Taking a close look at the coalition contract: Not (yet) ready for a successful administration?

The still ongoing administration building process has potential for making history. First the Jamaica coalition negotiations fell through and then the grand coalition almost failed. The twists and turns in the administration building saga were drifting so far into absurdist territory that it might have been rejected as too farfetched for Game of Thrones. Sometimes the grand coalition talks gave the impression that these politicians have never met before. However, the negotiating partners have been collaborating for many years and still are! Even now that the five-month-long epic is coming to a close, it still is not clear if most social democrat members even support the coalition agreement. In all the grandstanding a discussion on the content of the coalition agreement seems to have been marginal. This may be due to the fact that only very few seem to have bothered actually reading all 178 pages of fine print. Thus we endeavored to do just that and – our dear readers may be forewarned at this point – came to a devastating conclusion. We think it is near impossible that an administration can be clear and successful on the basis of this agreement. The coalition agreement reads like a never-ending loop of repetitive platitudes, filler phrases, and non sequiturs. The three most prevalent words seemed to be “would, could, and might.” It is getting much worse, though. The entire contract smacks of authors with an almost childish understanding of societal and economic mechanisms. Some parts of the contract even read like a hodgepodge of topics and solution approaches put together for a class room project by high school students that are as eager as they are inexperienced.

Moreover, current major issues (immigration, education, and European politics) receive completely inadequate treatment while the contract authors devote large stretches of the prose to rather tangential topics (gender diversity, dealing with mentally ill parents, limiting interaction risks in chat rooms, supporting researchers with migration history, potential of creative business, artist poverty, media competence, supporting game developers). One cannot shake the impression that the new administration may be a little out of touch with reality and confuses real-life politics with a game of “When You Wish Upon A Star” free of budget constraints, topical necessities, and priorities. At the same time it is obvious that they try to please select voter and special interest groups with election gifts whilst lacking any cohesive political concept or economic guideline. Indeed the contract reads as if it has been turned into a grammatically correct patchwork of random fragments from the respective parties’ election platforms by artificial stupidity disregarding the need for content consistency, logic, or any kind of coherent vision of the future. The future is actually an important concept in analyzing this text. The contract frequently mentions digitization and families but then turns this in almost all cases into a discussion of wealth maintenance for the elderly. And when the contract does discuss how to prepare for the future it gets hardly any better. The contract repeatedly hints at the coalition partners’ apparent foreknowledge of future technology and economics including what specific support measures are useful and which are not. Overall, the contract tends to exude in these passages an activist if not outright interventionist spirit of the Government Knows Best kind. Procedural political thinking used to be the strong suit of German politics but not in this contract. When it does pop up it takes the form of platitudes. If you think this assessment too harsh please enter with us the wonderland of the coalition contract. Below we will discuss the most conspicuous incongruities within the various subjects the contract covers.

Competitiveness

An economy’s competitiveness does not depend on how many support programs the government maintains. The standard procedure for boosting competitiveness is relatively simple. You need a good infrastructure, high education levels, reasonable unit labor costs, efficient administrative and judiciary systems, and sensible taxation. With these basic building blocks the rest will follow. The coalition contract takes a different view. It feels as if the contract mentions leverage points for investment promotion programs to boost competitiveness on every other page or so. That would cost a fortune and probably make little if any difference. The government simple does not know what capabilities will be needed in the future. When countries tried such approaches in the past these have generally been unsuccessful.

Social Policy

The new administration also wants to be strong on intervention measures in social policy. What is new is the idea that apparently the grand coalition intends to reinvent the wheel on a European scale, too. The new administration wants to develop a framework for national social security systems in the EU member countries. Social disparities and wage competition are to be combated Europe-wide. It is getting curiouser and curiouser. This would actually mean that the EU has to set minimum standards without any idea of how to finance those. Indeed there is an extreme disparity of social security within Europe but this is a direct result of the extreme disparity in economic performance. Equalizing social security benefits by raising the minimum standards in weak economies will reduce their competitiveness and thus their tax revenues and consequently the financial basis for social security. No matter which way you look at it, one can only equalize social security standards by equalizing economic performance. Putting the lever at the social benefits will put the cart before the horse and only shows a lack of understanding fundamental societal mechanics.

