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## German election: CDU/CSU-SPD coalition likely, but there are hurdles to debt brake reform

Friedrich Merz is very likely to head a new government that is more stable than the outgoing one and focused on a more growth-friendly policy agenda. However, the composition of the Bundestag makes reform of the debt brake to increase defence spending difficult, and the German economy will continue to face economic headwinds.

### Key Takeaways

- The CDU-CSU won the German federal elections, gaining 29% of the vote and 208 seats, with leader Friedrich Merz set to become the next chancellor.
- The results are broadly in line with polling before the election, but still represent a significant surge for the AfD, with 21% of votes and 152 seats. The SPD and Greens lost votes, while neither the FDP nor BSW crossed the 5% threshold to enter the Bundestag.
- A grand coalition of the CDU-CSU and the SPD is likely to form the next government. But leadership changes in the SPD may slow down talks.
- While a two-party coalition should be more stable than the outgoing traffic light coalition, this government inherits deep economic and geopolitical headwinds.
- The economy has stagnated amid years of low investment and high energy prices, while demands on European defence spending are increasing.
- The coalition will likely agree on tax cuts, reforms to migration policy, increased energy security, and deregulation. But changes to fiscal policy and defence spending will prove more challenging.
- Indeed, there is no straightforward two-thirds majority between the CDU, SPD, and Greens for constitutional reform of the debt brake. While Die Linke has supported debt brake reform in the past, it may oppose the creation of extra fiscal space for defence spending.

### The centre has held, but German politics is fragmenting

As expected, the Christian Democratic Union (CDU) and the Christian Social Union (CSU) have emerged as the largest party in the German federal elections, with around 29% of the vote and 208 seats in the Bundestag (see Figures 1 and 2). This means Friedrich Merz will almost certainly be the next chancellor.

Alternative for Germany (AfD) is the second largest party, with 21% of the vote and 152 seats, roughly doubling its 2021 vote share.

All three parties in the outgoing coalition lost ground. The ruling Social Democrats (SPD) secured only 16% of the vote, their worst post-war performance. The Greens saw their vote share fall to under 12% and 85 seats. The Free Democrats (FDP)'s vote collapsed, meaning it has failed to cross the 5% threshold required to enter the Bundestag.

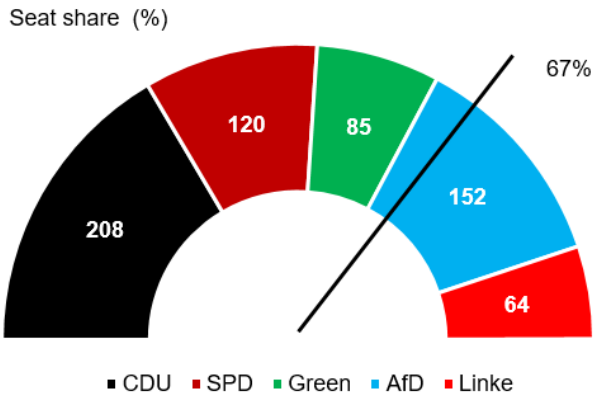
Parties on the left have seen an increase in support, highlighting the ongoing polarisation of German politics. The Left (Die Linke), a far-left party, won nearly 9% of the vote and 64 seats. That said, the new populist left party, the Sahra Wagenknecht Alliance (BSW) appears to have fallen just below the 5% threshold to enter the Bundestag.

Overall, vote shares were generally close to pre-election polling, albeit with the CDU-CSU marginally underperforming and the AfD marginally outperforming.

Turnout was elevated at 82.5%, a post-unification high.



**Figure 1: The CDU and SPD have together won more than half of seats, although there is no simple path to a 2/3rds super-majority**



Source: bundeswahlleiterin.de, February 2025

**Figure 2: The final vote shares were close to pre-election polling**

Party	Vote share (latest formal projection)	Final pre-election polls
CDU/CSU	28.5%	29.9%
AfD	20.8%	20.5%
SPD	16.4%	15.3%
Greens	11.6%	13.0%
Linke	8.8%	7.3%
BSW	4.97%	4.4%
FDP	4.3%	4.4%

Source: FT.com, February 2025

### The CDU will look to the SPD first to form a government

Merz is likely to seek a grand coalition with the SPD, which would give a narrow majority of 328 seats (see Figure 3).

