German election primer – CDU manifesto leaning towards market reforms

- The likely change of government after the snap elections planned for 18Sep is likely to spell a new era in German politics, different not only from the 7 year Red-Green coalition but also from 16 years of centrist politics under Helmut Kohl.
- The CDU manifesto presented 11 Jul confirms a general reformist leaning as regards taxes, social security reform and labour market deregulation.
- It is striking that former flagship reform projects – cut in income tax rates to 12% and 39% and health care – are set to start in 2007. By contrast in 2006 the CDU wants to start with a pain for gain platform, offsetting a cut in social taxes for unemployment insurance from 6.5% to 4.5%, by a 2% hike in VAT (to 18%).
- The SPD manifesto dating from 04 Jul proposes higher top tax rates and extended unemployment benefits for older people in employment.
- Next to the political challenges as chancellor Angela Merkel faces the personal challenge to win support from powerful conservative state premiers and intra party rivals.
- In the end a CDU-FDP coalition seems the most likely – and most market-friendly – election outcome; a narrowing of the CDU lead/rise of the left are substantial risks.

Asset conclusions: resuming reform momentum should be positive for capital markets, possible disappointments on income tax reform. Rejection of snap elections seems low risk.

Opinion polls show stable lead for conservative opposition

The capital markets took the announcement of general elections by Gerhard Schröder (23 May) in their stride. A change of government, as indicated by the opinion polls would have two benefits for the markets: (1) a market-friendly economic policy program on taxes and social welfare reforms; in fact a possible centre-right coalition might have a stronger commitment to economic reforms not only than the Schröder government but also the former Kohl government; (2) speeding up implementation of political measures, given the coinciding majorities in both houses of parliament (Bundestag and Bundesrat).

Despite the CDU’s comfortable 17 %-point lead over the SPD (44% vs. 27%), only 1/3 of the Germans see its victory in the 18 Sep snap elections as a done deal. The reception of the CDU’s election manifesto (presented 11 Jul) by the general public will be key in assessing the likelihood of a win by the CDU on a market friendly ticket.

Voters see the CDU as having a clear edge in terms of economic and labour market competence. The level of acceptance for appropriate measures among the population is, however, still limited – on the contrary: there is a clear majority in favour of general minimum wages and special taxes on high incomes. Moreover the ascent of a new hard-left grouping (based on the post communist east German PDS) to double digit figures in the opinion polls confirms wide-ranging scepticism of “anglo-saxon neoliberal free market reforms.”

On the other hand the CDU/CSU might benefit from the SPD’s loss of credibility after the 2002 general elections, having had to admit that its program of “soft-reforms” had been insufficient to stabilise the economy. Maintaining credibility but not over-estimating the
public acceptance for painful – albeit economically sensible – measures will remain a fine line to tread for the CDU/CSU or any electoral contender.

Unemployment yy and lead of opposition parties in polls

Outlook after the elections – political credibility a key issue

The need for reforms has been a recurring subject among the German electorate for some time. But the recent sharp under-performance of the German economy in terms of job creation highlighted the structural imbalance of the economy and its inability to cope with global competition. A rising fear of being personally affected by job losses – according to a DIMAP opinion poll late 2004, 35% of employees no longer see their jobs as secure – seems to have increased the level of acceptance for painful measures.

Chancellor Schröder (14 Mar 2003) in his “agenda 2010” announced far-reaching cuts in social welfare – regarding unemployment benefits, pensions and health care – paving the way for more comprehensive measures. While these reforms received an overwhelmingly positive reaction among economists, among large parts of the media and public opinion they were held responsible for the heavy defeats suffered by his party in a string of state elections. But even when diagnosing the causes of the SPD defeats - which led to an erosion of its influence in the states and the upper house - opinion seems widely split. Political observers see a lack of acceptance for political reforms, whereas for economic observers it is mainly the credibility gap of the SPD – as the agenda 2010 measures were in clear contrast to the pre 2002 election commitments.

Against this background the CDU/CSU manifesto prioritises credibility over acceptance, and can be seen as a “pain for gain” platform. In the internal party dispute between centrist and reformers the manifesto, in key areas, leans towards the reformers led by Angela Merkel (EZA640/27Oct04). Economic reforms cover about 2/3 of the manifesto, with a general pledge for deregulation and simplification in key economic areas:

(1) Labour market reforms
(2) Social welfare reforms
(3) VAT hike and income tax reform
(4) Removing red tape from energy policy and research in advanced sciences like technology / biotechnology
Labour market reform – easing employment barriers

Key Points: more comprehensive deregulation on the labour market than previously planned, focus is on easing dismissal protection and reducing the scope for collective wage deals.