Tax Policy

It is somewhat perplexing to see how fervently the grand coalition wants to introduce a financial transaction tax. This makes no sense at all – unless one finds it sensible to appease the left end of the coalition spectrum. It is further-more inconceivable why the reunification surcharge should still be around almost thirty years after German reunification. Diverting attention from this fact by stressing the higher exclusion level for this tax is rather disingenuous because the exclusion mostly covers lower income brackets that never had to bear much of the surcharge burden to begin with. The German government thus may continue to count on billions in reunification surcharge income to use for election gifts even long after the original reason for this surcharge has ended. On the other hand, this is a longstanding German tradition considering that the bubbly tax was originally introduced to finance the imperial German fleet. The imperial fleet is long gone but the tax remains to this date. The solidarity surcharge may find itself blessed with similar longevity.

European Policy

The attentive reader may notice that the coalition contract makes some controversial statements on this topic. On page 9 it states: “The stability and growth pact shall remain our guiding principle going forward.” What exactly is that supposed to mean? The correct formulation would be: “We will steadfastly stay true to the stability and growth pact.” Actually, the fact that the authors did not say that may be interpreted as an admission of the coalition’s tentative first move in the direction of a transfer payment union. There is a good reason why later in that chapter the authors hint at evolving the ESM fund into a European Currency Funds. This plan had first been proposed by the EU Commission and is meant to fund EU intervention in times of financial crisis for countries facing insolvency. This may sound like a good idea but is not much more than sugar coating underhanded takeover and socialization of liability risks. The coalition contract remains silent on creating incentives for countries not to go bankrupt to begin with. The contract’s economic creativity remains limited to throwing money at a crisis rather than preventing a crisis from happening. It also makes some intriguing statements on EU expansion. In light of the already strong heterogeneity of economic performance and resulting problems it is a tad surprising that the coalition contract’s stance on EU expansion seems to be uncritical and undifferentiated. The contract’s statements go even further than that by championing EU ascension by all western Balkan countries and saying that Turkey’s ascension process should not be aborted. Size seems to matter here more than sensibility. At least there seems to be no reflection on the future structure of the EU to keep it attractive to the existing members in the long term. There are lessons to be learned from Brexit but the coalition contract has apparently missed them.

Digitization

It is in principle a good thing that the coalition contract discussed digitization at length. Yet, how the authors envision a policy for a successful journey into the digital age is disconcerting to say the least. With some literary license, the authors seem to believe that that you just have to put all school children in front of computers and accelerate internet speed to ensure a successful digital future. The coalition partners seem to be lacking in educated insights into the characteristics of digital business models. They appear to realize that Germany’s digitization potential could be on the level of about industry 4.0. However, government can do nothing to enforce success in this specialized segment either and government busy-bodying in economic processes as proposed in the coalition contract has little if any effect. All a government really can do is laying a foundation with good education and infrastructure plus some clear and simple guidelines for the economy to do the rest. However, a government is overreaching when it claims to know the innovation potential of enterprises in terms of digitization and industry 4.0 and derive special promotion programs from such knowledge.

Labor Market Policy

The idea that government can create benefits for workers by regulating trial periods and temporary labor is nothing more than smoke screens and mirrors. It only makes it more probable that there will be more temporary jobs and less permanent ones. After all, this is a classic example of raising a market entry barrier. That makes this another textbook case of politicians occasionally (and in the coalition agreement rather frequently) not thinking the consequences of the actions through. Especially in light of the impending long-term unemployment for many refugees this labor policy measure is a veritable shot in the own foot.

Research Policy

A wonderful example illustrating the coalition partners’ understanding of research policy is their call for collaborating with France on artificial intelligence research and developing capabilities in this area. That may sound all fine and well but the plan is absurd and only shows how far politics has moved away from reality. Of course, algorhythms and artificial intelligence will play an important role in the future, but developing such capabilities requires neither government assistance nor cooperation with France. The requisite fundamental research is going on at universities any way and the actual application development can almost only be done by companies as they have the necessary data bases for the learning process.

