



ELECTION CONSOLIDATES GOVERNMENT, FACILITATES FISCAL EXPANSION AND FOREIGN POLICY REORIENTATION

SPOTLIGHT GERMANY

February 2025

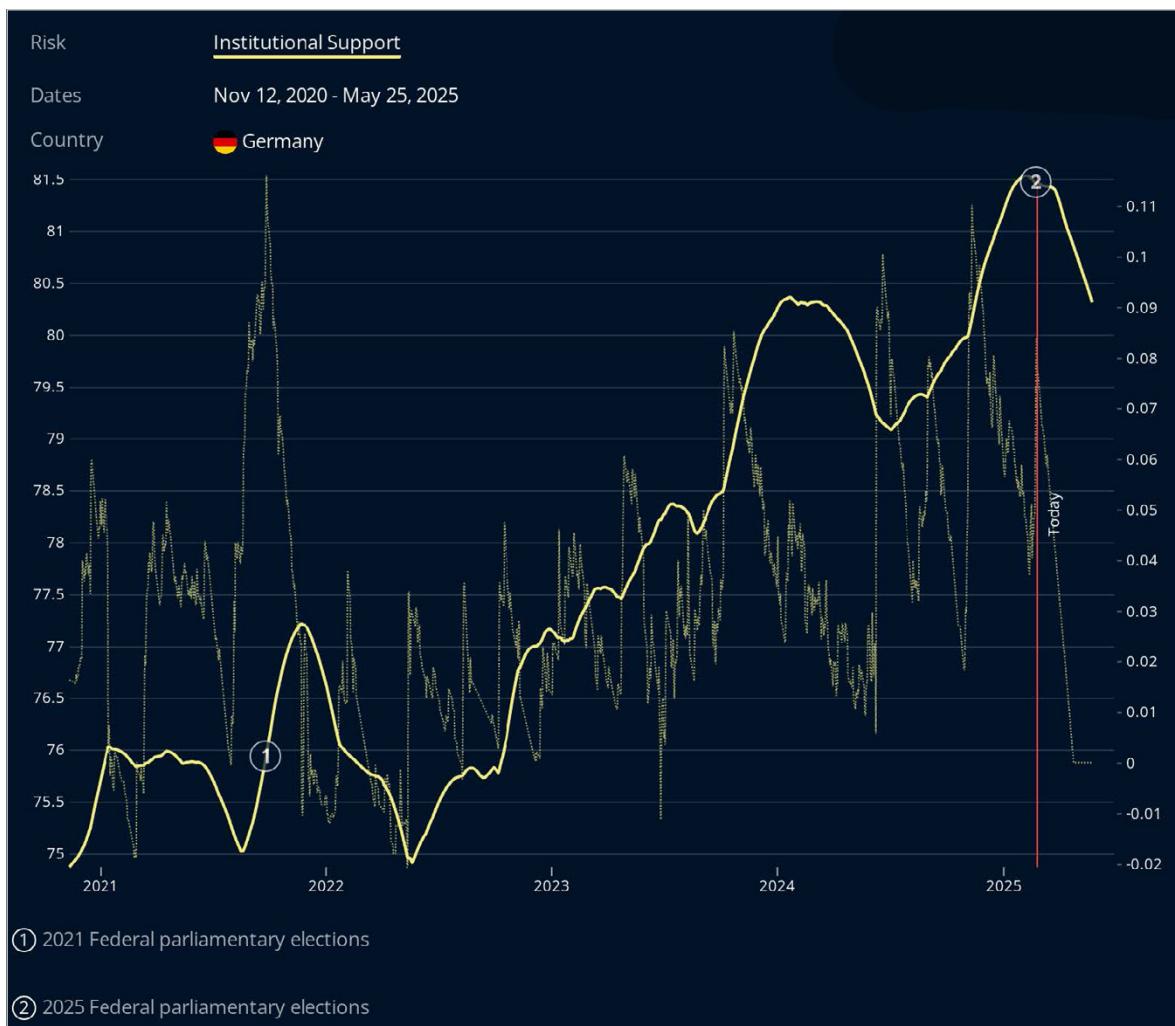
BLUF:

