

GERMAN ELECTIONS 2025

WINDS OF CHANGE

FEBRUARY 2025

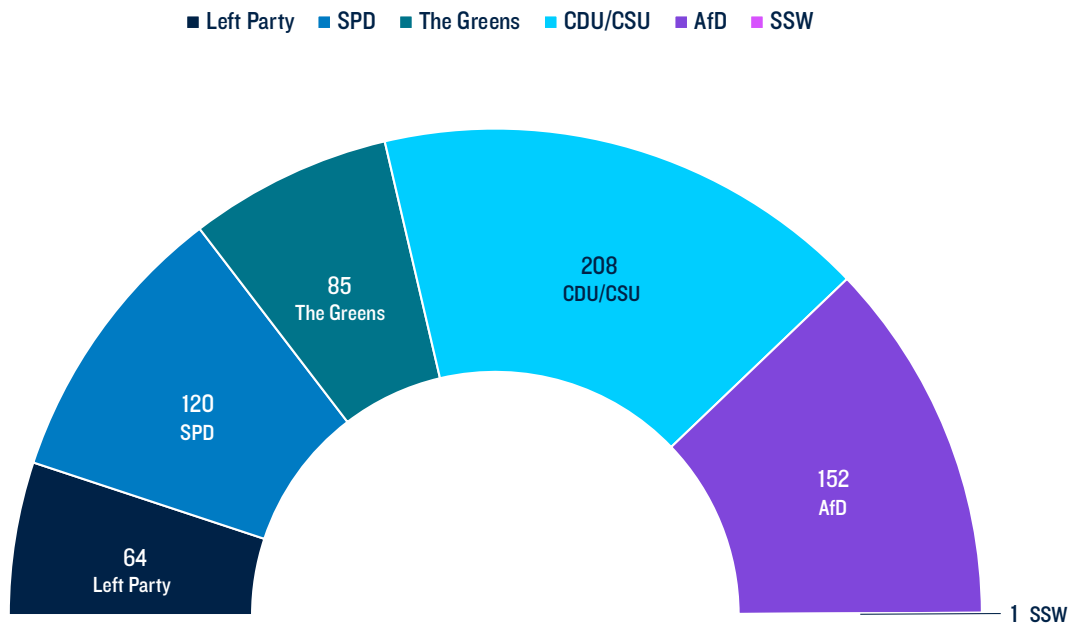
Germany is entering a pivotal moment in its political and economic landscape. With stagnating economic growth and pressing geopolitical challenges, the direction of its next government under Friedrich Merz is significant not only for the nation but also for Europe's future economic and security prospects.

Merz's conservative Christian Democratic Union of Germany (CDU/CSU) bloc emerged as the biggest party after the weekend elections, putting him as the favourite to become the next Chancellor, despite not winning an outright majority in the Bundestag. A partnership between the CDU/CSU and former Chancellor Olaf Scholz's centre-left SPD appears highly probable, with both parties aligning on key priorities like promoting more business-friendly policies.

Although this outcome appears most likely, reaching an agreement could prove to be a lengthy and complex process. In recent decades, the average time taken to form a working coalition was between one and three months, which increased to five months in 2017. Recent parliamentary debates on migration have also clouded relations between the parties and its leaders and will therefore make the coalition-building process more strenuous.

However, the far-right Alternative for Germany (AfD)'s emergence as the second biggest political party raises concerns about the stance of Europe's largest economy on sensitive issues such as migration and further European integration, potentially leading to turbulence across the eurozone. Historically, grand coalitions between the CDU/CSU and SPD ushered in policy continuity and moderation while a coalition with the Greens led to compromises on fiscal policy and immigration concerns.

Exhibit 1: German Elections 2025 - Seats in Parliament



Source: The Federal Returning Officer | Status: February 24, 2025, 04:08 AM UTC+1

The former corporate lawyer has presented himself as a bold economic reformer who can shake Germany out of the current economic malaise that has enveloped the country.

Once the engine of Europe, Germany has stagnated in recent years and is predicted to flatline this year too - its “longest period of stagnation since the second world war,” according to the Munich-based Ifo Institute of economic research.¹

The country’s stock market index has surged to record highs in recent months, powered by a handful of major exporters, yet this performance paints a skewed picture, detached from the broader economic landscape.

The world’s third largest economy shows little sign of near-term improvement after two years of recession. A sluggish manufacturing sector and diminished competitiveness highlight Germany’s struggles in retaining its historical industrial dominance. Meanwhile, high energy costs and persistent inflationary pressures have hurt consumer spending and business investments, hampering the broader economic recovery.

STRATEGIC IMPLICATIONS FOR INVESTORS

Merz’s leadership could create a more business-friendly and competitive economic environment, benefiting investors across various sectors. However, his focus on fiscal discipline and limited government intervention may require investors to adapt to a greater reliance on private sector-driven growth. Strategic positioning in sectors like energy, technology, real estate, and infrastructure could yield significant opportunities under his administration.