US American and Chinese companies are already so far ahead of Europe in their AI capabilities that trying to catch up is virtually futile. The reason for this is that all successful digital business models are platform dependent one way or another and extremely data intensive. There is not a single business model in Europe that can compete with that – not least because the European market is relatively fragmented and thus less suited to platform-based business models. If France and Germany believe that they can become innovation drivers in this market they are only exposing themselves to ridicule – and waste their money.

Industrial Policy

The coalition contract offers a plethora of examples for misguided industrial policy approaches. A prominent one is the call for manufacturing electric car batteries in Germany and offering promotional programs for it. This even seems logical at first glance. If the future belongs to the electric car and the main value of such cars is in their batteries, Germany should be making them. The logic does not hold, though. On the one hand, Germany’s environmental standards for battery production are far too high and, on the other, Germany's energy costs are not competitive. It will never be cost-effective to mass produce electric car batteries in Germany. Another logic lapse is that there is no proof that electric car batteries are indeed the way of the future. What if hydrogen takes over as the fuel of choice? And, shouldn´t Germany wait for a paradigm shift in battery technology (for instance the glass battery) that overcomes the disadvantages of lithium ion batteries?

Pension Policy

The pension policy of the new administration borders on the grotesque. Despite disastrous demographics and a consistently low income volume of people with migration background, the new administration nevertheless plans to set the statutory pension at 48% of the last wage with contributions limited to 20%. This is mathematically impossible and therefore the gap is to be financed with tax revenue. That is clearly an election gift to the current retiree generation and a slap in the face for young people who are just entering the work force. It is most of all an example for the coalition partners' inability to face facts and draw realistic conclusions as well as taking responsibility for it.

Military Policy

The German military is in a sad state. Almost all weapon systems and troupes are impaired or completely undeployable. The German military is like a formula 1 team with great drivers and cars that cannot even participate in the training for want of spare parts. Every year, Germany spends 37 billion euros on defense and gets virtually nothing in return. That is a scandal all by itself. This failure continues on in the coalition contract. The authors neither analyze (at least beyond basic newspaper level) what geostrategic challenges must be addressed nor discuss any implications for necessary military capabilities. Instead, the contract points out procurement problems that will be solved in the next few years. That was already in the previous coalition contract with painfully obvious lack of results.

Housing and Rent

It is a well-known fact that housing is scarce especially in Germany's conurbations. It therefore stands to reason that the new administration intends to create 1.5 million new housing units in the next four years or 375,000 units per year. Current new housing construction stands at some 300,000 units per year which is about 25% short of that. It remains questionable whether this goal is attainable. Although the new administration has many measures planned including extending low income housing programs, introducing special deductions set to expire in 2021, and simplifying the process for zoning new residential building sites. At the same time, the new administration intends to introduce housing-construction-dependent child benefits and help with equity requirements for real estate purchases through a loan guarantee program by Germany's Reconstruction Bank. This will indeed create incentives for residential construction but it also makes the already numerous and convoluted regulations even less transparent.

Moreover, increasing rent caps and tenant protection as well as limiting modernization prorating in the rent will counteract some of the above measures as it makes residential construction less attractive to investors. This limits the success of this policy for the foreseeable future.

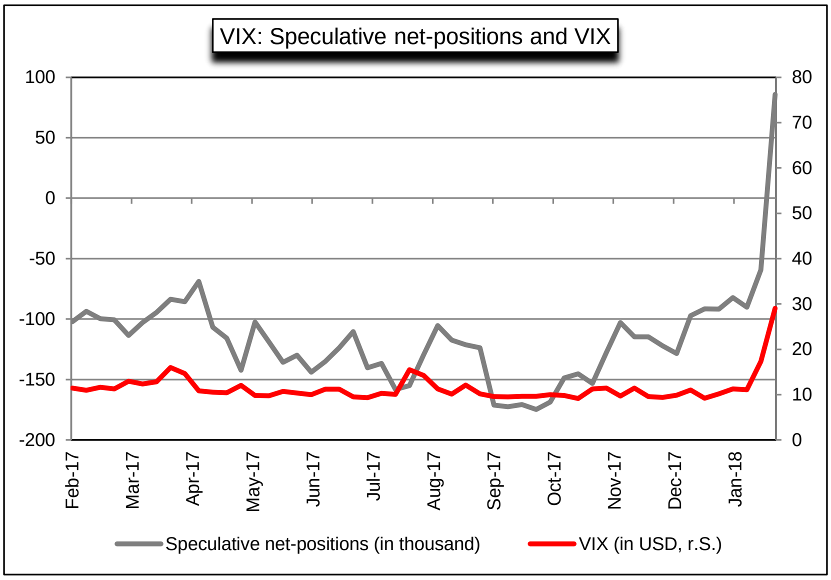
Are we too hard on the new administration? We do not think so. Citizens have a right to good government. This contract gives the impression that the new administration cannot even measure up to a middling level of political and economic substance. Germany deserves better.

