

Germany's election: what should we expect?

Germany's government fell in November. What new government will emerge now? Will it be able to tackle the country's big structural economic problems? And what will it mean for German financial assets?

IN A NUTSHELL



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- German elections to the Bundestag used to be fairly boring affairs. Not this time! A fragmented electoral landscape could see as few as four or potentially as many as nine parties enter the next parliament.
- The stagnant economy needs big structural reforms. Swift formation of a new government might help. But the election risks resulting in a period of uncertainty in which no government is formed.
- That said, we think markets would treat a decisive win by Christian Democrats followed by a swift government formation as a modestly positive surprise.

On February 23rd, after a particularly heated election campaign, Germany will elect a new parliament in an election process that is itself more complex than in most countries. The balance of power that emerges between the many different parties will be crucial to the formation of what is likely to be a new coalition government. The coalition that governed until November 2024 fell apart, not least over economic and fiscal policy. The formation of a new government is likely to involve policy negotiations between the parties – which could progress rapidly if the election produces a clear winner but may be protracted if it does not. It could take months for a new policy agenda to be formulated.

The election is the starting point for our analysis. We then look at why the German economy has been struggling in recent years and to what extent an improvement may be possible after the election. What are the parties' proposals for strengthening the German economy, and which have most chance of being implemented under different political constellations? And what does all this mean for German financial assets and for investors?

1 / Germany's electoral landscape

1.1 More parties may enter the Bundestag this time around

In the imminent elections many parties are vying for the right to influence Germany's political future. Leading the polls now are the Christian Democratic Union (CDU) and its Bavarian sister party, the Christian Social Union (CSU). Together they are known as the Union parties – and we will refer to them collectively as the Christian Democrats. They represent the center-right in Germany, and traditionally emphasize economic stability, national security, and a strong European Union (EU). Both the CDU, founded after World War II, and the Social Democratic Party (Sozialdemokratische Partei Deutschlands -- SPD), which was established in the 19th century and has its roots in the labor movement, have historically been the only parties to

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nominate the chancellor. The SPD is a center-left party which has been a longstanding advocate for social justice, labor rights, and strengthening of the welfare state. Meanwhile, Alliance 90/The Greens – commonly referred to as just the Greens – have their roots in the environmental movement of the 1980s and prioritize environmental issues, sustainability, and social equality. The Alternative for Germany (AfD), founded in 2013, in part in response to the Eurozone crisis, is a far-right party that has gained traction through its populist rhetoric and criticism of immigration policies and the EU.

Alongside these major players, numerous smaller parties are also competing for influence in shaping Germany's political future. The Free Democratic Party (FDP), founded in 1948 with the primary aim of rebuilding Germany's economy, is known for its liberal economic policies, championing of individual freedoms and commitment to a free-market economy. Die Linke (The Left), which has its origins in the Party of Democratic Socialism in the former East Germany, stands for democratic socialism, anti-capitalism and pacifism, and appeals to voters on the far left. Then there is "Bündnis Sahra Wagenknecht" (BSW), a party recently founded by the former deputy leader of The Left, Sahra Wagenknecht, which combines left-wing populism on economic issues with cultural conservatism. Lastly, the Free Voters (Freie Wähler, FW), not a traditional party but a loose association of independent voters and local politicians, focuses on grassroots democracy, decentralization and community-oriented policies; its stance on political issues often varies across different regions.

1.2 Polling and the campaign so far

[Attacks by migrants have made the migration question the primary topic in campaigns](#)

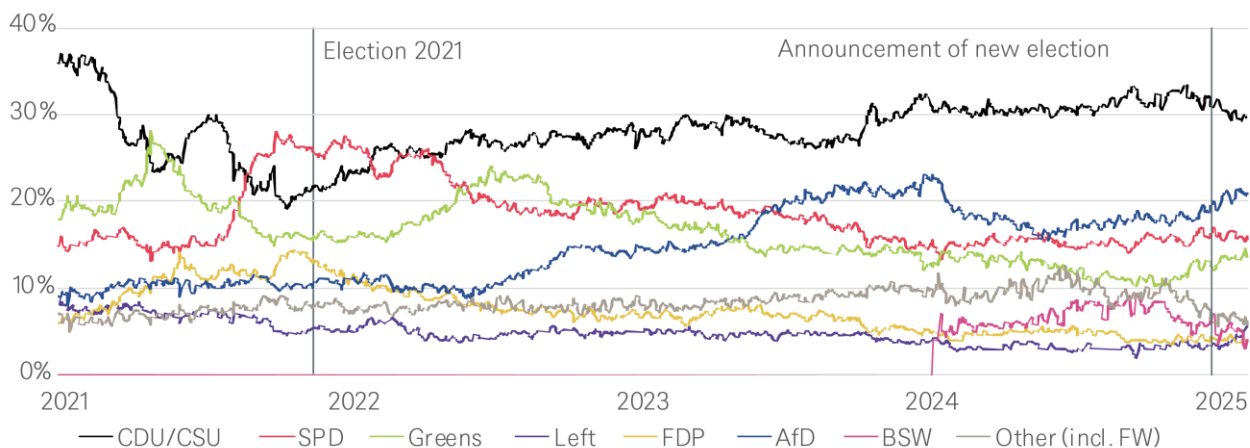
Germany has been going through one of the most momentous election campaigns in living memory. A number of fatal stabbings and other assaults by migrants, most recently in the city of Aschaffenburg in January, have caused widespread alarm and further increased the importance of migration as an election issue in the final weeks of the campaign, triggering high-profile debates in parliament.¹

The previous government, led by chancellor Olaf Scholz, was unpopular and the Ampel or "traffic-light," coalition, based on the colors of the parties involved, the Social Democrats (SPD), Greens and Free Democrats (FDP), collapsed spectacularly in November amidst mutual recriminations. The center-right Christian Democrats, the biggest opposition party, might have been expected to benefit. But looking at polling data it is striking that the CDU and CSU, have, if anything, been losing ground since the collapse of the previous government. This is a highly unusual development, perhaps reflecting lingering doubts among some voters whether they want Christian Democrats back in government so soon. It may also be that voters distrust all the major parties, feeling that none has successfully addressed the problems the country faces. Prior to Scholz's period as Chancellor, the Christian Democrats were in power for 16 years during which reforms were delayed as the economy seemed to be doing fine. Since then, it may have become clear to some voters that many structural problems predated the Ampel. The Christian Democrats' previous openness to migration may also have cost it popular support, and the AfD has been able to profit from that.

