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German Federal Elections: An Analysis

As federal elections approach, the media tends to blow them out of proportion calling them historic, trail blazing, or even fateful. In the case of Germany's upcoming federal elections this is not entirely exaggerated. For the first time ever there is a real chance that Germany may elect a strong eco-socialist coalition comprised of SPD (Social Democrats), Die Linke (Socialists), and the Green Party. It is also almost but not quite entirely impossible that Germany could get a wrap-around coalition consisting of CDU/CSU (Christian Democrats), FDP (Neoliberals), and Green Party or just another Grand Coalition of SPD (Social Democrats), Green Party, and CDU/CSU. Even SPD, Green Party, and FDP could have a shot at forming a ruling alliance. Depending on how the coalition negotiations turn out, there could be far-reaching changes in regulatory issues, tax policy, foreign relations, social issues, and European policy. One may also get the impression that each of the possible coalitions have preset break points making it near inconceivable that any original coalition will make it to the end of the term. Moreover, it cannot be categorically ruled out that the coalition negotiations end in a stalemate resulting in new elections.

The elections are overshadowed by popular disappointment if not outright confusion and anger with the parties as they are right now. From pandemic inaction to Afghanistan withdrawal to mishandling of the recent flood disaster, German politicians and administrators at all levels and of all colors have clearly shown what they are made of, and the people were thoroughly unimpressed.

The triad of shortcomings was particularly stark when compared to the capabilities thirty or forty years ago. Even compared to emerging economies Germany's performance was on the pathetic end of the scale.

Failure No. 1: Inability to Formulate Strategic Objectives

Maybe German politicians have just become too complacent or there is an as yet unexplained inertia, but one cannot deny the distinct impression that they no longer know how to formulate their own strategic objectives. While countries like China are gaining new technological and entrepreneurial capabilities at breakneck speed and define new geopolitical objectives, Germany seems to be just blabbing about the topic of the day. It is disconcerting to observe how the world's fourth-largest economy is evading key questions of great future import. This includes the question whether Germany wishes to become the second-most desirable destination country for immigrants after the USA: Do we just let anybody come or do we set criteria for controlled immigration? And then there is the question what pharmaceutical, technological, and industrial capabilities should be kept strictly at home and in what areas does Germany want or need to reach a leadership position to play its capabilities to the best advantage? How would we react if Russia invaded the Baltic countries or China were to take back Taiwan? In the past few years, German politicians have been decidedly silent on these issues short of some lip service statements. This is already a glaring omission that any future federal government will have to deal with. It was possibly also not the greatest feat of intelligence to be the only country on this planet that first phased out its nuclear power and coal power plants immediately thereafter. And then there is the problem that Germany neglected building state-owned and offering subsidies for privately built affordable housing as the population started to grow again and the trend favored small single-person households. And let us not forget how the German government dragged its feet on expanding and updating direly needed power infrastructure even though this rendered German climate change policy ineffective.

And then there was the great self-foot-shot of building the North Stream 2 pipeline considering that the pipeline not only increased Germany's already high dependence on Russian natural gas but also further complicated the Ukraine situation. The new pipeline takes away gas transit from Ukraine which is an important income source for the country as well as a military protection function because Russia would rather not jeopardize its natural gas trade with Europe over a war with Ukraine. This strategic protection is now gone.

Failure No. 2: Inability to Learn from Mistakes

When the Covid pandemic hit in March 2020 no German citizen criticized the federal government for being hesitant and undecisive at first. Now, eighteen months into the pandemic, it is rather surprising how little the administration has learned over the course of this crisis. Indeed, the data basis for making political decisions is still unnecessarily obtuse. Where do people really get infected? What are the incidence indicators for what pandemic stage? How do schools and universities figure into virus propagation? How to use what masks and when? Should we use cloth masks, surgical masks, N95s vented or unvented or any combination thereof? The conclusion is that we do not really know. Theoretically available pertinent data cannot be used for data privacy reasons and even public domain data remains unanalyzed because nobody really cares. It therefore fails to surprise that that information flow on infection chains has made little to no progress since March 2020 and public health services still work at capacity limits similar to the beginning of this pandemic. Another shameful example is the Financial Intelligence Unit that had fallen into many years of enchanted beauty sleep rather than fighting multi-billion-euro money laundering rackets. What these government agencies are missing here is an iron will to self-improvement and the capacity to learn from their mistakes. What we are seeing instead is self-congratulatory grandstanding and slow-motion paper shuffling. This stands in increasingly stark contrast to real life that the citizenry is living. They have to navigate professional, public, and private standards on a daily basis and are getting ever less understanding of government inertia.

