private investment and strengthening Germany's position in Europe. Meanwhile opponents point out that it fails to distinguish between investment and consumption expenditure, that it limits the ability to respond to crises, and that debt financed special funds demonstrate its ineffectiveness. They argue that the debt brake has negative consequences for political stability, modernization efforts, and climate action and should be reformed. The adjustments that they advocate range from excluding net/gross investments, strengthening the cyclical component by increasing the 0,35% threshold or softening the yearly requirement to create room for stimulus during recessions, or exempting certain expenditure categories, such as climate and defence.

At the same time, we must note that the party programs of Union and SPD have few overlaps, and where they do, they lack ambitious goals. This means that few far-reaching structural reforms are expected, although they are necessary, for example, in reforming the inefficient banking sector, revising the unsustainable healthcare and pension systems, and improving education. The plans for businesses and families are focused on preserving what exists instead of freeing up what could be.

If important choices are postponed, uncertainty may persist, with businesses and families sitting idle. This would result in an economy that continues to falter, creating an ideal breeding ground for growing discontent, a situation that AfD would thrive in. That could mean that the AfD could score well during the next elections and will be difficult to exclude from government participation by 2029.

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	AFD	BSW	Die Linke	FDP	SPD	The Greens	Union
Candidates	Alice Weidel	Sahra Wagenknecht	Heide Reichinnek and Jan van Aken	Christian Lindner	Olaf Scholz	Robert Habeck	Friedrich Merz
Party's stance	Shifted from liberalconservative to radical-right	Socially-conservative, nationalist-left	Anti-capitalist, democratic-socialist	Liberal-democratic	Social-democratic	Progressive-liberal, social-environmental	Christian-democratic, liberal-conservative
Economy, energy and sustainability	Abolish renewable energy subsidies. Direct savings towards tax cuts. Keep option of nuclear energy open.	Abolish CO2 price and import fossil energy to lower energy prices. Cut subsidies on renewable energy.		Implement structural reforms. Apply a three-year moratorium on bureaucratic regulations for SME's. Flatten corporate taxes to below 25 percent. Keep option of nuclear energy open.	Establish a Germany Fund to invest in electricity and heating networks, as well as charging stations and housing.	Establish a credit-financed Germany Fund to invest in innovation, public transport (the rail network), and daycare centres	Reward work more. Cut bureaucracy and regulation for businesses. Protect businesses from unfair foreign competition. Keep option of nuclear energy open.
Debt brake	Maintain	Ease to increase social benefits.	Abolish	Maintain	Reform. Introduce exceptions, for example for investments.	Reform. Allow investments.	Adhere. However, important party members deem reform necessary.
Taxes	Lower income taxes. Raise tax exemptions on capital income. Abolish CO2 levy, property tax, and inheritance tax.	Increase taxes on wealthy people.	Lower VAT on food to zero. Increase taxes on wealthy people.	Income tax relief of at least 1,000 euros per taxpayer. Abolish the solidarity surcharge, which was introduced after the fall of the Berlin wall to pay for German unification efforts.	Tax relief for 95 percent of all taxpayers. Keep solidarity surcharge for the wealthy. Lower VAT for food.	Establish a higher tax-free allowance. Incorporate solidarity surcharge in income tax. Increase taxes for wealthy people.	42% tax bracket should start from a higher income level. Abolish the solidarity surcharge.
Housing		Freeze Mietbremse (rent cap) till 2030	Invest EUR 20 bn in housing associations	Abolish Mietbremse	Make Mietbremse permanent		

Labor market and social security	Maintain statutory minimum wage. Restrict maximum allowance to people who provide for part of their income.		Raise social benefit to, for example, EUR 1,400 for singles.	Reform social security. Increase incentive to work	Increase minimum wage to EUR 15 per hour. Limit temporary work contracts. Strengthen labour unions' role. Support collective wage negotiations and make them generally binding.	Increase minimum wage to EUR 15 per hour. Introduces climate policy to discussion between employees and employers.	Wage negotiations should take place at regional and company level. Social security allowances are conditional and restricted to those willing to work.
Pensions and healthcare	Introduce penalty free pension after 45 years of contribution.			Make retirement age more flexible. Introduce individual pension savings accounts. Create more room for private health insurance.	Adhere to the current pension system (benefit of 48% of their last earned income after 45 years of service at age 67). Reduce distinction between private and collective health insurance.	Supply loans and grants to fund that invests in sustainable European companies.	Reject pension cuts. Encourage seniors to keep working by offering a tax exemption of up to EUR 2,000 for those who continue to work.
Migration	Close borders for asylum seekers.	Halt migrants not eligible for asylum. Increase number of 'safe origin countries,'	Emphasizes the right to asylum.	Promote orderly migration by clear regulation.	Focus on quick return, preferably on a voluntary basis. Reject relocating of asylum procedure to non-EU countries.	Fair distribution of asylum seekers in Europe	Stricter asylum policies. Abolish possibility to naturalize after 3 years. Increase number of 'safe origin countries', including Syria and Afghanistan.
Foreign policy and defence	End to sanctions of Russia.	End to military support for Ukraine. Call for peace negotiations.	Focus on negotiations and diplomacy in Ukraine war.	Deliver Taurus cruise missiles to Ukraine	Continue arms deliveries, but not of Taurus cruise missiles. Increase military spending to at least 2% of GDP.	Increase sanctions on Russia. Increase military spending to at more than 2% of GDP.	Expand armed forces and reinstate conscription. Conditional supply of Taurus cruise missiles to Ukraine.

Tax relief: total cost to Treasury¹	EUR 149 billion	EUR 122 billion		EUR 138 billion	EUR 89 billion	EUR 48 billion	EUR 30 billion
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¹ Beznoska, M. Hentze T., IW Köln