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National polling averages show modest but potentially significant changes since new elections were announced

7-day rolling unweighted polling average



Source: Simple averages created based on data from wahlrecht.de as of 01/31/2025

Too early to call the impact of recent parliamentary maneuvering

The polling data is inconsistent and suggests many voters remain undecided – and therefore open to being persuaded by one party or another. For example, the simultaneous findings of normally quite reliable pollsters show a CDU/CSU support at anywhere between 28% and 34% -- an unusually wide range.²

Up until the fatal stabbing in Aschaffenburg, in which a man and a 2-year-old boy were killed, the Christian Democrats had attempted to talk as little as possible about migration, presumably because the party felt that its economic policies would be more likely to draw support from its target electorate. Friedrich Merz, their candidate for chancellor, also tried, not always successfully, to avoid any collaboration with the far-right AfD, including at the local and regional level. But, in the final days of the current parliament, the Christian Democrats joined forces with the AfD and Free Democrats (FDP) to pass a non-binding resolution on migration in the Bundestag.

This joint vote was extremely controversial because it arguably breached the so-called “Brandmauer,” or firewall – a determination on the part of all centrist parties that they would not collaborate with the extreme right, especially at the national level. This led to an intervention in the debate by the former chancellor and CDU leader, Angela Merkel, at the end of January in which she criticized Merz and said it was wrong for the CDU to do this.

A later attempt to pass an actual migration law (at least through the lower chamber) failed, but not without further highlighting divisions among the Christian Democrats. Although Merz has gone out of his way in recent days to paint the AfD as an unacceptable partner for any governing arrangement, we expect the Christian Democrats to continue to be dogged by questions about the party’s flirtation with the far right.

1.3 How polls translate into majorities

A complex system, in which smaller parties matter a lot

Germany’s voting system remains unusually complex and in German federal elections the eventual parliamentary seat count is hard to forecast.

Unlike voters in most countries, Germans get two votes when electing the Bundestag – one for a local candidate in each of the country’s 299 constituencies, and one for a party list.³ Winning 5% of the national vote via the party list is one way to enter the Bundestag under a proportional representation system.

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The other way is to secure so-called "Direktmandate" (best translated as "direct seats"). Voters who are particularly keen to boost a small party's fortunes therefore have two ways to do so – give it their list vote so that it clears the 5% hurdle nationally or vote for that party's local candidate, if they happen to live in a district that is unusually favorable to the small party. In most instances, whoever gets the most votes in a district wins a direct seat.⁴ Winning at least three such direct seats (i.e. obtaining a plurality of first votes in at least three constituencies) allows parties to enter the Bundestag and to participate in the distribution of seats allocated via proportional representation defined by the share of second votes.⁵

Therefore, until the election has taken place, which of the smaller parties will be represented in the lower chamber of Germany's parliament, the Bundestag, will be unclear. Apart from the Christian Democrats, Social Democrats, Greens and AfD, the only other party that is very likely to win at least one seat is the Südschleswigsche Wählerverband (SSW) – a regional party that many Germans may never have heard of.⁶

In addition, BSW and The Left, the left-wing parties, have both been hovering at about 5% in polls, with the more right-wing, liberal Free Democrats usually a touch below.

Direct seats may enable smaller parties to enter the Bundestag

The main practical implication of the direct seats is that The Left looks reasonably well placed to get into the Bundestag as it has a decent chance of securing three direct seats in districts in the former communist east -- and a number of well-known incumbents in those seats.⁷

The right-wing populist Free Voters (FW) are the junior members at present of a ruling coalition in the southern state of Bavaria with the CSU and are targeting four direct seats there, but this is a trickier call.⁸

By contrast, polling data, electoral history and the campaign so far all suggest that the Free Democrats, whose vote is evenly distributed throughout the country, are unlikely to be in contention for any direct seats, whether or not they fall short of 5% nationally.

1.4 What this means for government formation

How will recent events influence the vote?

The upshot of all this is that investors would be ill-advised to prejudge the likely outcomes of both the election itself and the subsequent process in which a coalition is likely to be formed.

It remains unclear whether the recent votes on immigration in which the Christian Democrats drew on AfD support will help or hurt the party. Merz, the Christian Democrat leader, has made his migration proposals, which will make it harder for immigrants to enter the country, a make-or-break item for coalition negotiations. This could create sizeable obstacles for any coalition with either the Greens or the Social Democrats. And it may be necessary to convince not just the leaders of these parties but also their ordinary members, who are likely to be consulted (one way or the other) on any coalition deal.

Possible coalition outcomes

Against this backdrop, it is prudent to prepare for a range of election outcomes. In particular, investors should be aware that both a clear result, leading to the rapid formation of a stable coalition with a majority in the Bundestag, and an unclear result, leading to a prolonged period of political uncertainty, are possible.

It may be that the biggest source of uncertainty is the question of which parties secure either at least 5% nationally, or 3 direct seats. The smaller parties represent a combined total of approximately 20% of voters. But if none of them obtains any seats in the Bundestag, a combined voter share of as little as 40% of possible coalition partners would probably be enough to command a majority of Bundestag seats. If, on the other hand, all or most of the smaller parties manage to win some seats, a coalition would probably need to command a combined level of voter support in the 45% to 50% range.

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Which of the smaller parties have won seats and what level of popular support is likely to be needed to form a coalition should become clear on election night or soon thereafter. Outperformance or underperformance could lead to significant changes in party leaderships. For example, if the Christian Democrats barely improve on their disastrous 24% of the vote in the 2021 election, the party's lowest share since WWII, and lose ground to the SPD, the Greens, AfD or even all three, Merz would probably resign, as his predecessor Armin Laschet did in 2021. A departure of Merz, however unlikely it may seem at this stage, might help smooth coalition negotiations, but that would also depend on the profile of whoever succeeds Merz. After voting with AfD, Merz is distrusted by the Greens and the Social Democrats, but most other Christian Democrat Members of Parliament voted likewise. In short, unless there is a dramatic surprise, the next government is likely to be led by the Christian Democrats, but beyond that, a wide range of outcomes is possible.