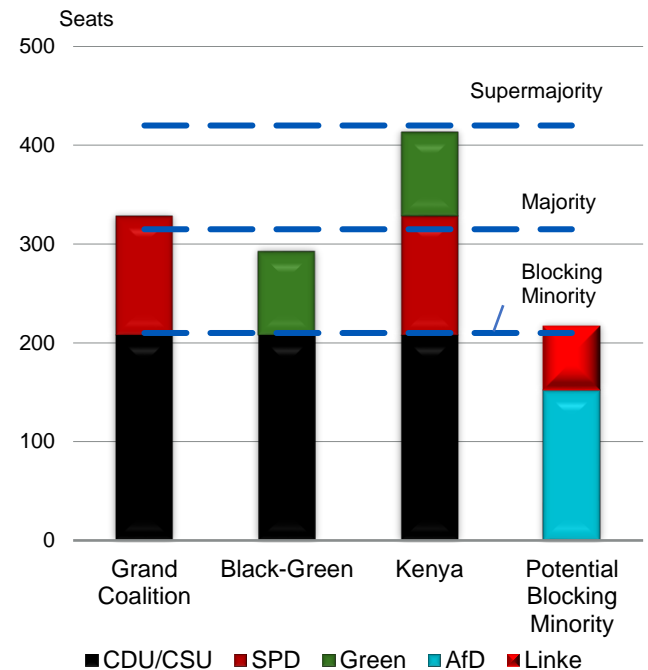
This alliance has been relatively well tested in modern German political history. While not without its challenges, it would likely be more stable than a three-party option also involving the Greens.

Typically, German coalition negotiations take two to three months, and sometimes stretch as long as six months. Merz has signalled a strong preference for a shorter timeframe, given critical upcoming events including the Special European Council summit on 6 March to discuss defence issues, and the formal Council meeting on 20 March.

That said, the SPD may struggle to start coalition talks as rapidly as Merz might hope. A historically poor result for the party means Olaf Scholz may need to be replaced with a new leader before the party participates in coalition talks.

Given these challenges, Merz's aim of forming a new government by Easter is ambitious.

**Figure 3: A CDU/CSU-SPD grand coalition will be Merz's first choice**



Source: abrdn, Haver, February 2025

### Defence, tax and spend, energy, immigration, and deregulation are top of Merz's in-tray

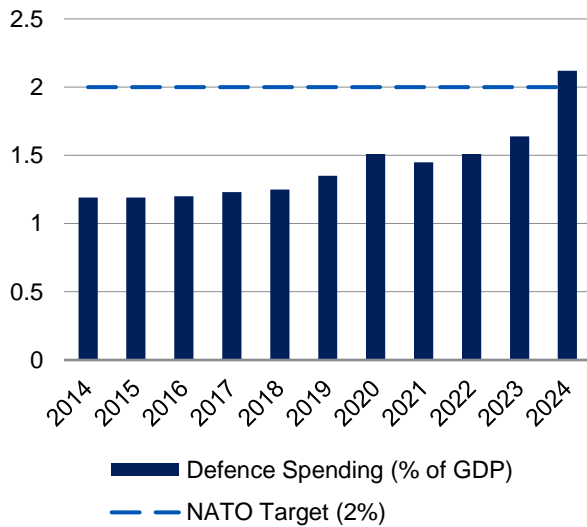
Merz has advocated for a significant shift in German and European defence policy. The recent signals from the Trump administration, including US Vice President JD Vance's speech at the Munich Security Conference, have required a strategic pivot away from the Atlanticist security policy traditionally favoured by the CDU.

In line with this support for a more independent European security architecture, Merz has softened his previously strong opposition to common EU borrowing for defence. The goal of the CDU is likely to be increasing German defence spending from its current 2.1% of GDP (see Figure 4), as well as returning Germany to a leading role on questions of European security strategy.

This will require navigating domestic and foreign policy challenges. Germany is unlikely to be able to increase defence spending beyond current levels without debt brake reform, and without doing so will lack the credibility to lead the discussion on European security policy. In addition to questions of common EU borrowing, Merz has recently proposed opening discussions with the UK and France on "joint nuclear security", something that may be challenging given the less hawkish views of the SPD.



**Figure 4: German defence spending will likely need to increase significantly**



Source: abrdn, Haver, February 2025

Merz will be keen to demonstrate progress on lowering energy costs, which were a major voter concern during the election. With the Greens now likely to be out of government, Merz is likely to pursue a policy that prioritises increasing production over one that mandates decarbonisation.

Despite calls from opposition parties including the AfD to resume Russian gas imports to lower energy prices, such a solution remains unlikely given Merz' desire to be at the forefront of a renewed European security architecture and the broad opposition to such a policy within the German political centre.

The CDU proposes a significant tightening in immigration policy, including enhanced border controls, a de-facto entry ban for undocumented migrants, and increased deportations. The SPD has been critical of these proposals.