- **Government Formation:** A **strong CSU/CDU plurality** should enable a more ideologically coherent two-party coalition to form a government with the SPD; this government will be more effective than the previous one and keep the far-right AfD outside any legislative coalition.
- **Fiscal Policy:** Incoming Chancellor Friedrich Merz has already signaled support for loosening debt constraints, which would facilitate increases in defense and other spending. However, the AfD's strong gains could block Merz from gaining the two-thirds majority he needs to reform the debt brake.
- **Foreign Policy:** Merz has also signaled a substantial reorientation of postwar European foreign and security policies to counter the U.S. shift under Trump toward Russia.
- **Migration Policy:** While the SPD will moderate some of the CDU/CSU's more extreme policies on immigration, the new government will be part of a growing chorus in the EU aiming for immigration reform.
- **Investment/Trade Policy:** Merz will need to address Germany's flagging, export-oriented political economy given the challenge of China's export machine and Trump's willingness to use tariffs as a bargaining chip in any negotiations.

Details:

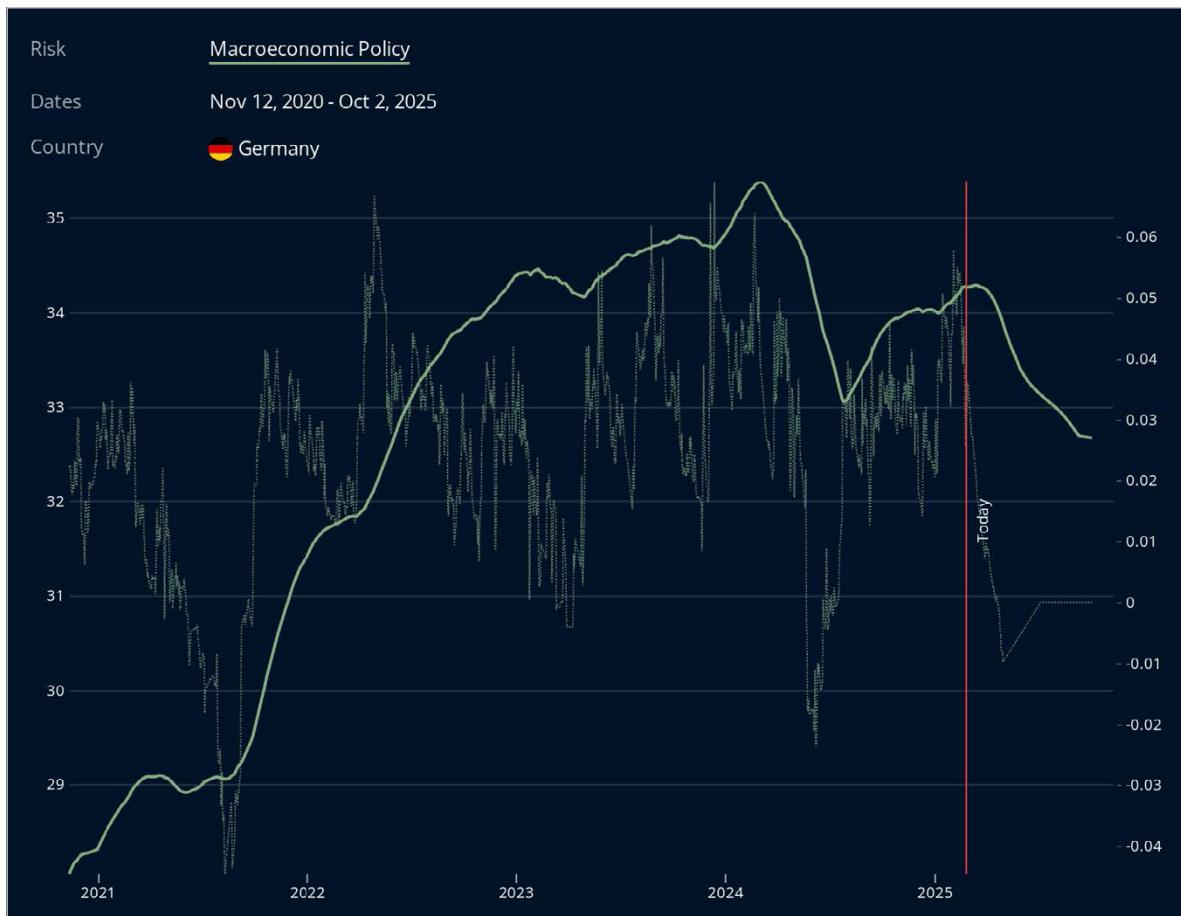
- **Government Formation:** Preliminary election results indicate that CDU/CSU will be able to form a so-called “grand coalition” with the SPD. Forecast declines in both composite and pulse Institutional Support Risks suggest a less contentious legislative environment than the outgoing government faced (Figure 1). However, **preliminary results** show the populist BSW party with 4.97% of the vote, just 0.03% below the mandated 5% threshold to gain seats. If it surpasses the threshold in the final count, the grand coalition between the CDU/CSU and SPD will not be enough for a majority and the Greens would need to be added to the coalition government. Regardless, the AfD will remain in opposition, in line with our call.