Could we see a minority government?

Conversely, a surprisingly strong showing for the Christian Democrats, together with a fragmented Bundestag, could paradoxically make cobbling together any governing arrangement that excludes the AfD very hard, as proved the case recently in several East German states, causing minority coalition governments led by the Christian Democrats to be formed in Saxony and Thuringia. It is also worth pointing out that Germany's so-called Basic Law (the Grundgesetz⁹) was designed to make it difficult to trigger fresh elections in order to avoid reaching compromises. In theory, at least, Germany looks well prepared to function under a minority government – even if most of the current national political leadership is not.¹⁰ Bringing down a minority government would be hard, as long as the opposition is divided. Potentially, such a government could try to seek majorities on a case-by-case basis, though we admit that this would very much go against Germany's political culture. More plausible, at least in theory, would be confidence and supply arrangements of the sort quite common in the states of the former Eastern Germany in the 1990s, when formal coalitions with PDS (predecessor of The Left) were widely considered taboo, but political realities were such that both PDS and Social Democrats had something to gain from the former agreeing not to topple left-leaning state governments in return for policy concessions. This time around, we still find it hard to see any confidence and supply arrangement between Christian Democrats and AfD in the Bundestag, though it could be a topic for after the next election – especially if tried at the state level in the meantime.

1.5 The role of the Bundesrat

Compromises are also encouraged by the fact that power in Germany is widely distributed. Most importantly, the balance of power in the upper house, the Bundesrat, is determined by frequent regional elections in each of the federal states (the Bundesländer) and the subsequent formation of state-level governments. This gives even small parties in government at the state level significant veto power on most matters of legislative significance.

The Bundesrat currently includes all the parties mentioned in this report except the AfD, which so far has no participation in any state government, as all other parties have up until now refused to enter coalitions with it. This means that even if the AfD was somehow able to emerge as the largest force in the next Bundestag and to ally itself with a defeated, shrunken and demoralized Christian Democrat party, the resultant government would be heavily constrained in what it could do, from laws relevant to states to changing parts of the Basic Law.¹¹ Whatever the agenda, reforming Germany requires a broad consensus that stretches beyond the parties that are in government nationally.

2 / The German economy and the election

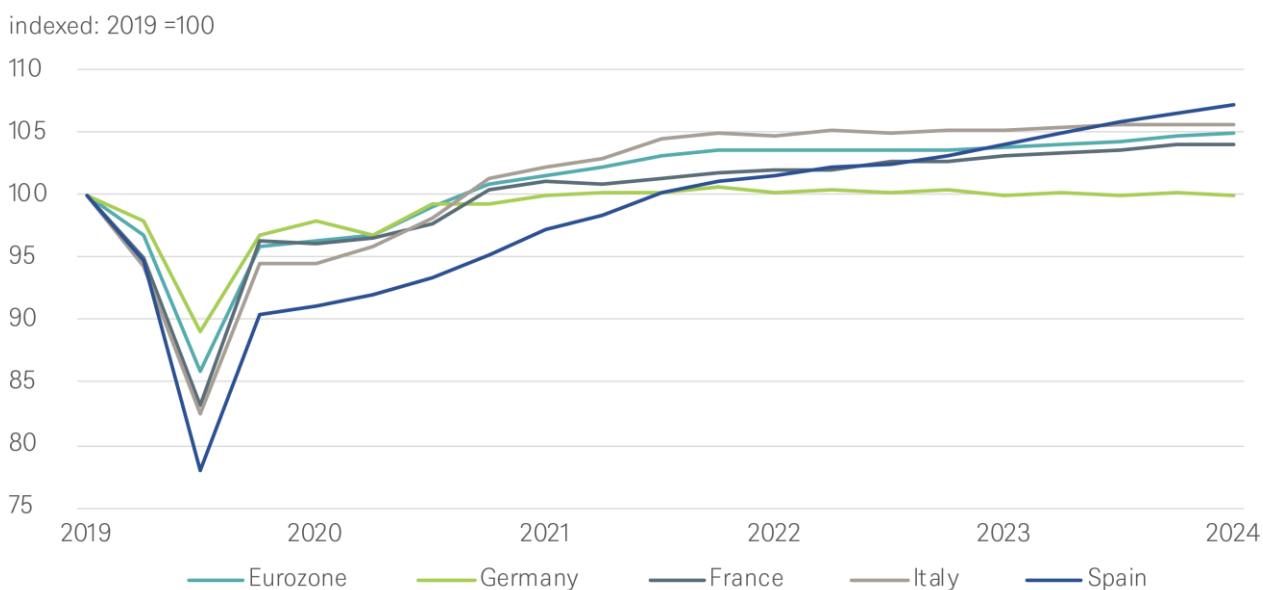
2.1 The cyclical problems

Five years of stagnation

The German economy has been stagnant for five years. Initially, it weathered the Covid-19 pandemic relatively well. The slump was not as deep as elsewhere, and the recovery was also well underway thanks to a strong industrial sector. But since then the economy has stagnated. In the fourth quarter of 2024, Germany's output was slightly below that of the fourth quarter of 2019. That puts Germany at the back of the pack among Europe's major economies in terms of economic growth.

