

# Germany: Friedrich Merz faces a difficult but essential challenge



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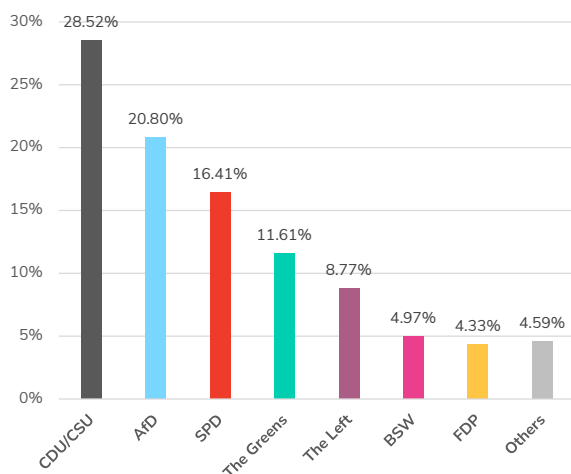
The German elections have brought results broadly in line with polls' expectations. The centre-right CDU/CSU came ahead and Friedrich Merz will likely become the next Chancellor. The SPD suffered a significant setback, while the far-right AfD made considerable gains, becoming the second-largest party in the Bundestag. From an economic point of view, the results have left the prospect of fiscal policy easing more limited, as opposition parties will be able to block a constitutional reform of the debt brake in the newly elected Parliament. With the CDU/CSU set to form a coalition with the SPD, the new government will face critical economic challenges, including revitalizing Germany's stagnating economy amidst geopolitical uncertainties. The coalition negotiations are expected to be intense but crucial for the country's future leadership and economic direction.

### The results

Sunday's elections in Germany have delivered their verdict. Amid a record turnout (82.5%, the highest participation rate since the reunification), the results of the vote are very close to the pre-election polls:

- ▶ The centre-right CDU/CSU has won the election and will be the largest party in the next Bundestag, with its leader Friedrich Merz likely to become the next Chancellor in charge of forming a government.
- ▶ The centre-left SPD of outgoing Chancellor Olaf Scholtz suffered a clear setback from the previous elections and will become only the third party in terms of seats in the future Parliament.
- ▶ The far-right AfD recorded an upsurge in votes, in a dynamic similar to what had been seen in other recent European elections. The AfD will become the second largest party of the Bundestag, with limited influence as traditional parties have excluded a political alliance with the AfD.
- ▶ The Left party also recorded a significant increase in support, almost doubling its score of the previous elections.
- ▶ The Green party lost some ground compared to the 2021 elections.
- ▶ Two smaller parties, the leftist BSW and the liberal FDP, fell short of reaching the threshold of 5% of the votes required to enter the Parliament. They will therefore not have any seat in the next Bundestag.

*The CDU/CSU wins the elections, the AfD becomes the second largest political force in Germany*



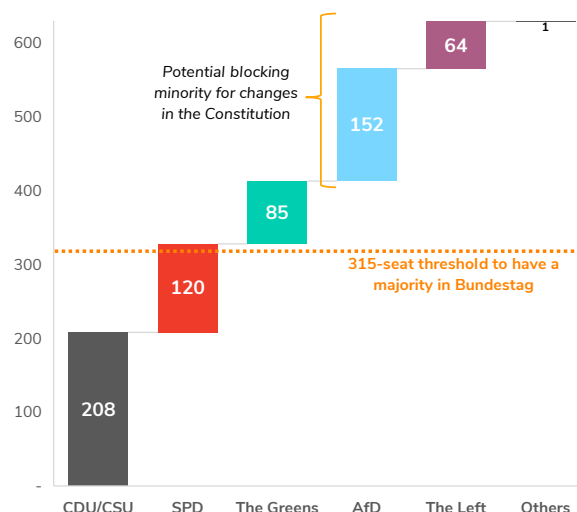
### Limited potential for fiscal support, but the potential for an effective governing coalition

Ahead of the elections, we had two key questions in mind, for which the answers would shape the economic prospects of Germany and Europe:

- ▶ **What will be the aggregate weight of parties opposed to fiscal policy easing, and will they be able to oppose a reform of the debt brake preventing public deficits for Germany's public budget?**