In terms of labour market reforms the key pledges are regarding dismissal protection, company exemptions from collective wage arrangements and subsidised wages at the low end. These measures reflect the interests of both the reformist CDU and centrist CSU.

As regards dismissal protection, a key topic of the CDU, protection shall be suspended for companies with 20 or less staff, ie a large share of the German craft and retailing sector. Also dismissal protection is only applicable for employees after two years service and for the remainder it should be negotiable against severance pay. These measures – taking a lead from former CDU governments and experiences in other European economies – are meant to lower entry barriers for the unemployed, accepting a temporary shift in company dismissal power. It remains, however, an open question, whether they are a disincentive for employees to change jobs, particularly in less dynamic industries.

Allowing companies to seek exemptions from industry-wide wage agreements is designed to prevent bankruptcy or business re-location. In contrast to current regulations (which give the industry-wide negotiation parties a vetoing power), company specific “alliances for jobs” will be validated by the consent of 2/3 of the staff and the work council. Stipulating such a majority is meant to head off legal challenges by the unions, but also deflect the criticism of the left wing. This measure is the strongest challenge to the current practice of industry-wide wage agreements. It should be particularly relevant in industries and regions which face heavy “migration-pull” to the east, which could be one of the main reasons for the strong support by the Bavarian CSU – despite its usually centrist leaning.

Measures directly related to reduce unemployment include; allowing reduced starting wages for long term unemployed and subsidising wages which are below the contract wages. The first measure is meant to reduce disadvantages for long term unemployed in regular jobs. Subsidised wages go back to a model developed by economists of the Ifo institute for a more efficient allocation of central labour office funds (EZA650/17Dec04). Among economists the debate is on the risk of a resulting general downshift in wages.

Social welfare reform – spending lid through lower funding

As regards welfare reforms the CDU/CSU made two key commitments

- Cutting contributions to unemployment insurance by 2% to 4.5%
- Switch in the funding of public health care towards a “health tax” in 2007, consisting of a flat employee contribution and an employer contribution proportional to incomes.

Key Points: focus is on reducing funds for social insurance, notably central labour office and health care, thus putting a lid on social spending and curbing the benefit component in employment costs. This is a major provocation to the trade unions.

The cut in unemployment contribution can be seen as a political carrot to justify higher VAT and massive spending curbs to the central labour office. Of the € 50 bn budget for the central labour office about € 16 bn has been directed towards training in business
startups, which is scheduled for massive downsizing. By downsizing spending for training the CDU/CSU would kill two birds with one stone: apart from freeing public funds it would hurt the trade unions, which sponsor “training agencies”, absorbing about €8 to €9bn pa. Imposing external budget curbs would build up powerful pressure on the unions, which – led by their vociferous deputy president Ursula Engelen-Kefer – control half of the supervisory council. In fact the CDU/CSU obviously hopes to offset most of the €16 bn income cuts, triggered by the decline in unemployment contributions within the first two years.

Compared to labour market reform the reform of health insurance, initially meant to decouple health costs from wages while putting a general lid on health care spending, has been de-emphasized, only covered in the last third of the manifesto. It repeats the compromise achieved last year, providing a flat employee contribution, demanding significant subsidies for low wages and children, who will be insured for free. Not stating a number for the flat contribution may be an act of prudence, but it does not make funding – estimated at a net of €8 bn to 17 bn – more credible.

Only vague indications have been given regarding pension insurance, since this has only been on the party reform agenda this year. The party pledges a higher pensionable age and a shortening of life time in education. While intending to freeze contributions to public pensions and reduce contributions for families, more emphasis will be given to corporate pension schemes and individual savings.

The need for welfare reform
Welfare reform is a matter of particular urgency, given the combination of high unemployment (second highest among the G7 next to France) and rapidly ageing population (second next to Japan). The need for an overhaul of the social system – health care, central labour office insurance and pension insurance – and the need for reform is generally recognized. With a total of €470 bn, social welfare accounted for 22.5% of national GDP in 2004. Even more important is the fact that social welfare contributions account for 41.9% of gross wages and 64.5% of net wages - a major disincentive for companies to hire.