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Gross Domestic Product: Germany brings up the rear



Source: Haver Analytics Inc., DWS Investment GmbH as of 1/31/25

The causes of the stagnation are complex

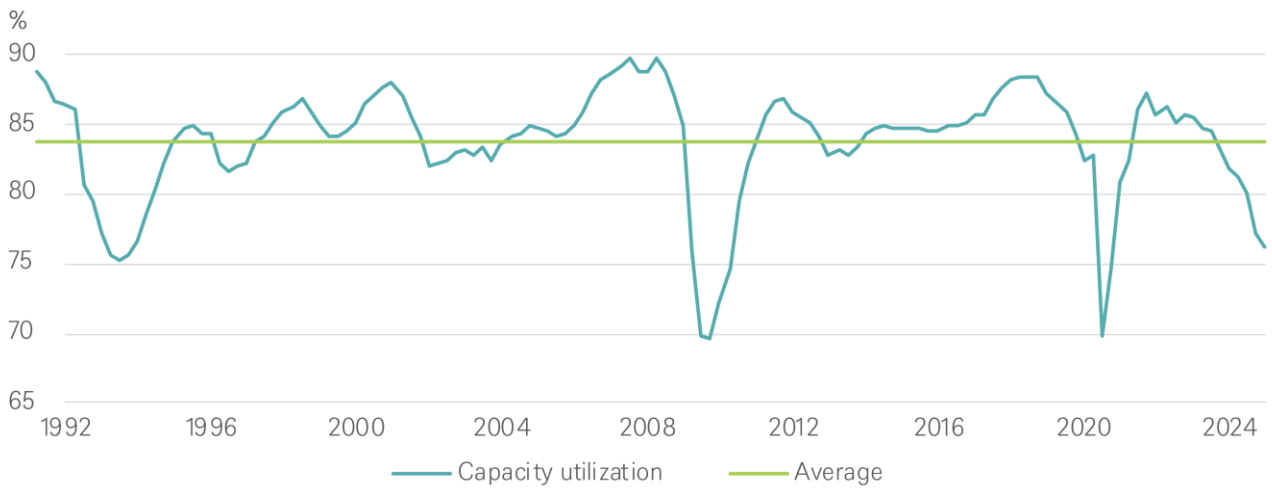
The causes of this stagnation are far more varied than is often portrayed in public or political debate. In the immediate aftermath of the Covid pandemic, German industry was hit by numerous supply-chain problems. Raw materials and intermediate goods were in short supply, either because production in China was paralyzed by shutdowns or because global transportation routes were under pressure. Then Russia's invasion of Ukraine sent gas prices and, as a result, electricity prices skyrocketing. Germany was able to significantly reduce its gas consumption and avert a gas shortage. In this Germany was quite successful: while industrial gas consumption fell by about 20%, industrial production fell by less than 3%. However, weaknesses in the German economic model were revealed. The German economy is highly specialized, above all in industry, and therefore dependent on free international trade and functioning supply chains. It became clear that some of the preventive measures to stay competitive in a changing environment had been neglected in the years leading up to Covid, and not just by policymakers.

Global industrial recession hits Germany particularly hard

The global industrial recession is hitting Germany particularly hard, as manufacturing accounts for almost a quarter of the country's gross value added. The widespread view that poor supply conditions lead to low capacity utilization misses the point. The supply side is responsible for the level of capacity, while the demand side determines the degree of capacity utilization. Surveys of industrial firms also show that while concerns about supply chains, inputs or even labor have receded, more than 40% of firms now cite lack of demand as a constraint on production.

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Industrial capacity utilization: recession



Source: Haver Analytics Inc., DWS Investment GmbH as of 01/31/2025

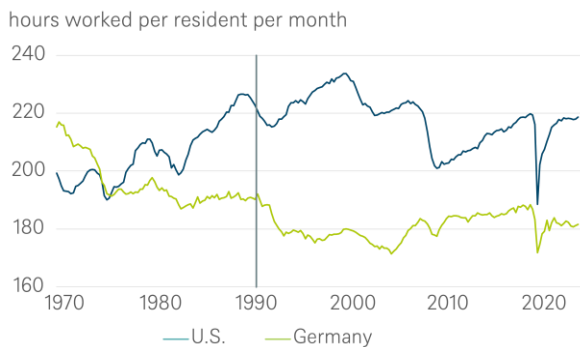
2.2 The structural problems

The labor force participation rate and government investment are too low

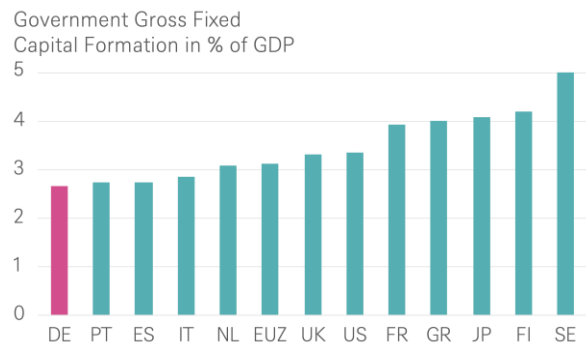
But there is no question that Germany also faces serious supply-side problems. We estimate that Germany's potential annual gross-domestic-product (GDP) growth rate is currently around 0.5%. The main source of this potential growth is demographics, or rather the low labor force participation rate. While it is true that more people are currently working in Germany than ever before, there are also more people living in Germany than ever before. The number of hours worked per capita has fallen significantly in recent decades. The main reasons for this are a retirement age that has not kept pace with increased life expectancy, low incentives to work due to generous support offered by the welfare state and a high proportion of part-time workers.

Unfortunately, productivity growth has not been sufficient to compensate for the unfavorable demographic trends. One reason for this is the low level of investment in Germany, especially public investment, where Germany has been lagging far behind in international comparisons for many years.

Working hours per inhabitant: Germans don't work enough and retire too early



Government investment in % of GDP: Germany is investing too little



Source: Haver Analytics Inc. as of 01/31/2025: DE = Germany, PT = Portugal, ES = Spain, IT = Italy, NL = Netherlands, EUZ = Eurozone, UK = United Kingdom, US = United States, FR = France, GR = Greece, JP = Japan, FI = Finland, SE = Sweden

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The debt brake hinders growth

Germany is falling victim to its obsession with sound public finances. If applied consistently, the German debt brake would lead to a public debt ratio of around 15% - far too low for an advanced economy. This is because the debt brake currently only allows new cyclically-adjusted debt of 0.35% of GDP per year, well below the 3% limit of the European Stability and Growth Pact. There are currently numerous proposals to reform the debt brake. (Removing it without replacing it is very unlikely; neither the Christian Democrats, nor the Social Democrats, nor the Greens are calling for it). The necessary constitutional amendment would require a two-thirds majority in both the Bundesrat and the Bundestag. According to current opinion polls, a majority of this size is quite possible after the election, but by no means certain.