FIGURE 1.



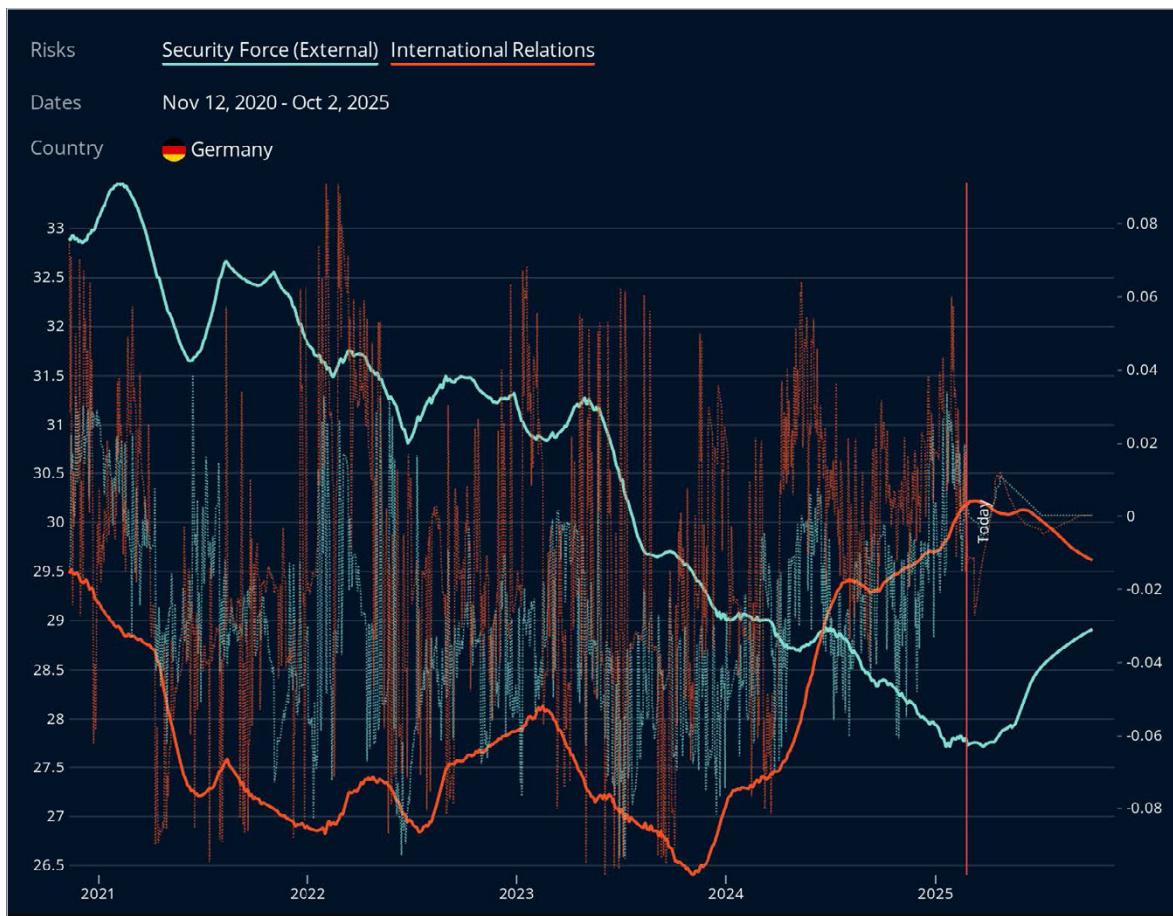
Source: GeoQuant

- **Fiscal Policy:** Germany has ample fiscal space to **loosen spending policy**, reflected in low and falling Macroeconomic Policy Risk scores (Figure 2), but requires a 2/3 majority in the Bundestag to lift the constitutionally imposed “debt brake”. This requirement puts the Greens in a strong negotiating position as Merz needs its support regardless of whether he puts forward the vote now, before the parliament is officially ended, or after the new legislature sits at the end of March. The Greens are likely to demand increased spending on green infrastructure. The party could also try to use its leverage to enter or influence the new government, even if it is not required to secure a majority.