Schröder’s government started a trend change in unemployment spending through the Hartz (I – IV) reforms (in effect since 2005) as well as a general pension reform with more focus on funded pensions. Also on health care a small reform (in effect since 2004) provided cost sharing for medication and spending curbs.

But only the central labour office is under direct government control; the pension system consists of separate entities, called public pension insurance “trusts”, distributing the contributions of the 26.3 million employees (currently 19.5% of gross incomes).

(3) Taxation – higher VAT signals shift towards indirect taxes

Key tax changes proposed by the CDU-manifesto are

- hike in VAT main tax rate from 16% to 18%
- reduction in income tax rates to 12% (low end of sliding scale) and 39% (high end of sliding scale)
- reduction in corporate taxes and in capital taxes
- reduction in tax allowances
Key Points: a shift in the tax burden from income taxes to indirect taxes. This is a significant turn away from the CDU position held until early this year, when it promised a net tax relief of €10 bn. Only modest progress is made in terms of simplification.

As regards the hike in VAT, it is obviously the biggest bet for the CDU, since it will feed directly through to goods and service prices. According to the federal stats office this would lead to a 0.9% increase in CPI - a cost of €450 per average household per year. Lower unemployment contributions (1% equals €250) will be an offset for employees, benefiting middle incomes more than small incomes. The main criticism of this measure regards the disproportional burden for smaller incomes and families resulting from this measure.

Despite this strong criticism the VAT hike could have some merits for the CDU, as it adds to credibility and would give the new government some time to fine-tune its key reforms on income taxes and on health care. In some way pledging an early VAT hike could deflect criticism from other measures being perceived as “socially unjust.” Also leaving the lower VAT rate unchanged at 7% could be seen as going some way towards the critics. A more serious problem for a future CDU-led government could be the desire of the länder (states) to participate in a VAT hike, conflicting with Merkel’s objective to cut labour costs.

**Income tax reform**, one of the two projects topping the CDU agenda – as it was for the both the Kohl and Schröder governments – somehow falls short of expectation. The fact that the tax reform project lost its visionary profile is partly due to last year’s resignation of fiscal expert and CDU heavyweight, Friedrich Merz, partly due to real budget constraints, and partly due to the centrist hand of the CSU. This regards the timing of the reform as well as the fact that there is no mention of the medium term objective of a more radical simplification towards a three band tax system, pledged by former fiscal spokesman Friedrich Merz and proposed in a joint CDU/CSU platform in Mar04. The CSU figured last year that a cut in income taxes would cost €10 bn, which might be offset by a cut in tax loopholes.

The cut in corporate tax rates to 22% – instead of 19%, as planned by the current government and the SPD platform – is perceived among economists as just as disappointing as
maintaining local business tax. Against the background that the CDU/CSU in the past strongly opposed the 25% corporate tax rate – and the coinciding change towards the half-income taxation method, the party has gone a long way. The resulting loss in tax income (€ 2.5 bn) will be offset in “the field of corporate taxation”, ie re-introduction of a tax on capital gains on the sale of corporate stakes. Finally the manifesto proposes a change in withholding tax to a final tax of 25% deducted at source. This is likely to be hiked in any event to 35% in 2010 according to an EU tax arrangement.

Also in terms of tax allowances and tax loopholes the manifesto is closer to (centrist) CSU positions than to the reformers of the CDU. Official mention has been made of the commuter tax allowance and wage supplements for work on Sundays and night shifts: while the cut in the commuter tax allowance can be seen as minimal (€ 0.5 bn p. a.), no mention has been made of investment in tax-saving funds or of the home ownership tax allowance. The least one could expect would be tough bargaining between the CSU and the CDU next year on tax allowances, diluting the thrust of a general simplification.

(4) Removing red tape – new thinking required

Removing red tape is a recurring subject in various fields of the economy

- fostering research in high end technologies
- as regards small companies
- as regards energy generation
- as regards east Germany

Deregulating research in high end technologies – a broad range is mentioned in the manifesto – can be seen as a means of keeping researchers in Germany rather than attracting researchers from abroad. Committing itself to such a measure is relatively courageous in the wake of a public opinion which is sceptical on key areas of research.

In terms of small business the call for removing red tape on statistics and public authorisations for construction has been a long standing demand. But the CDU manifesto somewhat lacks credibility in this field since the party has been opposed to deregulation in craft industries – e. g. masters requirement, abandoning of chambers of commerce.