Weekly outlook for February 19 to February 23, 2018

	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Release
DE: Producer prices, m/m	0.3%	0.3%	0.1%	0.2%	0.2%		20 February
DE: Producer prices, y/y	3.1%	2.7%	2.5%	2.3%	1.8%		20 February
DE: ZEW Economic expectations	17	17.6	18.7	17.4	20.4	20.2	20 February
DE: ZEW Economic assessment	87.9	87	88.8	89.3	95.2	94.8	20 February
DE: PMI manufacturing Flash	60.6	60.6	62.5	63.3	61.1	60.8	21 February
DE: PMI services Flash	55.6	54.7	54.3	55.8	57.3	56.9	21 February
DE: Ifo business climate index	115.4	116.9	117.6	117.2	117.6	117.4	22 February
DE: Ifo business expectations	107.5	109.3	111	109.4	108.4	108.2	22 February
DE: Ifo Economic assessment	123.9	124.9	124.6	125.5	127.7	127.2	22 February
EUR-19: Consumer confidence – Flash	-1.2	-1.1	0	0.5	1.3	0.7	20 February
EUR-19: PMI manufacturing Flash	58.1	58.5	60.1	60.6	59.6	59.4	21 February
EUR-19: PMI services Flash	55.8	55.0	56.2	56.5	57.6	57.3	21 February
EUR-19: Consumer prices, y/y - final	1.5%	1.4%	1.5%	1.4%	1.3%		23 February
EUR-19: Core inflation, y/y - final	1.1%	0.9%	0.9%	0.9%	1.1%		23 February

MMWB estimates in red

Chart of the Week: Short Squeeze in the VIX Part II



The nose dives of the Dow Jones, DAX, and many other stock indexes across the globe will have taken many investors by surprise when they came home on Monday last week. Even more surprising, however, was the spike in the VIX volatility index. The VIX is nicknamed the "fear gauge" and measures implicit volatility in the US stock market index S&P 500 using options prices. The more investors are willing to invest in options to hedge stock prices, the higher the VIX level. Investors can buy or sell the VIX through exchange traded notes and thus invest in implicit volatility. Investors usually can make a lot of money in short positions, i.e. by buying volatility. This is because market participants are willing to pay higher prices or an insurance premium on hedging with options. Short positions in volatility profit from that. However, if this insurance case comes up, short positions, the insurers, can lose a lot of value. To protect themselves against further losses and protect their vulnerable flanks, short buyers buy even more volatility which drives option prices and thus the VIX even higher. If you are aware of this mechanism it should be easy to trigger it: First one drives up volatility a bit by buying VIX options or futures and then waits until short position covering automatically drives up the VIX – this is called a short squeeze. Many market participants are well aware of this, which makes it a natural suspicion when comparing the speculative net VIX position in the week before the spike and last Monday's spike. It almost looks as if investors had anticipated this volatility increase. In light of the otherwise excellent economic and corporate data such high net speculation is rather puzzling, though. That is why we are wondering whether this is really a case of prudent anticipation or a deliberate market manipulation by some market participants that caused the VIX to spike. That would then have little to with real fear or outright panic as touted by the media.