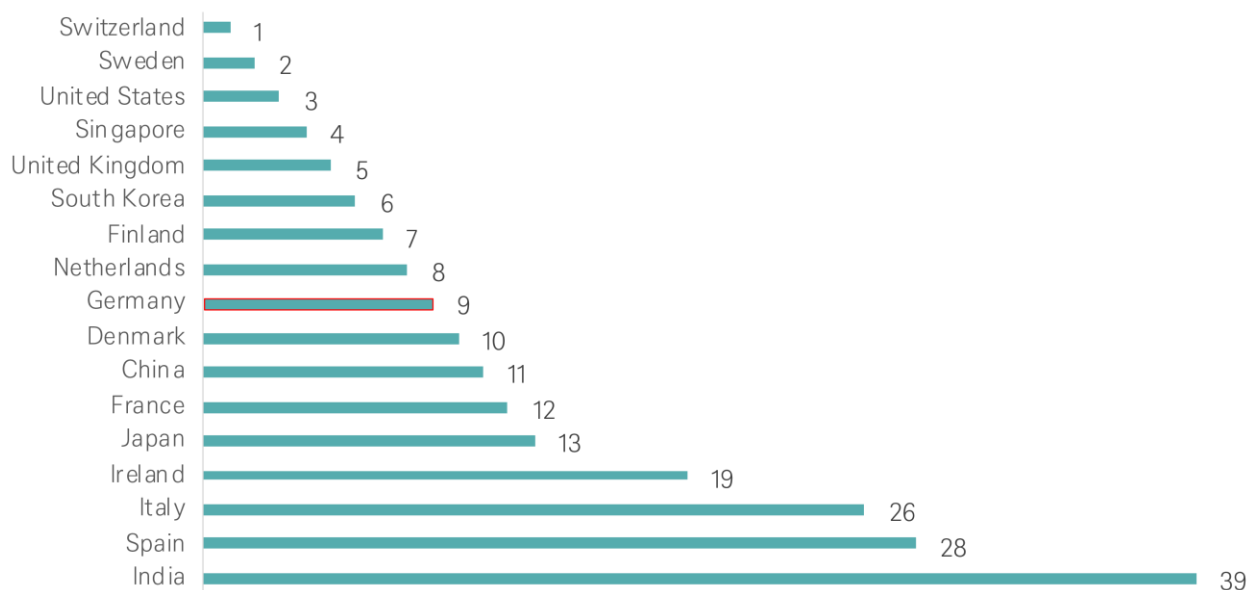
What could a reform of the debt brake achieve?

However, one should not expect too much from a reform of the debt brake. The actual budget deficit, as defined by the EU's Stability and Growth Pact, was 2.6% of GDP last year. Moreover, the debt-to-GDP ratio of around 63% is already in the range at which the EU requires Germany to make fiscal adjustment efforts. The political consensus is that Germany will continue to comply with EU law even if the German debt brake is reformed. We therefore estimate the fiscal room for maneuver that would theoretically result from even a complete abolition of the debt brake, which we do not expect, at just over 0.5% of GDP. That is not enough to deliver a major impulse to economic growth. And there will certainly be no boost "in the near future," since the parliamentary process will, in any event, take a long time. What will most likely happen much faster, although it would also require a two-thirds majority in the Bundestag, is expansion of the "special fund for the Bundeswehr (the armed forces)" in the constitution.

Germany's innovative strength is still substantial

Nevertheless, Germany's future should not be painted too darkly. Internationally, Germany is envied – at least so far – for its political stability, well-trained workers, high quality products, and high level of innovation, particularly with regard to improving production processes. There is certainly scope for Germany's political parties to move the country forward again after the election.

Innovation ranking*



Source: Haver Analytics Inc. as of 01/31/2025. * Country ranking among 132 countries

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How would Trump's tariff plans impact the German economy?

At least for now, it is not clear that the net impact of U.S. President Donald Trump's plans to impose trade sanctions on the EU will be as negative for Germany in particular as many still fear. It is hard to find substitutes for many of Germany's exports. For the automotive sector, the tariffs imposed on Mexico could be even more impactful, as many German companies have set up production facilities in Mexico to serve the U.S. market from there.

Major parties' positions on campaign issues

The following table shows how the three political groups with the best chance of participating in the formation of the next government have positioned themselves on various substantive issues.

	CDU/CSU	SPD	Greens
Fiscal policy: debt brake	No reform	Reform	Reform
Taxation	Lower overall	More gradual but overall higher on top incomes	More gradual between tax brackets
Public investment	Higher	Higher	Higher
Social policy / Labor market	Increased incentives to work (longer) Reform of basic income	Increased incentives to work (longer) Minimum wage of 15 EUR	Minimum wage of 15 EUR Reform of basic income to increase work incentives
Energy taxes / Network fees	Lower	Lower	Lower
Migration	No illegal immigration	Managing migration Stronger border controls	Managing migration
Joint EU borrowing	No	Yes	Yes
Defense spending	Higher	Higher	Higher

Source: CDU/CSU, SPD, Die Grünen as of 1/30/2025

3 / Will things get better after the election?

Will Germany's mood improve after the elections? We are skeptical. First of all, as described above, a long period of political uncertainty is possible. Coalition negotiations could prove difficult, especially after the fatal stabbings in the last week of January, which have inflamed the debate on migration. We continue to rule out the formation of a formal coalition with the participation of the far-right AfD. And so, unless there is a dramatic surprise, the next government is likely to be led by the Christian Democrats, but beyond that, a wide range of outcomes is possible.

In the short term the potentially prolonged period of political uncertainty could weigh on sentiment, at a time when the war in Ukraine and the looming trade war with the U.S. is already causing anxiety.

But once a government is formed, what can we expect? On the supply side Germany's structural problems (excessive bureaucracy, overregulation, high energy costs) will certainly be addressed by the new government. Progress can certainly be made, given the necessary political will and social consensus, as there is a lot of low-hanging fruit, for example in terms of providing digital government services. Germany could draw on progress made by countries with which it enjoys good relations, from Finland to Estonia and Ukraine.