Finally, Merz' planned deregulatory push will also hinge on the outcome of coalition negotiations. Many of the areas he has been most critical of – increasing regulatory burdens and efforts to rapidly decarbonise – were hallmarks of the SPD's policy agenda. Nonetheless, we expect Merz will successfully push for a lighter-touch regulatory framework, particularly as this chimes with the consensus across the EU at present.

#### A theoretical blocking minority complicates the path to debt brake reform

Notwithstanding some potentially more growth-friendly aspects of the new government, reform of the debt brake – the constitutional reform limiting the structural budget deficit to 0.35% of GDP – will be difficult. While the CDU-CSU and SPD, alongside the Greens, are seemingly all in favour of debt brake reform, they are likely to control a combined 413 seats, just short of the 420 required for a two-thirds supermajority for constitutional change.

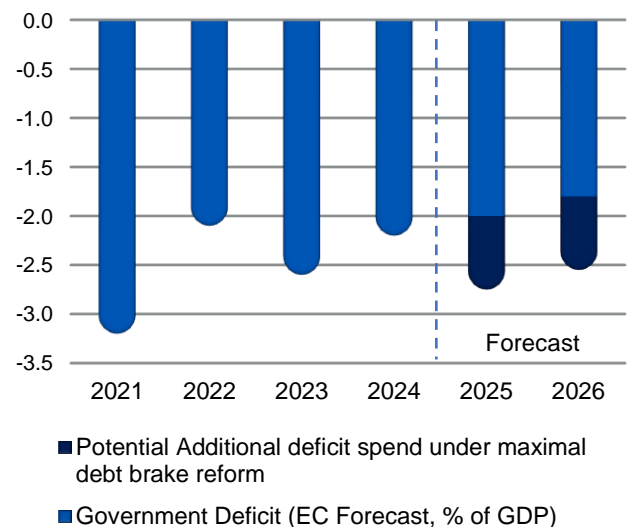
While the AfD is opposed to any debt brake reform, Die Linke is a longtime proponent of abolishing the debt brake. However, they might well block reform if they perceive it to be part of a broader effort to increase defence spending.

Indeed, even stop-gap approaches to increase defence spending are now in doubt. The relatively rapid increase in German defence spending since 2022 to the current 2.1% of GDP is due to the creation of a special debt funded €100bn fund. The fund will be fully allocated by 2025 and expire in 2027, meaning it will not be able to contribute to any further defence spending increase. The creation of another fund would require a two-thirds majority, making this unlikely.

The government could trigger the escape clause to the debt brake with a simple majority, although this would have to be renewed every year and may face challenge in the courts.

In any case, any potential loosening of the debt brake wouldn't be transformative (see Figure 5). Realistic options might allow the structural deficit to increase to 0.75% of GDP, while the EU-wide fiscal rules would still apply (albeit excluding defence spending, for which EU Commission President Ursula von der Leyen has indicated the escape clause will be triggered).

**Figure 5: Even if the debt brake can be loosened, the resulting fiscal boost won't be transformative**



Source: abrdn, Haver, February 2025

Moreover, the increase in defence spending may not all be additive to the overall fiscal stance, with some of the financing coming from existing government spending. Indeed, it is plausible that a shift towards defence spending could even constitute a net drag on the economy, if the multiplier on defence spending proves to be quite low (which would be the case if most of the spending ends up procuring equipment from the US), and if it crowds out other growth-enhancing investment.



All told, then, any hopes the market may have harboured for a large loosening in German fiscal policy are likely to be somewhat disappointed.

### **Is this the last chance saloon for mainstream German parties?**

The challenges facing the new government are significant.

Geopolitically, Germany will need to play a crucial role in navigating the more transactional approach the Trump administration is taking to the transatlantic alliance, while also carving out an acceptable role for Europe in any Russia-Ukraine ceasefire.

Economically, Germany faces many deep structural problems. At their heart, both public and private investment spending have been extremely weak, causing Germany's capital stock to deteriorate sharply. Even with policy

changes coming under the new government, we think Germany's potential growth rate will remain among the worst in the Eurozone.

This leaves the long-run outlook for German politics volatile. As the second largest party and natural opposition to the new governing coalition, the AfD is well positioned to benefit from any perception that the government fails to reform the economy and improve living standards.

Granted, the "firewall" preventing formal political alliances between the AfD and establishment parties remains in place for the time being. But with the AfD now the largest party in the five Eastern states, it may only a matter of time until no state government can be formed without them. At this point, the future of the firewall may start to look precarious, and eventual much more profound political change in Germany would be possible.

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