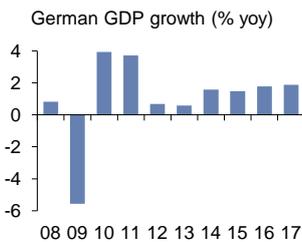


## ECONOMICS | Eurozone

23 August 2017

**The never-ending cycle...**


Source: Thomson Reuters, ING estimates

**...has brought unemployment down...**


Source: Thomson Reuters

**...but wage growth remains well-behaved**


Source: Eurostat, ING estimates

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## Germany: Don't say 'boring'

The upcoming election might be a small step for Germany but could be a giant leap (or setback) for the Eurozone

**With one more month to go, the German election campaign should currently be at its peak...should. The reality is a rather unexciting campaign, characterised by Chancellor Angela Merkel's high popularity and the inability of all the other parties to initiate an accentuated debate. It would almost need a political miracle to prevent a fourth term in office for Merkel. However, what looks like a minor event for Germany could turn out to be a major event for the future of the Eurozone.**

After the excitement around the national elections in the Netherlands and France earlier this year, the German election seems to usher a welcome change in terms of dullness. Neither the ongoing campaign nor the potential election result is likely to have resulted in sleepless nights for any financial market participant. What German observers and voters in particular might consider ennui, looks like admirable solidity and stability in the eyes of most international market participants and observers.

Indeed, judging from the latest polls (and the trend over the last two months), chances are extremely high that Chancellor Merkel and her party will come first on 24 September, followed by the SPD, the current junior coalition partner. Only a political miracle, unexpected external events, a huge scandal or completely wrong polling could probably hinder a fourth term in office for Angela Merkel. However, the question of who will be Merkel's coalition partner(s) will be unanswered until after election night. With four parties currently at c.10% in the polls, the race for No.3 is wide open and, in our view, the most exciting feature over the next few weeks. Small changes in voter preferences could make a big difference.

Currently, and based on recent polls, almost everything is still possible. The options for the next German government range from an absolute majority for Merkel's CDU party to coalitions of the CDU with the liberal FDP, the Greens or the SPD or even a three-party coalition led by the SPD (though very unlikely).

Why should we care about which parties join the next coalition...is it not enough to simply bank on Angela Merkel? Not really. In our view, and assuming that the next German government will be led by Angela Merkel and the CDU, Merkel's choice for a junior coalition partner (if the election outcome allows for a choice) will definitely have an impact on the future of the Eurozone. While more public investment and few structural reforms appear likely in any government headed by Merkel, the plans for future Eurozone integration could range from 'muddling through' or a return to a strict no-bail-out clause and a Eurozone budget with a European Monetary Fund.

In all, after the election excitement in the Eurozone in the first half of the year, the German elections are a welcome return to solidity. However, let us not underestimate the German elections. It still has some potential surprises in store, particularly when it comes to the future of the Eurozone...even if the excitement might have to wait until the coalition talks after 24 September.

# 'It's not the economy, stupid'

The economy has gained even more momentum...

...and there is little reason to fear an imminent slowdown...

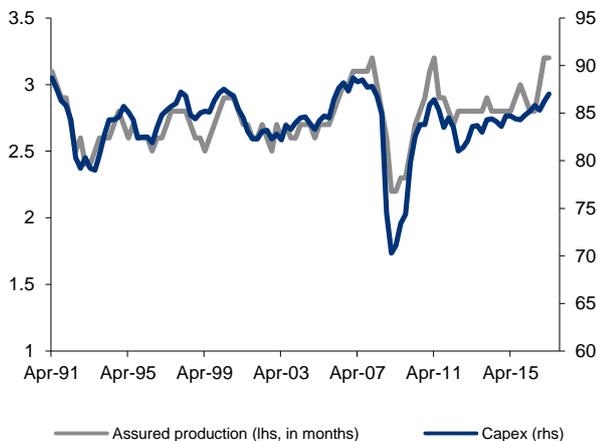
...as investments could take over the baton from the current growth drivers...

The German economy has gained even more momentum since the start of the year. While already at a mature stage of the current business cycle, the economy managed to 'go the extra mile'. Posting quarterly growth rates of 0.7% and 0.6%, even in the ninth year of the recovery, illustrates the current strength of the German economy.

Germany's economic success story goes on and on and on and there is very little reason to fear a sudden end to the current performance, even though some kind of slowdown from current growth rates looks almost inevitable. The drivers supporting the domestic economy, like record high employment, higher wages and government consumption, might lose some momentum along the way, without turning negative. The same holds for the export sector, where a stronger euro, weaker-than-expected US growth and Brexit uncertainty could take some wind out of the economy's sails, without bringing exports to a halt.