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However, it will take some time for this to translate into growth, and the extra growth generated is likely to be modest. Given the tight fiscal situation, a tax reform that significantly lowers corporate tax rates is unlikely. Nor do we expect the new government to address Germany's demographic challenges by increasing immigration or raising the statutory retirement age. However, measures that lead to an increase in the effective retirement age by increasing incentives to work longer are both likely and helpful. This could ease the shortage of skilled workers somewhat. However, this too will not provide a major stimulus in our view.

On the demand side, the new government is not expected to accomplish significant changes. Household tax cuts, if implemented, will probably be modest, and any modifications to the debt brake will require time to take effect and may have only limited impact. We anticipate that the global industrial recession will come to end, as inventories gradually decrease. A full-blown trade war could threaten this potential recovery. Even though this is not our base case and the so far proposed tariffs by the U.S. administration should have an only modest impact, we cannot rule out such a development. Despite these challenges, it is important to note that every recession eventually ends, which could support the reigning party's popularity, irrespective of who is in power in Berlin.

The European dimension

Of course, any change in government in Germany will have implications for the European Union as a whole. At EU level there appears to be growing political willingness to address some major economic challenges. Before the EU elections the former Italian Prime Ministers, Mario Draghi and Enrico Letta, were tasked to write separate reports on European competitiveness¹² and the Single Market.¹³ These recommendations have been hard wired into the new EU Commissioners' job description or 'Mission Letters'.¹⁴ And the Commission's work plan¹⁵ sets priorities for innovation, decarbonization and security, pledging to strengthen Europe's workforce, access to capital, savings and the Single Market. Germany's next government could play a critical role in facilitating or hindering these efforts.

4 / Asset-class implications

What are the probable impacts of the different possible election outcomes?

From the perspective of the financial markets, election day itself is unlikely to mark a particularly big turning point in terms of the actual policy outlook. In most policy areas, it will probably take months before concrete conclusions for individual asset classes can be drawn from the program of the next government. In Germany, as elsewhere, priorities set out in party campaigns tend to have a very limited shelf life, though they typically provide some indications on each party's starting point in coalition talks. They are a signaling device, showing where red lines have been drawn, which may hinder the formation of a coalition with certain other parties but offers voters some seemingly clear choices – though these choices may later be superseded by events and the realities of governing in coalition. In short, party platforms don't tell you much about what the next government will do, but they can be very relevant to how parties seek to win votes. An added complication in this election is that the Christian Democrats have moved very far to the right in many policy areas under Merz. If this shift fails with the voters, more centrist priorities could well emerge by the time coalition talks start in earnest. This also goes for the Greens and Social Democrats, particularly in the tricky area of migration.

So, what can be expected in terms of the near-term impacts of the election on financial markets? As outlined above, investors should be prepared for outcomes in which all four minor parties – BSW, The Left, the Free Voters and the Free Democrats make it into the Bundestag – or fail to do so, which would reduce the vote share needed by the Christian Democrats, Social Democrats and Greens to cobble together a majority without the AfD. Of course, all sorts of combinations in between are possible, as outlined in Section 1. In terms of preparing for market reactions, we propose two main scenarios: swift formation of a new coalition; or a long period of political uncertainty before a government is eventually formed.

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4.1 Scenario 1: Rapid formation of a coalition with majority support in the Bundestag

Modest positive effects for German risk assets in the short term

Given that the government is mathematically and politically likely to include the Christian Democrats and either the Social Democrats or Greens, we would expect plenty of compromises and few policy changes of immediate market relevance. Of course, external pressures will have an influence. In addition, there now appears to be a broad consensus among mainstream policymakers and society at large that “if we want things to stay as they are, things will have to change.” However, we would expect markets to remain largely in wait-and-see mode until policy details emerge.

Specifically, we think the implications for various asset classes of a rapidly formed coalition would be as shown below.

Equities

In German equity markets, we might see some short-term positive impact but think there is unlikely to be a positive change immediately in earnings expectations. An adjustment of the debt brake would be a positive catalyst if investments in infrastructure were to follow. More deregulation and reduced wealth redistribution would be potential positive surprises for German equity valuations – should they eventually materialize.

For European equities more broadly, we see little meaningful impact from the formation of a new coalition government for a number of reasons. First of all, Germany constitutes less than 15% of the whole European market, less than, for example, Switzerland, the UK or France. Moreover the German benchmark heavyweight stocks have very limited exposure to the domestic economy.¹⁶ Second, as outlined above, any conceivable coalition at this point seems likely to deliver only marginal policy changes. A potential constitutional change on the debt brake would be likely to be the most relevant change after the election. Potentially, this could result in more money flowing into social welfare and into defense. Therefore, the European equity market sector that is most likely to benefit would be defense.

Currencies

In foreign-exchange markets any rapid formation of a coalition with majority support in Bundestag would be slightly positive for the euro in our view. There is consensus among German parties that Germany has to invest in nearly all areas. If a government can be formed quickly, markets would probably price in some medium-term positive impact from the expected policy measures.

Rates

In German and indeed European government bonds we expect to see only a limited impact, though that could change if policy changes that are more radical than we are currently expecting to take place. Quick formation of a new government and subsequent reforms would be seen as positive for the longer-term growth outlook.

- The most important factor for bonds will be whether or not we see an adjustment to the debt brake. But, even then, as outlined above, the impacts on growth, the fiscal deficit and debt-to-GDP forecasts will not be large and are therefore unlikely to have a big impact on Bunds.
- EU-wide initiatives, such as joint military projects financed by the EU, are a second relevant factor. Are joint European bonds to finance projects of this kind possible? If common debt issuance were to become more “normal” and elements of the Draghi plan (see above) find their way into the legislative process, it could be a trigger for tighter spreads in Eurozone government-bond markets.

Credit

For corporate credit we do not see any marked impact, whether or not a government can be formed quickly. Germany accounts for 14% in the iBoxx Euro Corp Index, which is well diversified in terms of sectoral exposure. The problems of the German automobile industry (which accounts for just 3% of the index) cannot be fixed by government or policy changes, at least in the short to medium term.¹⁷

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Infrastructure

In Infrastructure a quickly formed new government would be more likely to focus on delivering infrastructure projects and would therefore be a net positive. Germany is a key bottleneck in the European energy market, and so a strong government focused on delivering on infrastructure would be generally positive.