In terms of energy generation the CDU promises a softening of the commitments of the current government in terms of nuclear energy, while phasing out coal subsidies. This should be seen as a clear step towards deregulation of the energy market, in which Germany has started to fall behind other EU countries. The way in which demand for lower prices will interfere with the deregulation target remains unclear however.

As regards east Germany there is official mention of lowering production standards for east German companies and facilitating business start-ups. But it seems that the CDU is still sticking to a principle of support via subsidies.

Having said this, making the removal of red tape a general principle is a positive step towards re-directing public opinion. It will, however, be down to the FDP to drive this forward and put the principle into practice.
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<td><strong>Other</strong></td>
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<td>2005 / 2015 1 → 4</td>
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**Public reception and alternative SPD platform**

In terms of public reception of the election manifesto it may be telling that the most vociferous criticism comes from the unions – Engelen-Kefer sees the “most massive attack on employees’ rights of all her (long) working life” – the most positive verdict from the employers.

The trade unions’ criticism was predictable, since enhancing the scope for company-specific wage bargaining and reducing the budget of the central labour office is breaking “social” taboos. Putting a lid on funds will have also a direct bearing on the funding situation of the trade unions. More interesting seems the harsh criticism of the liberal FDP – the potential coalition partner – which demands the revoking of the VAT hike and demands smaller government. It also pledges the dismantling of the central labour office and privatising job mediation alongside further pledges on general competition in health care.

More substantial criticism concerns the lack of consistency of the tax measures, which is even mentioned by generally pro-CDU dailies and weeklies like the FAZ or the “Wirtschaftswoche.”
By contrast business leaders – apart from small trade and retailing associations – seem to be less critical of the manifesto; partly because they acknowledge the attempt to remove red tape and also because they already had low expectations with regard to tax changes.

The SPD manifesto naturally pledges a continuation of the current political balancing of “supply side and demand side measures.” Between the lines the SPD also emphasises its supply measures on labour market reforms and on taxation. But in contrast to the CDU talk of deregulation the SPD reiterates commitments to social balance. The area of labour market deregulation is one of the main differences between the CDU and SPD manifestos with the SPD relying on more flexible industry wage agreements and pledges to postpone the cut in jobless benefits. This marks a falling back behind previous positions. Smaller – albeit significant – differences are on taxation and energy policy. Instead of a VAT hike the SPD pledges a 3% tax supplement on top incomes – mainly a symbolic gesture.

More serious are the SPD commitments in terms of energy policy, pledging to maintain the time line for abandoning nuclear power. Flagging up this commitment may be seen as less of an attempt to court the Greens than to stop the defection of its own voters.

Key Points: the SPD platform combining left-wing “speak” and modest market oriented politics confirms its own limited scope for reform policy. The CDU might take criticism from the trade unions and from the FDP as confirmation for its own judgment.

Key personalities of a potentially CDU-led government

Given its dual roots from the catholic centre party and the right liberal German peoples party the CDU/ CSU combines centrist positions calling for “social balance” and a regulated economy with market oriented liberal reform positions. These two positions are also reflected in the leading personalities of both parties, notably CDU head Angela Merkel and CSU head Edmund Stoiber. Stoiber’s defeat in the 2002 election propelled Merkel’s ascent – and with her, that of the reformists.

Regional party strength in the upcoming election will be an indication of the relative strength of Merkel’s reformists versus Stoiber’s centrists as will be the showing of the liberal FDP. The personalities and functions in a future centre-right coalition – the most likely government after the elections – can be divided into three groups next to party leaders Merkel and Stoiber:

(1) Merkel’s inner circle of party confidants
(2) Minister candidates by party affiliation – CDU, CSU, FDP
(3) State premiers

Angela Merkel

Combining party leadership and chancellorship predestines Merkel – aged 51 – for political leadership. Her reform-mindedness and political ruthlessness predestines her to be a major force to shake-up German economic and fiscal policy. Key ingredients to her political positioning are her belonging to party minorities – being East German, protestant and female – and her close affiliation to former chancellor Helmut Kohl, who gradually assumed reform positions.
Since joining the CDU in 1990 Merkel’s career path has been steep, propelled by former chancellor Helmut Kohl, as she fitted his desire to promote women and integrate East Germans. Apart from two positions in government – family minister (to 1994) and minister for environment (to 1998) – she held a key position as one (out of seven) deputy party heads of the CDU from 1991 to 1998. After the Kohl era she assumed the position of party whip, from which she rose to party presidency in Apr 2000, promising a new start for the party, which had been discredited by a sleaze scandal involving Kohl and his successor to the party presidency - Wolfgang Schäuble. CSU head Stoiber’s unexpected failure in the 2002 elections not only paved the way for her leadership ambitions, but allowed her to commit the CDU to a reform agenda on health care and taxes. While having to give ground to Stoiber last year in key reform projects, her reformist line got fresh endorsement by victories in this year’s state elections.