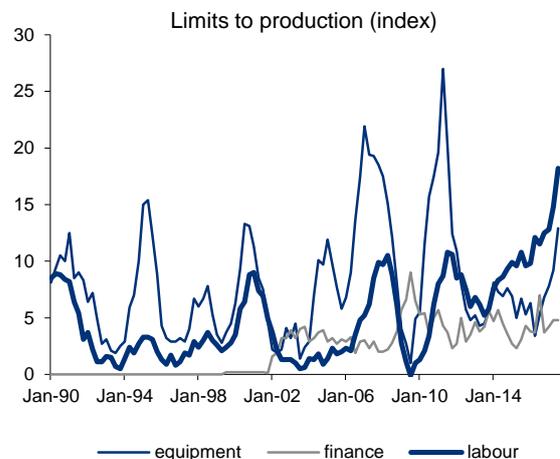
While the current growth drivers could lose some momentum, investments could emerge as the new growth engine, going into the second half of the year and beyond. Since the small setback at the turn of the year, production expectations have increased continuously. Order books are filled again and inventories have reduced. Capacity utilisation in the manufacturing industry has also increased continuously since mid-2016 and is now clearly above its historical average; a combination, which, under normal circumstances, should be a safe option for stronger investments.

Fig 1 Industry has gathered steam...



Source: Thomson Reuters

Fig 2 ...with several indicators pointing towards more investment



Source: Thomson Reuters

...making it hard for political parties to mobilise voters with economic topics...

...even though there is plenty to talk and debate about

With strong economic momentum, it will be hard for any opposition party to single out the economy as the main theme for the final stage of the election campaign. Even the social-democratic SPD, Angela Merkel's junior coalition partner, finds it hard to earn credit from the electorate for the current strong growth performance. When it comes to the economy, it seems as if Angela Merkel sits in a 'winner-takes-it-all' position.

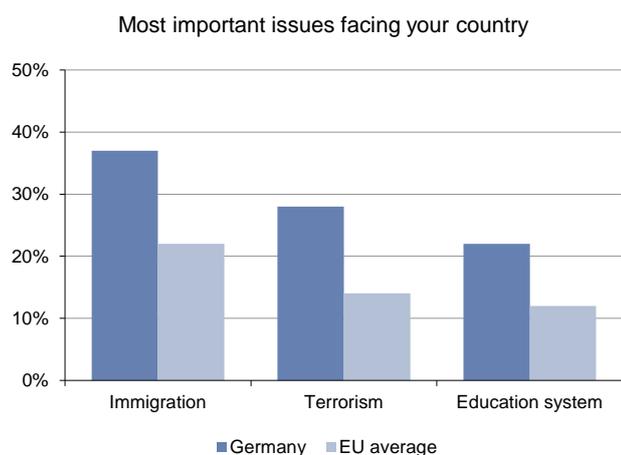
In our earlier note, *Two tales of one economy* (<https://think.ing.com/reports/germany-two-tales-of-one-economy/>), we extensively presented and analysed the current strengths and weaknesses of the German *Wirtschaftswunder*, or 'economic miracle'. The lack of new structural reforms, combined with lacklustre investment in both digital and traditional infrastructure, are the most pressing issues for any new government. The German economy is facing the challenges of an ageing population, digitalisation and immigration, topics closely related to the sustainability of the health and pension

system, investments, the future of SMEs, female employment and wage and wealth inequality; plenty of potential issues with a direct long-term impact on the German economy. However, economic topics do not seem to be at top of most voters' minds.

Education, old-age poverty and crime are the most important topics for German voters

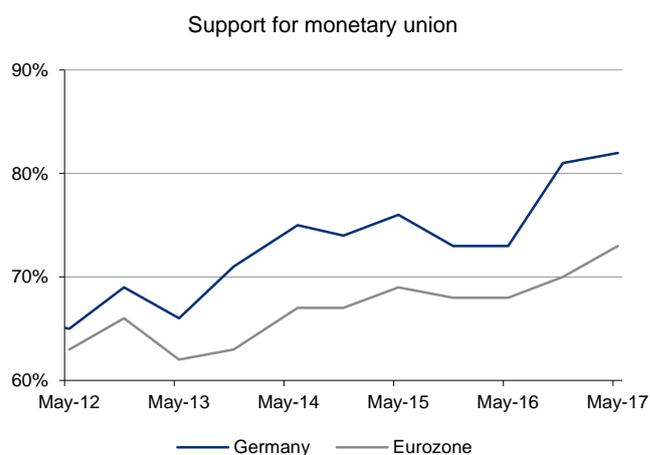
Instead, according to the latest polls by the Emnid institute, the three most important topics for German voters are education, old-age poverty and crime. Lower taxes, stronger economic growth and lower government debt come in at the lower bottom of voter concerns, along with topics like digitalisation and e-mobility. A similar trend is reflected in the most recent Eurobarometer, which shows immigration, terrorism and education as the most important issues for Germans. Not surprisingly, the solutions most political parties offer regarding these three issues do not differ much.