- Investments in fiber connectivity and energy security (through thermal and renewable energy and investment in the electricity grid), would be of particular benefit.
- A more prominent German voice at the EU could, however, prevent some of the more integrationist and fiscally expansive goals that are evident in the Draghi report and the Competitiveness Compass (see above) from materializing. This would be a long-term negative for infrastructure – an area highlighted by Draghi’s report.

Real Estate

For German real-estate markets, we would expect a calmer approach to regulation if the Christian Democrats play a dominant role in the rapid formation of a coalition after the election. One time-critical issue concerns plans of the outgoing government to prolong restrictions on how quickly residential rents can go up in rental hotspots (known as “Mietpreisbremse” and currently due to lapse at the end of this year) until 2029. These plans also envision no incorporation/extension to newer stock (construction year 2015-2019), which should have a positive impact on residential supply going forward. Given the salience of rents as electoral issues, we would expect some changes along those lines, but potentially a little more favorable to landlords than the current draft.

- We would also expect less emphasis on sustainability and energy efficiency, as well as possible changes in government support programs and grants, such as those from KfW.
- Overall, we may see a reduction in red tape, potentially leading to a positive impact on supply.
- For commercial real estate, i.e. mainly logistics, retail and office, we would expect that a strong and decisive government would have a broad positive impact on the economy and sentiment. This could help to propel the retail real-estate sector, thanks to improving consumer sentiment, and logistics, as business sentiment, exports or domestic consumption strengthen. In office space we would expect a more limited impact.

4.2 Scenario 2: Long period of uncertainty and policy paralysis

A weak German government at a critical time could hurt sentiment.

A long period of uncertainty should certainly not be ruled out. After the election a fragmented Bundestag is all too possible, if the current opinion polls are a good guide, and this together with the red lines drawn by various parties might make negotiations long and difficult. Even if coalition talks begin and progress swiftly there is a risk that internal party procedures, such as the balloting of party members, could scupper a deal, as almost happened in 2018. However, the longer-term overall impact of a political impasse on financial markets should not be overstated. Germany and, especially, its listed companies, is heavily dependent on global trade, and less so on the domestic market.

Specifically, we think the implications for various asset classes of such an outcome would be as shown below.

Equities

In this scenario, we would anticipate that the DAX 40 would underperform relative to the S&P 500 for the remainder of 2025. Additionally, we foresee Eurozone equities potentially underperforming their U.S. counterparts. Consequently, market sentiment would be expected to remain as it currently is.

Currencies

Prolonged coalition talks should have little or no impact for the euro.

Rates

As long as a government emerges eventually, without the participation of the far right or the far left, we see no big effect on Bunds.

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Credit

We think it could prove marginally negative for corporate bonds if a weak German government proved unable to respond to U.S. tariff policies, passing up opportunities to avoid the imposition of these tariffs or to water them down.

Infrastructure

For Infrastructure, uncertainty and policy paralysis could prove challenging. For infrastructure investors, long-term policy certainty is a key criterion in deciding which markets to invest in. Ultimately, however, much of the longer-term direction is set at the EU level through directives. Thus, uncertainty at the national level is not necessarily a huge problem. EU policy may well progress thanks to the Draghi report, but German infrastructure demand may be dampened as businesses reduce investment.

Real estate

In German real-estate markets we would expect political uncertainty to provoke plenty of market chatter on the risk of regulation becoming even more restrictive.

- Mietpreisbremse (rent control) restrictions on how quickly residential rents can rise in rental hotspots are due to lapse this year. Given the salience of rents as an electoral issue, we would expect these restrictions to be prolonged until 2029 and perhaps extended to newer stock (built in 2015-2019). Tweaks of this kind to the outgoing government's plans would have a negative impact on residential supply, weaken investor sentiment and damage the confidence of real-estate investors.
- On energy efficiency and Environmental, Social and Governance (ESG) issues more broadly, precise changes are hard to predict, but the impact of a delayed new government is likely to be negative, as decisions on government support programs are delayed and longer-term policy uncertainty on ESG persists.
- We would expect commercial real estate to be negatively impacted as a result of weaker economic growth, headwinds on real-estate valuations and weaker occupier markets.
- There would also be a negative impact on supply in all real-estate sectors, with weaker tenant demand (except residential) and rising construction costs (inflation). However, this could possibly result in a stronger rebound in the medium term, once fundamentals improve and a stable government eventually emerges.

5 / Conclusion

A government that can tackle the country's big structural problems robustly and impress markets is unlikely to emerge

In this Special we have outlined the deep political roots of the structural problems Germany's economy faces. These help explain the unusual degree of unpopularity of both the parties currently in government (the Greens and the Social Democrats) as well as why the Christian Democrats, the main opposition grouping, are hardly benefitting so far. The Christian Democrats, after all, were the governing party for 16 years during which the country's structural problems accumulated.

We have also outlined why, for all the flexibility Friedrich Merz has shown in other policy areas, it is doubtful that Germany's debt brake will be reformed as much as some commentators hope. And we see any reform that does emerge as being unlikely to have a big impact.

Markets, in our view, will care most about whether a stable government can be formed quickly or whether there will be a prolonged period of haggling, while the country lacks leadership. Unfortunately, this may not be clear even after all the votes are counted and the party leaders have clarified their post-election preferences. Internal party procedures, such as balloting members, could still scupper a deal.

That said, the implications for various asset classes will depend on the eventual policy measures implemented by the new government. A weak German government at a critical time could hurt sentiment, and this could be detrimental to Germany

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as well as the European Union and may also have negative consequences for NATO. But even the rapid formation of a coalition with majority support in the Bundestag would only be modestly positive for German risk assets in the short term. For any more sustainable boost, investors will want the next German government not just to be formed quickly, but also to deliver, not least in terms of deregulation of the economy and in supporting efforts to boost European competitiveness.

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Footnotes

¹ For background, see, for example: The Economist, Jan. 29, 2025, Merz's migration gamble: A day of drama in the Bundestag. Friedrich Merz, Germany's probable next chancellor, takes a huge bet and triggers uproar

² For a useful overview, see the website of Wahlrecht.de e. V.