Edmund Stoiber

Edmund Stoiber, CSU head, Bavarian state premier and (narrowly) defeated challenger of chancellor Schröder can be seen as a stark contrast to Merkel. His career as CSU whip, state minister and state premiership – sponsored by former charismatic CSU head Franz-Josef Strauss – can be seen as just as impeccable as his catholic southern German provenance. But it is just his strong affiliation with conventional conservative CSU party thinking, which – next to his membership of the CSU – has proved to be a major stumbling bloc in his political ambitions, because it reduced his responsiveness to new economic challenges.

He has left it open whether he will assume responsibility in a CDU/CSU-led government. Depending on the strength of the party grouping and the relative strength of the CSU in Bavaria he would prefer to assume the post of state secretary or a position of “super minister” for finance and economics. He stands for prioritizing fiscal consolidation over tax reform, a position, which has been endorsed by recent budget figures – showing an annual shortfall of € 19 bn until 2009.

(1) Merkel’s inner circle

Volker Kauder

Having assumed the post of party whip at the end of last year, Kauder’s conservative constituency in Württemberg, a traditional CDU stronghold, gives him the credentials to convey Merkel’s reform positions to a conservative, centrist party wing. He is tipped to become Chief cabinet minister in the chancellor’s office, hence a powerful coordinator of government policy.

Norbert Röttgen

Being a catholic Rhinelander, Röttgen, floor organizer of the CDU, not only combines traditional provenance with liberal party positions, but also seems a pragmatic negotiator to facilitate the legislation process. He is tipped to succeed Merkel as floor leader.

Merkel’s female senior office advisors Eva Christiansen and Beate Baumann – her first confidants during her stint as party head are tipped to become junior ministers.
(2) Minister candidates by party affiliation

**Michael Meister (CDU), finance ministry**

The deputy floor leader and fiscal spokesman is tipped as a likely candidate for finance minister, if Edmund Stoiber decides not to assume any other responsibility in federal government. A highly regarded expert in fiscal policy, Meister is still seen as lacking political clout and vision – in stark contrast to his predecessor Friedrich Merz. His candidacy depends on the strength of the CDU, a moderate to weak showing makes his candidacy more likely than a strong showing, which might make Stoiber claim the post of state secretary, leaving the finance ministry to FDP member Hermann-Otto Solms, a fiscal reformer.

**Wolfgang Gerhard (FDP), state secretary**

Wolfgang Gerhard, floor leader of the liberal FDP – which got 7% of the votes in the 2002 elections – has seen a comeback within the FDP, given the weakness of the current party head, Guido Westerwelle. Gerhard is seen as prioritising the trans-Atlantic relations over European policy, a position, which might be enhanced if Merkel creates the position of a junior minister for European affairs.

**Michael Glos (CSU), defence**

The CSU floor representative and Merkel deputy is seen as a key candidate for defence, the second largest budget next to social spending. His nomination hinges on the ambitions of Stoiber. If Stoiber assumes the post of state secretary, it is unlikely that a second post with foreign policy involvement will be given to a CSU member. In that case the CSU might assume the position of home secretary under Günther Beckstein, currently holding the equivalent position in Bavaria.

**Ursula von der Leyen (CDU), health or family affairs**

Von der Leyen, currently state minister in Lower Saxony and architect of the flat health tax is tipped as a key contender for a position in the field of social, medical reform. Her nomination would not only be a strong endorsement of reform positions but also enhance the CDU credentials in terms of family policy.

(3) State Premiers

**Jürgen Rüttgers**

Having seized power in Germany’s biggest state and former SPD stronghold, North-Rhine-Westphalia, Rüttgers is in pole position among state premiers, which are seen as the strong regional power centers in German politics. Having been minister in the Kohl government, he is seen as combining centrist provenance with openness to reforms. His support for university tuition fees and his decision to phase out coal subsidies are seen as enhancing his reform credentials.

**Christian Wulff**

Wulff, state premier of Lower-Saxony and CDU deputy, is seen as a rising star within the CDU after toppling the SPD state government in 2003. His centrist positions in terms of
labour market policy, in particular his defence of state involvement at Volkswagen, put him in conflict with Merkel. This has been exacerbated by personal jealousies, given Wulff’s popularity in the media. He is seen as astute tactically but lacking political vision.

