R&R Weekly Column
By Brunello Rosa

Is a German "Grand Coalition" Necessarily Good News?

The current consensus view is that Germany's political deadlock could be solved only by the SPD entering again a "grand coalition" with the CDU/CSU. This would represent good news for both Germany and Europe because: *domestically*, a "grand coalition" would likely last longer than a minority government or a Jamaica coalition, and an SPD-led finance ministry would partly soften the fiscal discipline imposed by former Finance Minister W. Schäuble; and *internationally*, the SPD would push for more European integration than a Jamaica coalition would have done, and would make German commitments more credible.

It is true that the more pro-European set of German policies deriving from this baseline scenario, coupled with French President Macron's push for more domestic reform as well as European integration and risk sharing should be able to at least counterbalance the centrifugal forces coming from Britain, as well as Southern and Eastern Europe, allowing the European integration process to muddle through for a few more years. At the same time, in our view, there are two downside risks that cannot be underestimated.

First, Germany traditionally tends to have a conservative fiscal stance regardless of the ruling coalition. So, even if a grand coalition is formed, the SPD might not be in the position of significantly moving this needle of German policymaking, in spite of somewhat increased infrastructure investment and higher spending on social programs. *Secondly*, if the grand coalition fails there is a risk of making euro-skeptic AfD and FDP stronger and that would be bad for Germany and for Europe down the line. In fact, if the SPD enters timidly the grand coalition (as it was the case in 2005-2009, and in 2013-2017), at the end of this experience its political capital could be completely exhausted, with the serious risk of becoming an irrelevant party like other socialist parties in Europe (e.g. PS in France, PSOE in Spain and PASOK in Greece), with the Greens and the Left sharing the spoils of the left-wing electorate. At the same time, a Merkel-less CDU could also be in dire straits, unable to attract more than 20-25% of votes, leaving a large proportion of the right-wing electorate to the FDP and AfD (which already now have, combined, almost 25% of the votes).

This means that, at the end of this experience (in 3-4 years), Germany runs the risk of finding itself with an even more fragmented political spectrum, unable to form a governing coalition, and express a government strong enough to complete the European integration process, when centrifugal forces could be even stronger. We have already argued that the 2017-2022 years are the most critical for Europe, when the integration process must be put on serious track for completion. Failure to do so would mean that 4-5 years from now, the ongoing dis-integration process would become unstoppable, and would likely lead to a re-configuration of Europe in clusters of countries with strategically diverging objectives.

Our Recent Publications

- *Will Fears from China Cause Another Global Risk-off Episode?*
  by Nouriel Roubini, 24 November 2017
- *Hard Brexit with Canada-Style FTA is the Most Likely Outcome*
  by Brunello Rosa and Nouriel Roubini, 27 November 2017
- *Progress on Further EU and EZ Integration to Remain Limited*
  by Brunello Rosa and Nouriel Roubini, 28 November 2017

The Week Ahead

US – Fed Chair, Government Funding, NFP: On Tuesday the Senate will confirm the next Fed Chair; on December 8, the government funding bill will expire. On December 5, the US Senate Banking Committee will confirm the Fed Chair nominee, Jerome Powell. If - before the December 8 deadline - the US Congress is unable to: a) pass a new bill to fund the government; and b) lift the current debt ceiling, a temporary government shutdown could bring volatility to the markets. On December 9, to prevent further increases, the debt ceiling level will be fixed (at the level of debt that day). In the US, unemployment rate and nonfarm payrolls (expected at 4.2% and 185k, respectively) will be released, while the EZ will publish its Q3 GDP (expected at 2.5%).

Europe: Eurogoup meets to elect new president, and EU Commission presents its EU reform proposals (see paper).

Middle East: Tension between the US and Turkey are likely to increase following new allegations directly involving President Erdoğan in a scheme to help Iran evade US sanctions.

