Economist's Weekly Market View

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Political risks easing could support the European economy

The federal elections in Germany, as expected, yielded a victor in the centre-right CDU/CSU, with Friedrich Merz expected to be the next Chancellor. However, his party just failed to reach the 30% level pre-election polls suggested, while far-right and left parties made strong gains. The incumbent SPD fell to its worst result in decades, but may yet end up in Government as the junior partner in a grand coalition.

The result drove a rally in the euro initially, rising above $1.05 against the dollar initially, before slipping back below that threshold, with investors perhaps pricing in some upside growth risk from the change of Government in Europe's largest economy. Alongside the relative calm in the French system following the passing of its fiscal budget recently, the German election means key political risks to the Eurozone outlook have subsided for now.

While much attention has focused on historically spend-thrift German governments, and the potential for a relaxation of the "debt break" to support higher infrastructure and defence spending, Germany's economy faces deeper issues. Its manufacturing sector has shed output and jobs in recent years, with a structurally higher cost base than competitors in Asia, and a collapse in demand for its goods as Chinese exports, including cars, have surged in recent years. Nonetheless, a reform of the debt brake could be a boon to the economy, particularly if it allows the Government to upgrade creaking infrastructure, and the second-order effects lead to higher consumer spending that benefits the wider Eurozone economy. However, reform of the brake will require a two-thirds majority in parliament – a hurdle its appears the mainstream parties may have just missed.

Turning to the week ahead, the data calendar is relatively quiet on both sides of the Atlantic. In the US, the main release of note will be PCE inflation for January. In the Eurozone, inflation data will be released. Most notably, the flash readings of HICP inflation for February in Germany, France, Italy and Spain are all due, and barring any upside surprises, are unlikely to give pause to the ECB in its rate easing cycle ahead of its next meeting in early March.

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