The FDP and BSW parties, both opposed to a reform of the debt brake and to fiscal policy easing, have failed to enter the Bundestag. But the AfD and The Left, also opposed to a debt brake reform, have posted strong showings. As a result, the aggregate share of seats in the Bundestag for those two parties will be above one-third of the votes (34% as it currently stands). This will allow them to block any change to the Constitution, for which a two-third majority of votes in Bundestag is required. An agreement between those two opposition parties and a CDU/CSU-led coalition appears highly unlikely on this matter. One of the key outcomes of the elections is therefore that the prospect of significant fiscal policy support is significantly reduced. Tax cuts and increases in public investment for defence, infrastructures or competitiveness will have to be financed by public spending cuts or some tax increases. This issue is potentially such a constraint that Friedrich Merz floated yesterday the idea of having the Bundestag in its former composition vote for some special fund, or even a reform of the debt brake, before the newly elected Parliament is inaugurated on March 24th. Indeed, the required two-third majority for such changes could be found in the former Bundestag. Such a move may provide the financing for additional defence spendings, and free some fiscal space in the next budget that will have to be adopted by the newly elected Parliament once a government is in place.

### Projected repartition of seats in the future Bundestag based on available results



- ▶ **What will be the relative weights of the traditional parties and the shape of the potential governing coalition?**

The results of the election have been close to the pre-election polls. They make the setup for building a coalition less complex than it could have been. Friederich Merz and the CDU/CSU could form a government with a majority in Bundestag by reaching an agreement only with the centre-left

SPD. A CDU/CSU-SPD coalition would control 328 seats in the Bundestag, above the 315-threshold required to have a majority and be able to govern. The scenario of a three-party coalition involving The Greens appears to be ruled out. If proven necessary, it could have complicated negotiations to form a coalition, and it could have diluted the weight and leadership of the CDU/CSU in the next government. In that respect, yesterday's outcome improves the outlook for a potential swift coalition agreement, and for an effective government led by Friedrich Merz.

### What's next? Reaching a rapid coalition agreement as Germany badly needs leadership

Discussions between the CDU/CSU and the SPD will start shortly in order to find an agreement on an agenda and form a so-called "Grosse Koalition" between the two main traditional parties of Germany. Former SPD Chancellor Olaf Scholtz will likely not be part of those discussions, having led the SPD to suffer its worst result of the post-war period. Friederich Merz has stated its intention to reach a coalition agreement before Easter, i.e. in the next two months.

In a rapidly evolving geopolitical environment and given its current economic situation, Germany needs an effective government and a leadership to start domestic reforms. Germany needs to speak up as the voice of Europe's largest economy and lead European efforts in the discussions around Ukraine or US trade pressures.

As the main party in the Parliament and in the future coalition, the CDU/CSU should bring its agenda as the core of the future government's program. From an economic standpoint, the main policy proposals are a lowering of the corporate tax cut (from 30% toward 25% over four years), a comprehensive review of public expenditures, an easing in regulatory burden, lower energy prices and a commitment for a minimum 2% of GDP for defence spending along with continuing support to Ukraine.

In order to find an agreement with the SPD, Friedrich Merz will have to give in to some of the key SPD proposals such as investments in infrastructures or some increase in pension levels or the minimum wage. With fiscal space constrained by the existing constitutional debt brake, the room-for-manoevre is more limited than if an easing of the debt brake, one of the SPD's proposed reforms, would have been made possible by the Bundestag's configuration. However, there might be ways to finance some of those reforms via off-budget measures, especially for infrastructure investments or defence spending. Injecting new capital into semi-public entities such as KfW might be one of them, so that they can increase their borrowing and finance railroads and other infrastructure investments. Regarding defence spendings, opening the door to joint European borrowing could help to finance some of the necessary effort, without putting an excessive burden on the German budget.

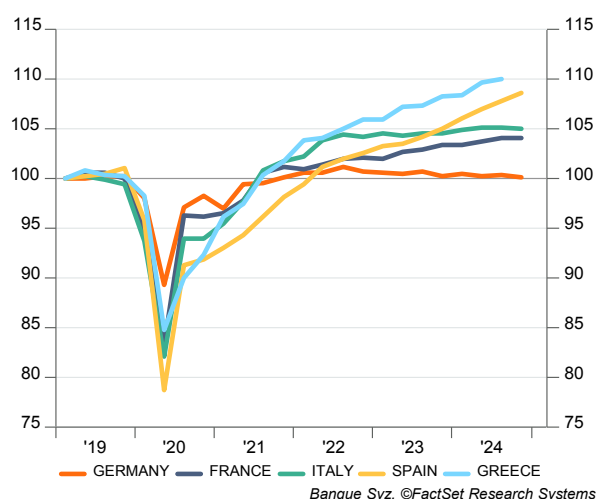
The economic agendas of the CDU/CSU and of the SPD are quite different and the negotiations to get to a common platform will likely not be easy. However, the fact that the CDU/CSU only needs one partner to reach a majority in

Bundestag and doesn't need to get The Greens on board as well, removes a potential additional layer of complexity and might facilitate the sealing of a deal. A sense of emergency in the current domestic and international environment might also act as a strong incentive for both parties to not let the discussions drag for too long.