Stock marktes	As of 19.02.2018 16:49	Change versus 12.02.2018 -1 week	16.01.2018 -1 month	16.11.2017 -3 months	29.12.2017 YTD
Dow Jones	25219	2,5%	-2,2%	7,5%	2,0%
S&P 500	2732	2,9%	-1,6%	5,7%	2,2%
Nasdaq	7239	3,7%	0,2%	6,6%	4,9%
DAX	12401	1,0%	-6,4%	-5,0%	-4,0%
MDAX	26064	3,4%	-3,5%	-1,5%	-0,5%
TecDAX	2565	3,5%	-3,3%	2,3%	1,4%
EuroStoxx 50	3409	1,2%	-5,9%	-4,4%	-2,7%
Stoxx 50	3039	1,0%	-6,1%	-3,3%	-4,4%
SMI (Swiss Market Index)	8918	1,1%	-5,8%	-2,5%	-4,9%
Nikkei 225	22149	3,6%	-7,5%	-0,9%	-2,7%
Brasilien BOVESPA	84670	4,7%	6,1%	16,8%	10,8%
Russland RTS	1260	4,4%	-0,1%	11,8%	9,1%
Indien BSE 30	33775	-1,5%	-2,9%	2,0%	-0,8%
China Shanghai Composite	3199	1,4%	-6,9%	-5,9%	-3,3%
MSCI Welt (in €)	2138	2,0%	-3,5%	-0,2%	-1,6%
MSCI Emerging Markets (in €)	1200	3,0%	-2,7%	1,3%	0,3%
Bond markets					
Bund-Future	163,14	517	237	44	146
Bobl-Future	130,62	8	-57	-113	-99
Schatz-Future	111,90	-1	2	-37	-8
3 Monats Euribor	-0,33	0	0	0	0
3M Euribor Future, Dec 2017	-0,26	0	-2	2	0
3 Monats $ Libor	1,88	5	15	45	19
Fed Funds Future, Dec 2017	2,05	7	8	32	0
10 year US Treasuries	2,87	0	33	50	46
10 year Bunds	0,74	3	24	36	31
10 year JGB	0,06	-1	-2	2	1
10 year Swiss Government	0,17	5	24	27	30
US Treas 10Y Performance	559,49	-0,2%	-2,8%	-3,9%	-3,8%
Bund 10Y Performance	595,04	0,5%	-1,4%	-2,4%	-2,0%
REX Performance Index	475,50	0,2%	-0,7%	-1,6%	-1,1%
US mortgage rate	0,00	0	0	0	0
IBOXX AA, €	0,78	-2	8	10	10
IBOXX BBB, €	1,35	-2	13	17	12
ML US High Yield	6,42	-12	35	20	27
JPM EMBI+, Index	816	0,9%	-2,4%	-1,4%	-2,4%
Convertible Bonds, Exane 25	7302	0,0%	-2,3%	-0,7%	-1,3%
Commodities					
CRB Spot Index	441,92	0,6%	0,7%	3,1%	2,2%
MG Base Metal Index	366,06	4,7%	2,9%	7,3%	2,0%
Crude oil Brent	65,37	3,4%	-5,9%	5,7%	-1,9%
Gold	1347,43	1,7%	0,9%	5,2%	3,4%
Silver	16,73	1,3%	-2,3%	-2,1%	-1,6%
Aluminium	2218,00	4,6%	1,7%	6,4%	-1,7%
Copper	7191,00	5,9%	2,2%	7,3%	-0,2%
Iron ore	77,20	2,0%	0,9%	25,3%	8,3%
Freight rates Baltic Dry Index	1084	-3,5%	-11,2%	-20,4%	-20,6%
Currencies					
EUR/ USD	1,2384	1,0%	1,3%	5,2%	3,3%
EUR/ GBP	0,8857	-0,4%	-0,3%	-0,7%	-0,2%
EUR/ JPY	131,94	-1,0%	-2,6%	-0,9%	-2,3%
EUR/ CHF	1,1526	0,2%	-2,3%	-1,4%	-1,5%
USD/ CNY	6,3438	0,2%	-1,5%	-4,4%	-2,5%
USD/ JPY	106,32	-2,2%	-3,7%	-6,0%	-5,7%
USD/ GBP	0,72	-1,2%	-1,5%	-5,6%	-3,2%

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