Fig 3 Non-economic issues on top of Germans' minds...



Source: European Commission Eurobarometer

Fig 4 ...while support for monetary union is at an all-time high



Source: European Commission Eurobarometer

## What the polls say

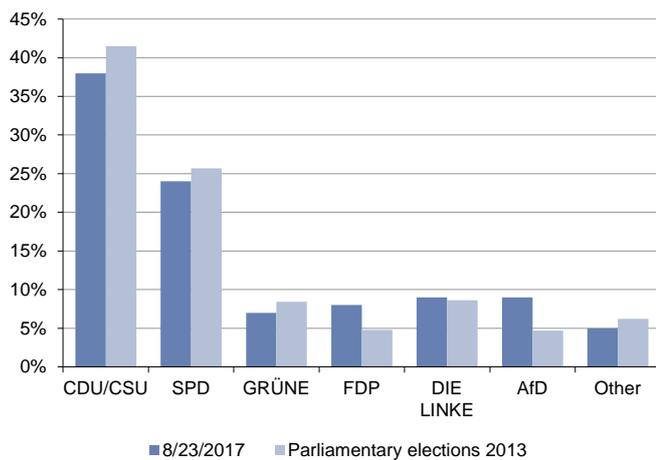
Angela Merkel is enjoying a comfortable and stable lead in the polls...

With seemingly little appetite from the electorate for economic issues, it is hard for the different parties to distinguish themselves from each other. Who would not be in favour of better education, preventing old-age poverty or fighting criminality? Therefore, it does not come as a real surprise that, judging from the latest opinion polls, the main election outcome seems to be clear: Chancellor Angela Merkel and her CDU party should come in as the biggest winner, very likely enabling Merkel to commence her fourth term as German chancellor. The margin between the CDU (currently at 38% in the latest polls) and the SPD (its current coalition partner and second largest party, led by former European Parliament president Martin Schulz), which now stands at 24%, is simply so wide that it would almost require a political miracle, an unexpectedly huge scandal, very flawed polling or a combination of all these factors for Merkel to not win the elections.

...as the 'Schulz hype' and the brief wind of change from earlier this year have almost entirely disappeared

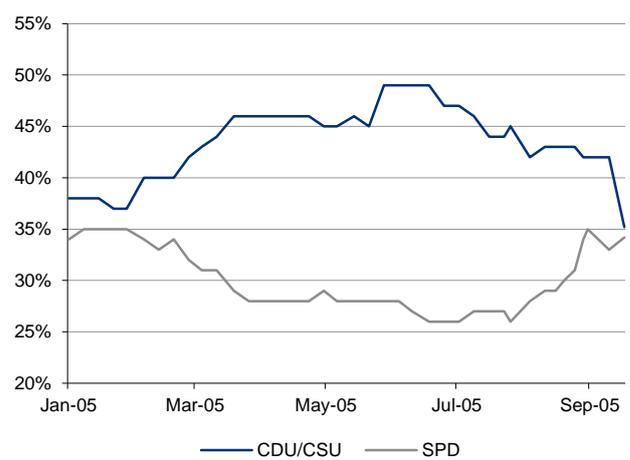
The 'Schulz hype' from the spring, when Martin Schulz and his SPD party were all of a sudden neck-and-neck with Merkel and her CDU party and when Germany seemed to have been hit by a political wind of change, has apparently evaporated into thin air. The reasons for the return of what many international observers see as German election ennui are manifold. In our view, it is a combination of: (a) campaigning mistakes by Schulz/the SPD, who, for example, missed the opportunity to use a Macron-type pro-European platform and only gradually presented piecemeal elements of the SPD's electoral manifesto; and (b) a resurgent Merkel, benefitting from strong economic developments, the slowdown in refugee influx and her performance and appearances on the international stage. To some extent, uncertainty stemming from the Trump administration and Brexit has, in recent months, restored Merkel's reputation as a reliable and stable crisis manager in the eyes of many German voters.

**Fig 5 Strong lead for Merkel's CDU in the polls**



Source: Several polling institutes, ING estimate

**Fig 6 Miracles are possible in Germany...at least sometimes**



Source: Forsa

The 2005 experience shows that political miracles are possible in Germany...