Real Estate Outlook

While investor sentiment toward Germany’s real estate market is mixed and will not be helped by a period of uncertainty as a new coalition government is formed, we expect the effect of the election result on real estate pricing to be modest. Central bank actions and global events, such as the effect of tariffs on inflation and near-term growth prospects, are having a more significant bearing on market interest rates and real estate borrowing costs than German politics. Interest rates remain low, supportive of real estate valuations, but ongoing uncertainty will not help investment market liquidity recover quickly from subdued levels. We continue to expect German real estate yields to remain stable in 2025.

Occupier demand in Germany is expected to remain subdued due to sluggish economic growth persisting through 2025. However, the rental growth outlook remains positive. Key factors such as low supply, improved affordability, and increasing space utilisation are driving rental growth that is projected to outpace overall economic performance.

We remain optimistic on several sectors within this landscape. The living sector stands out, offering predictable cashflows that are particularly appealing amid an uncertain macroeconomic and political environment. Logistics also presents opportunities, with valuations now lower than in recent years, while e-commerce continues to expand. Meanwhile data centers are experiencing rapid, AI-driven demand growth, making them a compelling investment story.

Fiscal Policy Adjustments

A partial relaxation of Germany’s debt brake rule - short of a full repeal - could pave the way for targeted investments in critical infrastructure and defence. Originally introduced in the aftermath of the global financial crisis to ensure fiscal discipline and curb irresponsible spending, the debt brake has become a defining feature of Germany’s economic policy. However, in a global environment marked by rising fiscal deficits as nations seek to stimulate growth, Germany remains an outlier. With the lowest government debt ratio among major eurozone economies, even a modest loosening of the debt brake could provide a meaningful boost to economic performance.

The debt brake, however, remains a contentious issue in German politics. The SPD advocates for increased public investment alongside expanded social welfare programs, while Merz emphasises fiscal discipline, prioritising growth-oriented and strategic investments. This ideological divide underscores the rule’s role as a key battleground in shaping Germany’s governing coalition and therefore its economic trajectory.

Energy Policy Evolution

Germany’s transition to green energy under its “Energiewende” policy will be closely watched. The success of renewable energy deployment and infrastructure expansion is critical to maintaining long-term competitiveness.

1 IFO Institute (2025) *Political Standstill in Germany Jeopardizes Growth*. (online) Available at: <https://www.ifo.de/en/press-release/2025-01-15/political-standstill-germany-jeopardizes-growth> (Accessed January 2025).

However, challenges such as high electricity costs, dependence on energy imports, and balance grid stability must be addressed. Investors should monitor breakthroughs in energy storage technologies and policy shifts aimed at accelerating the renewable transition.

Labour Market Dynamic

Demographic changes and an aging population pose significant risks to Germany's labour market. The increasing need for skilled workers could strain social security systems and impact workforce productivity. Reforms aimed at attracting international talent and enhancing digital skills among the domestic workforce will be vital priorities. Investors should assess the implications of labour shortages on sectors such as manufacturing and services.

A BLUEPRINT FOR REVIVAL

Friedrich Merz has focused his campaign on revitalising Germany's economy, presenting a comprehensive strategy built on tax reform, market liberalisation, and fiscal discipline. His policy framework is based on these key pillars:

- **Tax Reductions:** At the heart of Merz's economic strategy is a plan to reduce corporate tax rates from 30% to 25% over four years, positioning Germany as a more competitive player in the global economy. He aims to stimulate innovation and entrepreneurship by alleviating the tax burden. Additionally, he has opposed increases in inheritance taxes or income tax rates for high earners, signalling his commitment to financial stability for both individuals and families.
- **Market-Oriented Reforms:** Merz advocates for a decisive shift away from state intervention, arguing that excessive regulation hampers innovation and economic dynamism. His vision is rooted in the principles of the Social Market Economy, emphasising a limited government role focused on safeguarding property rights and professional freedoms. His influence is already palpable at an EU-level with the "simplification" agenda - a proposal aimed at reducing red tape and addressing regulatory burden to boost the eurozone economy.²
- **Renewal of the Social Market Economy:** A key component of Merz's agenda is the restructuring of social support systems to prioritise work incentives over dependency. He proposes reforming the citizen's income into a more traditional safety net, designed to provide temporary support while encouraging employment. This approach addresses long-term concerns about the sustainability of the welfare state, ensuring it fosters economic productivity rather than undermining it.
- **Energy Policy Revisions:** Merz has been a vocal critic of Germany's energy policies, particularly the nuclear phase-out, which he views as reactive and short-sighted. He has pledged to base energy decisions on long-term strategic goals rather than transient public sentiment. His focus is on enhancing energy security and ensuring that Germany's energy policy supports economic competitiveness in a rapidly evolving global landscape.
- **Fiscal Responsibility:** Merz underscores the importance of fiscal discipline, advocating for a government that operates efficiently within its means. He has also committed to avoiding additional financial burdens on citizens. By promoting a leaner, more effective government, Merz aims to support economic growth without resorting to higher taxes or increased borrowing.

