

### Angela Merkel may triumph but what will her government look like?

According to Bloomberg's poll of polls, it looks likely that Angela Merkel will be re-elected as Chancellor for a fourth term. Far from the confrontations we had come to witness in the US and France in the last 12 months, Germany's election has failed to capture much investor attention. In fact, the German DAX is one of the best performing equity indices month-to-date.

The key question coming out of Sunday's vote will be whether we see a renewal of vows between the current coalition parties - the Christian Democratic Union (CDU)/the Christian Social Union (CSU) and the Social Democratic Party of Germany (SPD) - or a new coalition involving the Free Democrats (FDP) and possibly the Green Party. Compared with previous coalition talks, these may prove to be more challenging since two of the three possible partners have memories of seeing their electoral standing suffer after serving in Merkel-led coalitions.

Based on a pro-business agenda, the FDP is regarded by some to be a more natural and traditional coalition partner. But the CDU/CSU and FDP may just miss out on winning enough seats to secure a coalition, meaning that they need the support of the Greens to form a majority government. Having both the FDP and the Greens in coalition could be possible - neither has ruled out such an alliance - but it would be difficult to manage given their different agendas.

More importantly, though, the FDP's views on 'Europe' clash with those of a Chancellor credited with being the region's crisis manager over the last decade. In contrast to Merkel's more integrationist view, the FDP supports a Europe of different speeds and would modify treaties to allow countries to make an orderly exit from the Eurozone. The CDU could also enter another coalition with the SPD; in particular, there is much more commonality in the two parties' thinking on Europe. However, opposition from the SPD's grassroots membership may not make this proposition so straightforward.

On domestic matters, the positive news for German households is that whichever configuration Angela Merkel ends up leading in government, there is broad consensus on implementing tax cuts. Middle-income households are expected to benefit from income tax reforms worth at least €15bn (0.5% of GDP) per year from 2018. In addition, the three main parties are all proposing a phasing-out of the solidarity surcharge tax, which was introduced in 1991 to pay for German reunification. This could add another €10bn (0.3% of GDP) per year to household incomes.

### Markets are likely to be unmoved

After 12 years as German leader, Angela Merkel is likely to be faced with the prospect of more challenging and longer coalition negotiations. To place in context, in 2013 the new government was sworn in 86 days after the election. If we see protracted discussions, then we do not expect an adverse reaction in financial markets. Coalition building is the norm in Germany and there is no immediate crisis in Europe that needs management. Furthermore, German borrowing rates are at historic lows, peripheral bond yields are well contained and economic growth remains robust. The confluence of these factors is quite a turnaround from Europe's election woes at the start of this year.

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