Risk of the German government collapsing appears higher than ever

While all eyes are on the US elections this week, German politics seem to have become a train crash in slow motion. The German government has just entered a new stage of a slow burning political crisis that could be the last step before the eventual collapse of the governing coalition.

German Chancellor Olaf Scholz and his governing coalition took a hit at state elections this past weekend

In January, according to finance minister Lindner at the World Economic Forum in Davos, an espresso should have been enough to get the German economy back on track. This assessment has clearly changed over recent months. Further, the awareness in German politics has grown that the economy has lost international competitiveness over the last decade and that it is in the midst of cyclical and structural headwinds. This is nothing new if you have read ING research regularly or the Draghi report earlier this year. “Sick man” or not, the German economy has, on average not grown, over the last four years and is in need of an overhaul. The Volkswagen headlines since early September seem to have increased the sense of urgency in the German government. Unfortunately, efforts to restart the economy and the entire economic model have so far not been coordinated. On the contrary, the economic stagnation seems to have intensified the tensions within the government coalition, as illustrated by the fact that first minister of economic affairs, Robert Habeck, announced a new plan for a “Germany fund”, while chancellor Olaf Scholz and then finance minister, Christian Lindner, followed suit by organising two separate dialogues with the corproate sector last week.

On Friday, internal government tensions reached a new high, when an 18-page document that Christian Lindner had sent to chancellor Olaf Scholz and minister of economic affairs Robert Habeck leaked. This is a document describing Lindner’s plans to reform the economy. It could very well seal the fate of Germany’s governming coalition and has, since Friday, kept German politics on edge.

What's in the Lindner paper?

Lindner’s paper gives a rather uncontroversial analysis of Germany’s current economic problems, problems that regular readers of ING Research should be familiar with. Think of Germany’s falling behind in international competitiveness, productivity corporate investments, energy costs or hours worked. Combined with unfavourable demographis, a clear consequence is the drop in Germany’s potential growth rate.

The paper then presents well-known policy measures including lowering corproate taxes, abolishing the solidarity surcharge, more venture capital, longer working hours and more flexible retirement ages as well as more top-level research. It also advocates an end to subsidies and regulations for climate protection, less ambitious climate targets and less social benefits. Not all proposals are supported by concrete details.

The paper ends with a new proposal for the 2025 budget. The budget gap of some EUR 8bn, still subject to negotiations in the coming days, would almost be closed by the not-paying out of a EUR 10bn subsidy for Intel. The above-mentioned cuts (social benefits and climate protection subsidies) are only needed to finance the reduction of the solidarity surcharge and the cut in corporate taxes.

Where are the controversial parts?

This analysis of the economic problems should be relatively uncontroversial. However, the proposal to reverse course on climate targets and subsidies as well as to reduce social benefits and flexibility in the retirement age and, if needed, lower pensions as well as longer working hours will be hard – if not impossible – to stomach for the Greens and the SPD.

Probably the most controversial part of Lindner’s paper is the very rigid position on public finances. Here, Lindner gives no wiggle room at all but rather uses the national debt brake as well as the European fiscal rules as reasons not to allow any fiscal room for manouvre.

In this regard, don’t forget that Germany’s fiscal position is anything but precarious; particularily when compared to most other G7 or European economies. Just as a reminder, Germany currently runs a debt-to-GDP ratio of slightly above 60%, has a fiscal deficit of less than 2% of GDP, an expenditure ratio of less than 50% of GDP and interest rate payments of less than 1% of GDP. For comparison, France runs a debt ratio of 115% of GDP, has had an average fiscal deficit of around 6% of GDP in recent years and an expenditure ratio of close to 60% of GDP, while paying some 2% of GDP on interest rates. Also, the fact that the debt ratio also has a denominator (GDP) and that financial markets are currently more concerned about Germany’s economic weakness than about debt is not mentioned at all in Lindner’s paper. As the IMF recently said, without a functioning infrastructure, there can be no productive economy.

Where do we go from here?

The problem of Lindner's paper is not the analysis of Germany's economic weaknesses and not even the proposed solutions. At least not all of them. The latter could be seen as a normal contribution for a fruitful discussion. The problem is the categorical stance on public finances and the debt brake as well as the direct attack on some of the other two coalition partners' holy cows. The tone of voice in the paper illustrates how cold the atmosphere between the coalition partners seems to have become.

In a television interview last night, finance minister Christian Lindner refused to call his paper and his proposals an "ultimatum" for the other coalition partners. He called the paper a clear signal to the entire German public how he and his party wanted to bring back growth to Germany. In his view, the onus is now on the other two coalition partners to present their own views. The facts that this discussion is now taking place out in the open in a government coalition that signed a coalition agreement almost three years ago and will have to sign off a 2025 budget in less than two weeks clearly shows how tense and how close to a government collapse the situation currently is. Up until now, however, none of the three coalition partners has wanted to pull the trigger; at least not in public.

In normal times, a compromise could be easily found. Take some of Lindner's structural reform measures (without touching holy cows of the coalition partners) and garner these with more investments and fiscal stimulus. However, these are not normal times in German politics.

Risk of government collapse as high as ever

The Lindner paper is just another step in an almost endless list of ever growing tensions within the German government. Up to now, the risk of snap elections had been relatively low as none of the three coalition parties had an interest in earlier elections, given their weak polling results. It now increasingly looks as if the next days could lead to a collapse of the government.

The situation can move quickly. Last night, Olaf Scholz and Robert Habeck met, while Christian Lindner was on TV. The next official meeting of the three is scheduled for Wednesday and earlier meetings or decisions cannot be ruled out. Let's not forget that Lindner tied his paper to the budget for 2025, which will have to be signed off by November 14th. As mentioned above, in theory, a compromise is possible, but a compromise without political loss of face looks increasingly unlikely.

However, even if Lindner were to withdraw from the coalition government, this would not automatically trigger new elections. In fact, only the federal president can announce new elections if the chancellor loses a vote of confidence in parliament. An alternative to snap elections could be a minority government until the next elections (which are scheduled for late September 2025). The option of the current parliament simply voting on a new chancellor looks highly unlikely.

All in all, we think that the risk of the German government collapsing has never been higher than currently. Even potential geopolitical uncertainty stemming from the upcoming US elections no longer seems to be the guaranteed glue to keep the government together.

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