FIGURE 2.


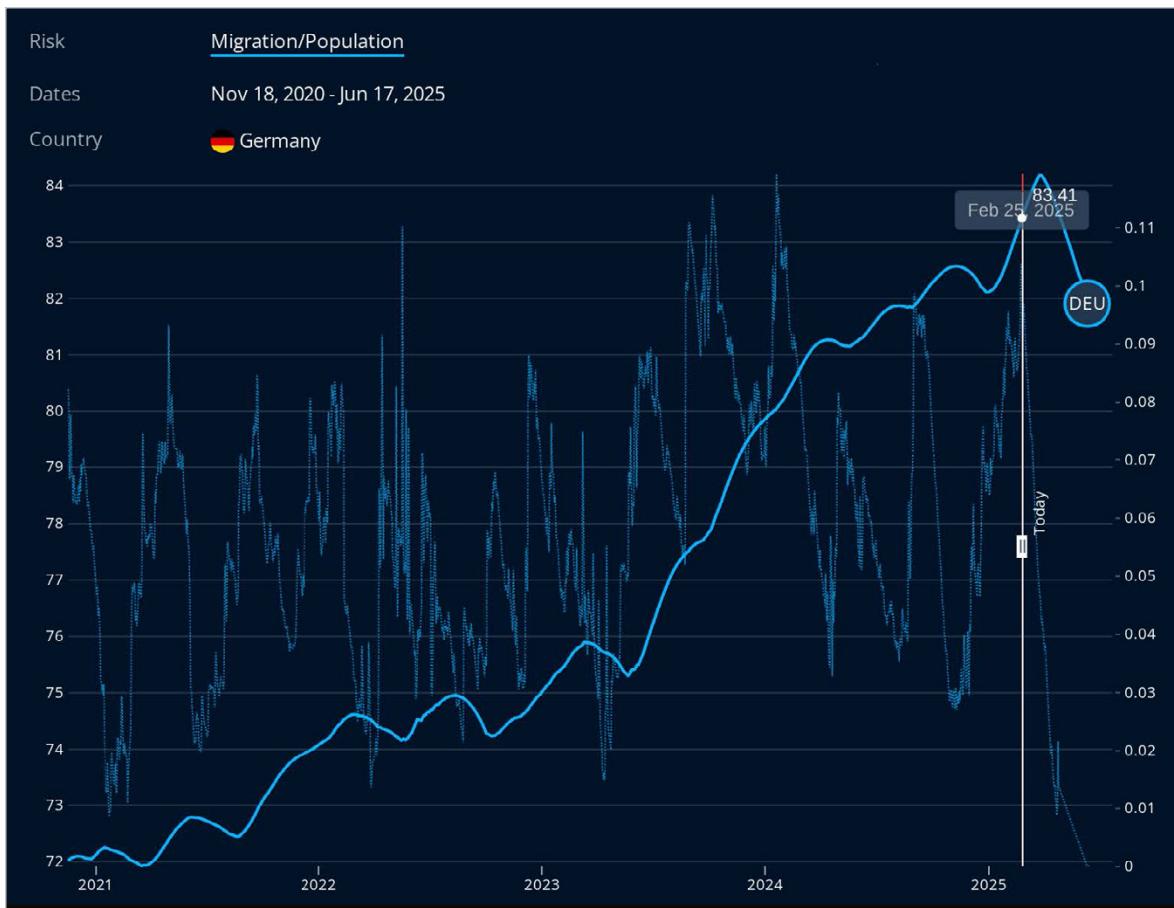
Source: GeoQuant

- **Foreign Policy:** Should Merz prove successful in reforming the debt brake, the government will very likely increase defense funding. However, funding for Ukraine could be challenged depending on whether Merz needs the Die Linke party, which opposes such funding, to raise the debt brake. Surprisingly, more expansionary fiscal policy may be overshadowed by a potential reorientation of European defense and foreign policies **away from the U.S.** German International Relations (IR) Risk (Figure 3) has been rising since late-2023 and has accelerated upward since Trump took office. Security Force Pulse Risk (External) has also recently spiked, stalling a previous decline in composite Security Force Risk (External) as a divide with the U.S. calls into question collective security arrangements. Merz's willingness to review defense arrangements in Europe represents a sea change in regional security policy.