### Putting back Germany on a growth path

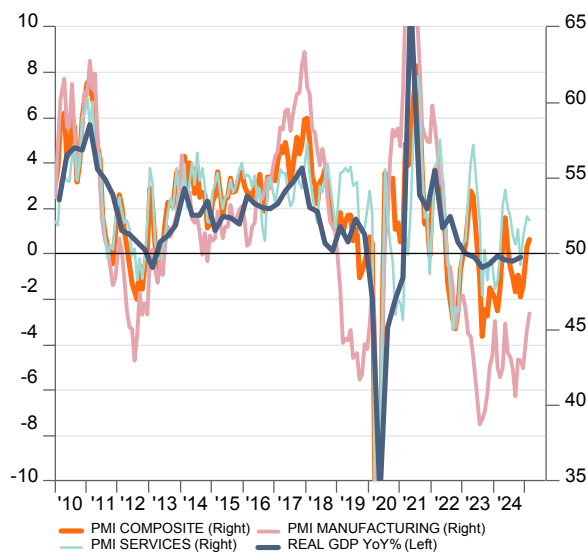
After a decade as Europe's powerhouse, Germany has revived the spectrum of "the sick man of Europe" that it was a quarter of century ago. Its economy has been contracting for two consecutive years in 2023 and 2024 and its GDP level stands at the same level as five years ago, while all other European economies have enjoyed positive growth since the end of the COVID era. A combination of external shocks, like lower Chinese demand, end of cheap Russian gas supply, plus rising interest rates and the lack of fiscal policy support, have all led to the dismal economic performance of the largest economy of the continent. In this context, the need for economic reforms designed to improve short and medium term growth prospects is enormous and the new government will have to take swift action to revive a positive dynamic in the economy.

*The German GDP is at the same level as 5 years ago and has been stagnating since 2022*



Such a challenge would probably have been made easier with expanded fiscal policy space, but the outcome of the elections appears to limit the potential for fiscal expansion. However, the economic agenda of the CDU/CSU should provide some support to economic sentiment by lowering taxes and easing red tapes and regulatory burdens. The rise in infrastructure spending advocated by its likely coalition partner SPD could also have some positive impact on short-term activity dynamics while enhancing medium-term growth prospects. Because of the debt brake's strict limits, the government can only lower business taxes, increase investment, or raise pensions and the minimum wage if it cuts other public spending or raises taxes elsewhere, like the VAT.

Economic activity indices have been picking up from a depressed level in 2025



As such, while the economic agenda of a CDU-led coalition can be expected to be supportive for growth prospects, it is unlikely to have a spectacular impact in the short-run. However, unlike its predecessor, the new government might benefit from a more moderate environment, even if significant risks and uncertainties continue to cloud the outlook. With China economic growth stabilising and the ECB in the midst of an interest rate cut cycle, some of the factors having dampened German's activity are starting to abate.

The uncertainty surrounding developments in Ukraine and their ramification, the need to increase significantly their defence spendings, and the prospects of US tariffs on European imports remain significant headwinds for the German's economic outlook. However, some early signs of improvement have appeared recently, with a pickup in PMI activity indices since the beginning of 2025. This tentative positive momentum, if confirmed, will combine with the pro-business measures expected to come with the next government and may help to resume a positive growth trend in Germany.

Cautiousness remains of the essence at this stage given the economic and geopolitical challenges that Germany is facing, and the uncertainties that still surround the composition of the next government. Already, the fact that there will likely be no reform of the debt brake limits the potential for rapid and visible improvements in growth dynamics. Infrastructure investment spendings and an easing in regulatory burden and bureaucracy will take time to be implemented and to have tangible effects on growth. In the short-term, the main support for economic activity in Germany might continue to come from Frankfurt rather than from Berlin, as the ECB will probably extend its interest rate cut cycle in the months to come. However, a new government supported by a solid coalition and promoting an agenda of supportive economic measures might help to improve business and households' sentiment and initiate some form of welcomed economic momentum. Germany needs those economic reforms, as much as Europe needs Germany's economic drive and political leadership to meet the enormous challenges ahead. It is now up to Friedrich Merz, CDU/CSU and SPD leaders to live up to the situation and reach a reasonable compromise.

#### For further information

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