The CDU's leadership under Merz suggests a more favourable shift in European and transatlantic relationships

- **Pro-Transatlantic Stance:** The CDU supports stronger U.S. - EU collaboration, particularly regarding security concerns around China and Ukraine, though that has been thrown in doubt by recent developments.³ Talks of a revived EU-U.S. trade agreement, though unrealistic considering the emergence of a new trade war, reflect Germany's outward focus. The key would be to fix Germany's relationships with EU partners. Germany "needed to speak more with Poland and better coordinate stances with France for the European Council," he said in a speech in January.⁴

² Rankin, J. (2025). *EU launches 'simplification' agenda in effort to keep up with US and China*. (online) The Guardian. Available at: <https://www.theguardian.com/world/2025/jan/29/eu-launches-simplification-agenda-in-effort-to-keep-up-with-us-and-china> (Accessed January 2025).

³ World Economic Forum. (2025). *A Conversation with Friedrich Merz, Leader of the Opposition, Federal Assembly of Germany*. (online) Available at: <https://www.weforum.org/meetings/world-economic-forum-annual-meeting-2025/sessions/a-conversation-with-friedrich-merz-leader-of-the-opposition-federal-assembly-of-germany/> (Accessed January 2025).

⁴ Marsh, S. and Rinke, A. (2025). *Leading German chancellor candidate Merz vows more assertive global role*. Reuters. (online) 23 Jan. Available at: <https://www.reuters.com/world/europe/leading-german-chancellor-candidate-merz-vows-more-assertive-global-role-2025-01-23/> (Accessed January 2025).

More importantly, unlike his predecessor, Merz openly advocates accelerating military aid to Ukraine, aligning with the broader European sentiment.⁵

- **China Hawk:** Merz has signalled a hawkish approach on China. He has warned domestic companies against making bigger investments in China, a departure from the China-friendly course of previous German governments. His views align with policymakers in Brussels, who have also hardened their stance in recent months.
- **Migration Policy:** Merz's stance on migration reflects ongoing EU-wide tensions over immigration policy. This may strain Germany's alignment with more liberal EU nations like Spain. Barely weeks before the national election, a dozen of his own legislators refused to support him in backing a migration bill that ultimately failed to pass in parliament. The support of the bill from the far-right AfD sparked outrage in Germany's political and civil society and was seen as breaking the so-called "firewall" - an understanding amongst democratic parties to not engage with far-right parties, which has been upheld since the Second World War.⁶ Migration is also likely to become a contentious issue between the CDU/CSU and potential coalition partners.

KEY UNCERTAINTIES REMAIN

Budget Constraints:

His plans are not currently financeable under Germany's strict fiscal debt brake rules or "*Schuldenbremse*," raising concerns about how reforms will be implemented. The debt brake restricts structural annual budget deficits to 0.35% of GDP and commits regional state governments to balanced budgets since 2020. Any changes need a two-thirds majority in parliament.

Resistance to Eurozone Debt Policies:

Merz's CDU opposes European debt sharing, potentially hindering EU fiscal unity as debates over joint euro bonds and defence funding remain contentious.

Limited Structural Reforms:

There is broad agreement that Germany requires sweeping fiscal investments akin to the U.S. Inflation Reduction Act. For example, Germany's rising cost of living and increasing inequality demand comprehensive policy responses. However, Merz's cautious spending approach raises doubts about delivering meaningful change for vulnerable populations.

Impact on Green Transition Goals:

The country's ambitious climate targets require significant investments in renewable energy, infrastructure, and innovation. Merz's fiscal conservatism risks delaying Germany's transition to a green economy and raises the risk of Germany falling behind both EU peers and global competitors in achieving its sustainability objectives.

THE BOTTOM LINE

Germany's trajectory in 2025 and beyond represents a delicate balance between bold reforms and political pragmatism. Investors must remain watchful as coalition dynamics form and fiscal policies evolve as policymakers decide how to deploy capital effectively.

The road ahead will be determined not just by Merz's leadership but by Germany's ability to harness its structural strengths while navigating geopolitical uncertainties. While progress is unlikely to be revolutionary, every incremental policy change will echo far beyond Berlin.

⁵ European Council on Foreign Relations (2024) *The Merz doctrine: What a CDU-led government would mean for German foreign policy*. (online) Available at: <https://ecfr.eu/article/the-merz-doctrine-what-a-cdu-led-government-would-mean-for-german-foreign-policy/> (Accessed January 2025).

⁶ Lunday, C., Schultheis, E. and Rixa Fürsen (2025). *Germany's far-right firewall weakens as Merz pledges migration crackdown*. (online) POLITICO. Available at: <https://www.politico.eu/article/germany-far-right-afd-firewall-weakens-as-conservatives-cdu-move-to-crack-down-on-migration-friedrich-merz-alice-weidel-election/> (Accessed January 2025).

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