The Quarter Ahead

US - Fed hikes to continue, Republican tax plan to be approved, Nafta Negotiations: The Fed Chair nominee, Jerome Powell, has expressed his intention to "maintain policy trends and ease regulations to enable banks to provide credit to families and businesses". The markets expect an interest-rate hike during the Fed's December meeting (with a 92.8% probability, according to CME Group FedWatch). To implement the Trump administration's tax cuts, a "Congress Joint Committee" will be formed to eliminate discrepancies between the House (bill passed in November) and the Senate (December), and prepare a text for the final vote in both chambers. GOP members expect an approval before the end of the year, as their positions are getting closer: for example, on the repatriation of US corporate earnings held overseas (USD2.6 trillion in 2016) the Senate proposed a one-time tax of 14.5% and the House a 14% (currently, companies would pay the 35% corporate tax rate). If approved, a sudden repatriation-flow could impact the markets and boost the USD, reversing the recent EUR gains: as of December 2, the EUR/USD appreciated by 2.1% m-o-m (from 1.166 to 1.190). The renegotiation of Nafta between US, Canada and Mexico will continue over the next few months.

Europe – EU reform meetings: A series of crucial meetings will be held on 14-15 December to discuss EU defense and migration policies, Brexit and EZ reform (including completion of the banking union). See our recent paper.

Middle East: ***Tension in Saudi to stabilize***. In the GCC, according to an unnamed Saudi official, Prince Miteb bin Abdullah—former: a) head of the National Guard; and b) contender to the crown prince position—was freed after agreeing to pay over USD 1bn to settle corruption charges. Iraq will resume war reparations payments to Kuwait in 2018. The last tranche of the compensation set by UNCC amounts to USD 4.6bn.

Last Week's Review

US Senate approves tax bill: The US Senate approved its version of the tax-cut bill. Stock markets were supported (the DJIA rose by 2.86% w-o-w) by improved sentiment on implementation prospects of the Trump tax plan. The bond market did not suffer the rising probability of larger deficits (yields on 10-year Treasury notes remained stable, closing at 2.36%, up 2 bps w-o-w).

Opec extends production cuts: Opec announced the extension until end-2018 of the agreement on production cuts. The deal includes the possibility of a review in June 2018, at the next ordinary meeting. The nine-month extension only pushed prices up marginally, suggesting that traders had already priced it in.

South African bonds downgraded: In EMs, S&P downgraded South Africa's rating to "junk bond" status. Local currency bonds constitute around 90% of the market, one of the deepest in the EMs. A downgrade by a third rating agency—Fitch was the first mover in April—would trigger forced sales, estimated in the range of USD 7-16bn.

Abbreviations, Acronyms and Definitions

bn	Billion	*IFO*	German Business Climate Survey
BoE	Bank of England	*IPO*	Initial public offering
BoJ	Bank of Japan	*KWSEIDX*	Kuwait Stock Exchange Index
bps	Basis points	*m-o-m*	Month-on-month
CB	Central bank	*Nafta*	North American Free Trade Agreement
CBT	Central Bank of the Republic of Turkey	*OECD*	The Organization for Economic Co-operation and Development
CPC	Communist Party of China	*Opec*	Organization of Petroleum Exporting Countries
CPI	Consumer Price Index	*PM*	Prime minister
DFMGI	Dubai Financial Market General Index	*PMI*	Purchasing managers' index
DJIA	Dow Jones Industrial Average Index	*QE*	Quantitative easing
d-o-d	Day-on-day	*qoq*	Quarter on quarter
EBA	European Banking Authority	*S&P*	Standard and Poor’s
ECB	European Central Bank	*SOE*	State-owned enterprise
EM	Emerging Markets	*SPD*	Social Democratic Party of Germany
EUR	Euro	*tn*	Trillion
EZ	Eurozone	*TRY*	Turkish Lira
Fed	US Federal Reserve	*UAE*	United Arab Emirates
FOMC	US Federal Open Market Committee	*UK*	United Kingdom
FRB	US Federal Reserve Board	*UNCC*	United Nations Compensation Commission
FX	Foreign exchange	*US*	United States
GCC	Gulf Cooperation Council	*USD*	United States Dollar
GBP	British Pound	*USD/bbl.*	USD per barrel
GDP	Gross domestic product	*VP*	Vice President
GOP	Grand Old Party (US Republican Party)	*y-o-y*	Year-on-year
IEA	International Energy Agency	*y-t-d*	Year-to-date
IMF	International Monetary Fund	*w-o-w*	Week-on-week

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