³ Voters are free to split their support, which can encourage tactical voting

⁴ Strictly speaking, candidates are elected by plurality of first votes to represent the respective constituency in the Bundestag by getting preferential treatment on their party's list at the state level. This leads to some further complications best left aside for today.

⁵ We will leave aside some further complications potentially inviting further legal challenges to the current rules, which were largely imposed by Germany's constitutional court last summer as temporary fix to the most recent reform measures.

⁶ Südschleswigsche Wählerverband (SSW), little known outside of Schleswig Holstein, will likely retain its single seat presence in Bundestag, thanks to special rules applying to parties representing ethnic minorities.

⁷ Districts such as Berlin's Treptow-Köpenick, as well as a few other, less prominently represented East German seats, such as Leipzig Süd.

⁸ Our polling chart includes them under Others, as they are rarely included in national surveys and only secured 2.7% in last year's elections to the European Parliament. Most district-level seat projections rely on simplifying assumptions for both Free Voters and BSW, given the lack of historical and district-level data for these parties.

⁹ Best translated as Basic Law. The Grundgesetz serves similar functions as written constitutions in other countries. However, it includes some extra protections for the rule of law and other democratic processes and constitutions, requiring two thirds majorities in both Bundesrat and Bundestag and explicitly listing parts that cannot be changed in this way.

¹⁰ For a good summary overview of Germany's limited experience so far with minority governments at both the state and the national level, see: Wissenschaftliche Dienste, Deutscher Bundestag, 13. Dezember 2018, "Sachstand Tabellarische Übersicht über Minderheitsregierungen in der Bundesrepublik Deutschland seit 1949", WD 1 - 3000 - 042/18. From a comparative perspective, one big reason is that Germany's political landscape used to be very unusual, until the last decade or so, in terms of how few parties were represented in various parliaments compared to those in many of its neighbors.

¹¹ Note, though, one other implication of last week's events in the Bundestag. Over the medium term, these might encourage various forms of parliamentary collaboration in state parliament, such as Christian Democrats relying on tacit support from the AfD to form minority governments, rather than reaching out to other parties for formal coalitions. In the Bundesrat, such arrangements would leave the Christian Democrats as the sole voice in these states, potentially making national lawmaking easier once again.

¹² "The future of European competitiveness", September 2024, European Commission

¹³ "Enrico Letta; More than just a market", April 2024, European Commission

¹⁴ "Commissioners-designate", July 2024, European Commission

¹⁵ "Competitiveness Compass", January 2025, European Commission

¹⁶ Source for any data points mentioned in this paragraph is Bloomberg Finance L.P., as of 2/7/25

¹⁷ Source for any data points mentioned in this paragraph is Bloomberg Finance L.P., as of 2/7/25

Glossary

The [Alliance 90/The Greens](#), also referred to as the "Greens," is an environmentalist political party in Germany that is considered center-left in the German political landscape.

The [Alternative for Germany \(AfD\)](#) is a nationally-conservative and right-wing political party in Germany.

The [Basic Law](#) is the German constitution.

A [budget deficit](#) is created whenever the spending in a public budget exceeds the income within a given time period

[Bunds](#) is a commonly used term for bonds issued by the German federal government with a maturity of 10 years.

[Commercial real estate](#) (CRE) refers to properties that are used for business or commercial purposes, such as office buildings, retail spaces, warehouses etc.

The [Dax](#) is a blue-chip stock-market index consisting of the 40 major German companies trading on the Frankfurt Stock Exchange.

Investors increasingly take [environmental, social and governance \(ESG\)](#) criteria into account when analyzing companies in order to identify non-financial risks and opportunities.

[Euro area crisis](#), often also referred to as the eurozone crisis, European debt crisis, or European sovereign debt crisis, was a multi-year debt and financial crisis that took place in the European Union from 2009 until the mid to late 2010s.

The [European Commission \(EU Commission\)](#) is the executive body of the European Union (EU) which represents the interests of the EU.

The [European Union \(EU\)](#) is a political and economic union of 27 member states located primarily in Europe.

The [Eurozone](#) is formed of 19 European Union member states that have adopted the euro as their common currency and sole legal tender.

[Fiscal policy](#) describes government spending policies that influence macroeconomic conditions. Through fiscal policy, the government attempts to improve unemployment rates, control inflation, stabilize business cycles and influence interest rates in an effort to control the economy.

The [Free Democratic Party \(FDP\)](#), also referred to as the "Liberals", is a market-friendly and social-liberal political party in Germany that advocates human rights, civil and economic liberalism and that is considered centre-right in the German political landscape.

[Free Voters](#) is a political party in Germany. It originates as an umbrella organisation of several Free Voters Associations, associations of people which participate in an election without having the status of a registered party.

The [German Bundesrat](#) is the upper house of the German parliament and is made up of representatives of the sixteen federal state governments who thereby participate directly in critical legislative decisions.

The [German Bundestag](#) is the national parliament of the Federal Republic of Germany. It is the lower house of the two legislative chambers, the German Bundesrat being the upper house.

The [iBoxx Euro Corporate Index](#) includes euro-denominated corporate bonds issued by investment-grade-rated entities.

[Inflation](#) is the rate at which the general level of prices for goods and services is rising and, subsequently, purchasing power is falling.

The [KfW](#) is a German state-owned development bank that offers financial and consultancy services within Germany and abroad.

[NATO](#) is a Western military alliance with currently 30 member states.

A [recession](#) is, technically, when an economy contracts for two successive quarters but is often used in a looser way to indicate declining output.

The [Sahra Wagenknecht Alliance – Reason and Justice](#) is a left-wing political party in Germany, founded in early 2024 by the former deputy leader of the left-wing party "The Left", Sarah Wagenknecht.

The [Social Democratic Party of Germany \(SPD\)](#), also referred to as the "Social Democrats", is a social-democratic political party in Germany that is considered center-left in the German political landscape.

The [spread](#) is the difference between the quoted rates of return on two different investments, usually of different credit quality.

The [Stability and Growth Pact \(SGP\)](#) is a set of rules designed to ensure that countries in the European Union pursue sound public finances and coordinate their fiscal policies.

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