FIGURE 3.


Source: GeoQuant

- **Migration Policy:** The rise in support for the AfD, along with the CDU's response, has driven Migration/Population Risk (Figure 4) to record highs. The SPD's participation in a new government would likely moderate some of the CDU/CSU's more extreme policy positions, helping to drive the forecast decline in this Risk. Nonetheless, Merz has also advocated for changes to EU asylum laws. Germany's support for immigration constraints gives a significant boost to countries such as Hungary and the Netherlands that are already pushing for new EU-wide legislation.

FIGURE 4.


Source: GeoQuant

- **Investment/Trade Policy:** Germany's **export-oriented political economy** will not be the first order of business for the new government, but it is the issue Merz needs to address to achieve a Merkel-like tenure as chancellor. Increased defense and (possibly) infrastructure spending will boost economic activity in the near-term. However, after experiencing economic contractions in 2023 and 2024, Germany's export-oriented industrial economy needs systemic reform. The challenge of China's export machine and Trump's tariffs may finally prod the country to rebalance economic growth toward domestic demand, and end near permanent current account surpluses. Ironically, a Union/SPD coalition – the two parties most responsible for devising Germany's postwar economy – will now have to address its contemporary shortcomings.

Why it Matters:

- **Fiscal policy:** The German government has not embarked on a fiscal spree since it absorbed the cost uniting the country after the fall of the Soviet Union in 1990. That experience brought both fiscal and current account deficits but by 1994 powered growth across the region. With government debt-to-GDP at 62.8% in 2024, lower than in 2015 despite the pandemic, a German fiscal shift would provide a powerful source of domestic demand.
- **Foreign policy:** With the U.S. backing away from Ukraine and demanding increasing European self-reliance for defense, Germany is in a strong position to fill the leadership void. The CDU's platform includes commitment to NATO defense spending rules and Merz is willing to discuss ways to finance greater EU defense spending. A stronger Russia will encourage the collective security arrangement to remain in place. Increased defense spending by NATO partners over the last three years will provide a backstop even if U.S. supports wavers.

What to Watch for:

- **What is driving coalition negotiations?** Merz has already started **negotiating with the SPD** and says he hopes to have a government by Easter (20 April). He said that he will prioritize migration policy in the talks, though economic and investment issues and defense spending will undoubtedly also be prominent.
- **Will Merz move against debt brake before the new parliamentary session?** Merz could gain the required two-thirds majority in the current parliament (which dissolves on 24 March) with just the SPD and Greens. However, the AfD's gains means that the government would also need support from die Linke in the new parliamentary session. Die Linke has said that they are not opposed to raising the debt brake in theory but opposes using it to send funding to Ukraine.
- **What role will the new government play in the EU?** Migration policies will undoubtedly be a significant focus in the EU as well. Germany will find allies for more stringent controls on immigration in Italy, the Netherlands and beyond, suggesting the issue will be addressed. In addition, funding for Ukraine will also be an EU policy effort. Merz's signaled shift from the U.S. on security matters makes clear that Germany will no longer follow the Trump administration's shift on Ukraine policy, potentially forcing any U.S.-Russia deal on Ukraine to consider EU preferences.



About GeoQuant

GeoQuant is an innovative AI-driven data and technology company, acquired by Fitch and now part of BMI, that is transforming the way the world's leading organizations are quantifying, integrating, and navigating political risk.

By fusing PhD-level political and computer science, GeoQuant generates high-frequency, quantitative measures of risk that are systematic, back-testable, and predictive.

The result is real-time updates for over 40 political risk indicators in more than 140 countries, and analytics that enable you to foresee risk trends and make proactive moves.

GeoQuant data, modelling and advisory services have been used to successfully inform the asset, risk and sovereign ESG strategies of leading institutional partners.

About BMI

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