**Roland Koch**

Koch, Hesse state premier since 1999, used to be the CDU star politician and biggest Merkel rival before his career was tainted by a finance scandal (in 2001) and his open challenge to Merkel’s reform positions in 2003. His political position might be restored, given his liberal stance on education and his openness to experiments in labour market reforms.

**Günther Oettinger**

Oettinger, as the most recent state premier – since Apr05 – has little national profile so far. But his political position might be enhanced if he can defend his premiership in the May06 state elections. A pronounced reformer, he could become a natural ally of Merkel.

**Ole von Beust**

Von Beust, Hamburg mayor since 2001, confirmed in 2004 state elections, has gained in stature as a reformer, given his successful economic and home affairs policy in Hamburg - in particular since Hamburg, the 2nd largest city, had been a traditional SPD stronghold. He is seen an ally of Merkel as regards key economic reforms, enhancing CDU credibility in urban areas.

**Alternative power constellations after the elections**

Despite the strong lead of the CDU and chancellor Schröder’s obvious lack of verve in defending his position, the election result still offers an element of uncertainty.

The biggest risk seems to be the president’s failure to endorse Schröder’s request for snap elections or the constitutional court endorsing a filing against it. In that case the current government would hang on to power until Sep06, with wrangling between the two houses of parliament delaying most significant economic reforms. An economic recovery during such a delay could make the election outcome less certain next year than it would be this year. Having said this, Schröder’s argument that he has no viable majority seems more convincing than the previous two successful cases of governments calling snap elections. We therefore still work on the assumption of the election taking place this year.

There are four alternative scenarios for possible coalitions. Ranking the scenarios by likelihood coincides with market preference, explaining the strong performance of the German capital markets since the 22May when the elections were announced.

(1) CDU/CSU – FDP coalition
(2) CDU/CSU absolute majority
(3) CDU/CSU – SPD grand coalition
(4) SPD/GREEN/Left PDS – coalition

Key Points: markets’ optimism on the prospect of a CDU/CSU-FDP coalition might be slightly overdone, but the risk of an outrightly negative coalition seems low.
(1) CDU/CSU – FDP

The most prominent poll, Politbarometer, implies about 51% support for this coalition, compared to 44% for a potential left-wing coalition – internal FDP calculations see a 2% corridor around this scenario. Such a coalition would be the most favourable outcome for the markets, since coinciding majorities in both houses of parliament would facilitate the legislation process, while the liberal FDP could tilt the balance of power within the CDU/CSU towards reforms. But this will be highly dependent on whether the FDP can maintain the 7.2% support of the last elections. **Likelihood of this scenario: 60%**

Assuming no specific disasters or international crises – like ahead of the 2002 elections – the biggest risks for such a coalition would be an SPD recovery in Schröder’s popularity or failure by the FDP to pass the 5% knock-out hurdle.

(2) CDU/CSU absolute majority

This scenario looked likely until about 12 months ago. Currently CDU/CSU and a potential coalition of the left draw in the polls; but CDU/CSU momentum seems slightly stronger than that of the Red-Green government, given failures on key policy areas such as home affairs. This scenario would be beneficial for Merkel, but not necessarily for reforms, in particular, as a strong showing of the CSU in Bavaria would endorse Stoiber’s centrist positions in fiscal policy. **Likelihood of this scenario: 20%**.

(3) “Grand” coalition of CDU/CSU and SPD

Although the popular preference for this coalition equals that for scenario (1), the likelihood is low. This might increase either in the wake of Schröder’s popularity or if election campaigning leads to a polarisation of political positions at the expense of the middle ground. Such an outcome would greatly facilitate the legislation process, but there is a significant risk that it would lead to a jostling for positions. Reduced scope for labour market reform and stabilising trade union influence would be a likely consequence. A major difference of such an outcome relative to the previous scenarios would be in foreign policy as the SPD would tend to prioritise European Integration over trans-Atlantic relations. **Likelihood of this scenario: 20%**

(4) SPD-Green-PDS-coalition of the left

Although in theory the gap between such a coalition and the CDU/CSU-FDP in the polls appears narrow enough to make it a realistic option, there seems to be strong resistance within the SPD against such a coalition, which would be out-rightly market negative. Therefore we assess the likelihood of such a coalition less than 5%.

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