Nevertheless, even though the race for No.1 looks like a done deal, Angela Merkel in particular knows that political miracles can happen in Germany. Back in 2005, six weeks ahead of elections, then opposition leader Angela Merkel and her CDU party had a lead of 16ppt over the ruling SPD party headed by Chancellor Gerhard Schroeder, who had actually called for snap elections to get backing for his reform agenda. On election day, Merkel's CDU had lost almost its entire lead and came in only 1ppt ahead of the SPD. Admittedly, back then, the SPD had the advantage of the 'Kanzler bonus' (bonus for the incumbent chancellor), which played out when Schroeder positioned himself as national crisis manager during the floods in some German regions in the summer of 2005. Also, the CDU's proposal to reform and simplify the tax system was disparaged by sections of the media and other parties.

...though not very likely

Admittedly, chances of a repeat of 2005 are extremely low. Still, some catching up by the SPD could still be possible, eg, driven by a good performance by Martin Schulz at the one and only live TV confrontation with Angela Merkel on 3 September.

### It's the race for the bronze medal that counts

It's the race for No.3 that counts...

With the race for No.1 being almost a done deal, the race for No.3 should be more exciting. In fact, it is our view that the race for No.3 will have a significant impact on the next German government.

...and this race is currently very close...

Due to German political arithmetic, virtually any composition for the next coalition is still possible, though not a given. Aside from an absolute majority for Angela Merkel's CDU party, the list of possible coalition governments ranges from a combination of the CDU with the SPD, the Greens or the Left Party. This wide range of possibilities is driven by the fact that currently four parties (Left Party, Liberal FDP, anti-euro AfD and the Greens) are all hovering at c.10% in the polls. (Small) changes in either direction are clearly still possible, including the risk that one of these four parties eventually drops below the 5% threshold required to enter parliament. Also, earlier elections have shown that German voters tend to vote strategically for their preferred coalition.

...but the outcome will determine the next government...

Currently, and based on most recent polls, the most likely coalition combinations comprise Merkel's CDU together with the FDP, SPD or Greens, or any combination of the three parties. A three-party government would be a primer for Germany. As stated earlier, in the event of a totally unexpected election outcome, coalitions led by the SPD could also be possible, but are currently very unlikely. The biggest turn-off for Merkel could be the fact that none of the next possible governments under her leadership would be 'love at first sight'. While the FDP has often been considered the politically closest ally of the CDU, a coalition with the Greens would be uncharted territory, at least at the national level. After having governed together in two out of the last three terms, another government coalition with the SPD would not be the most dynamic one, in our view.

...as many options are still possible

## Possible coalition puzzle

Despite all of the above, it is an unwritten law in politics that after election night, the 'reset button' will be pressed and all possible political combinations will be investigated. In fact, the only party that can be ruled out entirely as a candidate for the next government is the AfD. Given that campaign promises are often withdrawn during coalition talks, it is hard to tell what the impact of possible coalitions would really be. A lot will not only depend on which parties join the government, but also on relative electoral strengths of the potential partners.

The choice of next government will not have a huge impact on short-term prospects for the German economy...

In our view, and assuming that the next German government will be led by Angela Merkel and the CDU, Merkel's choice for a junior coalition partner (if the election outcome allows for a choice) will definitely have an impact on the future of the Eurozone. While more public investment and few structural reforms appear likely in any government headed by Merkel, the plans for future Eurozone integration could range from 'muddling through' or a return to 'no-bail-outs' to a Eurozone budget with a European Monetary Fund.

...but could have a huge impact on the future of the Eurozone

Looking at the election manifestos, Angela Merkel's CDU advocates a European Monetary Fund, a vehicle to fight youth unemployment and introduce some tax harmonisation between France and Germany. At the same time, debt mutualisation is explicitly ruled out. While these plans, at least to some degree, point to the same direction as Macron's plans and proposals by the European Commission, one potential junior coalition partner, the FDP, has an almost completely different vision for the Eurozone. Strictly sticking to the 'no bail-outs' clause, a smaller ESM, automatic sanctions under the SGP, an orderly government insolvency procedure and a Eurozone exit mechanism would make many German economists happy, but would hardly improve the monetary union. The Greens and the SPD have probably the most pro-European proposals, advocating, amongst others, a Eurozone government and budget, more European investments, youth unemployment insurance and tax harmonisation.

## Small step for Germany, giant leap for the Eurozone

In all, after the election excitement in the Eurozone in the first half of the year, the German elections are a welcome return to solidity. However, let us not underestimate the German elections. It still has some potential surprises in store, particularly when it comes to the future of the Eurozone. Given the wide range of possible coalitions, the direct impact for Germany might be small, but it could be significant for the Eurozone, even if this excitement might have to wait until the coalition talks after 24 September.

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