Failure No. 3: Inability of Consistent Action

When in 1962 a great hurricane brought flood and devastation to Hamburg and Germany's Atlantic Seaboard, Hamburg's Senator of Internal Affairs immediately called in the German military and NATO disaster relief forces without a moment's hesitation (or fear of constitutional issues) or concern whether it was actually within his power to mobilize a disaster relief force of some 25,000 troops with a large number of helicopters and rescue boats. Without a doubt there were numerous mistakes made in this hurricane response but overall, the action was well organized and consistent. This decisive action saved hundreds if not thousands of lives. The once-in-a-century floods of the Oder and Elbe rivers in 2002 were also met with such decisive action.

However, when catastrophic rainfalls hit parts of North Rhine Westphalia and Rhineland Palatinate with entire valleys going under some weeks ago, the initial government reaction consisted of a whole lot of nothing. At first, local authorities did not realize the extent of the disaster and, when the worst was just about over, they started setting off the alarms only to see that most of the sirens were out of order. The next day, authorities called the military asking for a functioning helicopter or two with crews. They eventually found a helicopter and one or two rescue tanks that even started on first try. Indeed, it was exactly the type of rescue tank this author encountered at a field exercise in 1988. Actually, it already looked like a sixty's military fossil back then and its primary redeeming feature was a working stand heater. If that sounds like comedy, please understand that it is deeply tragic. The recent floods and their aftermaths have shown us that the German government has lost its ability for decisive action in times of need.

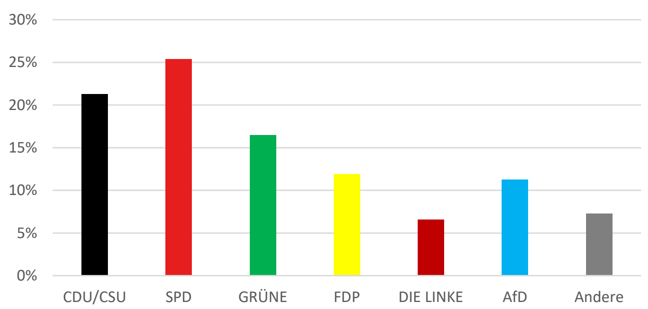
Another example is the recent embarrassment in Afghanistan. At first, German command did not understand that the Americans were going to withdraw quicker than originally planned. Then they underestimated how quickly the Taliban was going to take over. The next big mistake was that German command completely missed that – notwithstanding basic human decency – it ran contrary to Germany's future strategic, geopolitical interests to leave local cooperators behind. Who in the world and in their right minds will ever work for Germany in such dangerous circumstances again if Germany has a reputation to shaft foreign labor? And when German command finally got the point that this would require a major evacuation operation, it took several days to make its way through the chain of command. It will be a sad and shameful day when some longish while in the future a complete breakdown of the events will be made public.

The list of devastating failures for quick, decisive, and strategically well thought out action could continue on for an embarrassingly long time. Did it really have to take that long to buy a sufficient stockpile of Covid vaccine for the German populace considering that the demonstrably most efficient vaccine at the time was developed and manufactured in Germany? How could it be that the German government totally missed to massively fund and promote the development of therapeutics for acute and long Covid even though Germany has outstanding fundamental research capabilities that could have built an outstanding foundation for a successful new drug pipeline?

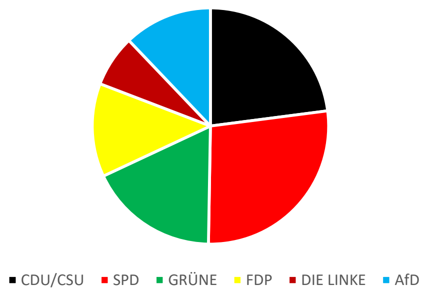
Germany is undoubtedly facing major challenges. Continuing on the status quo train is no longer an option while climate change and the need for building a digital infrastructure for the future are not making things easier. Moreover, the German economy has to deal with ever increasing structural burdens including dramatic demographics that could lead to a social security collapse unless the government will continue to massively subsidize the system. The federal government is currently pumping some 100 billion euros per year into the pension system. That means about one out of four (!) euros of the federal budget are used to prop up the social security system. As baby boomers are now heading into retirement this can only get worse just based on mathematics and is greatly limiting the financial leeway for other necessary actions. The large number of immigrants has not been much of a solution to the pension problem as some hoped it might be as these immigrants are neither in scope nor in number participating enough in the labor market to make much of a difference to the senior dilemma indicating suboptimal integration which may be interpreted as yet another government failing.

All of the above problems are enormous challenges going forward and almost presage failure of Germany's Next Top Coalition.

Possible election result:
Average of current polls

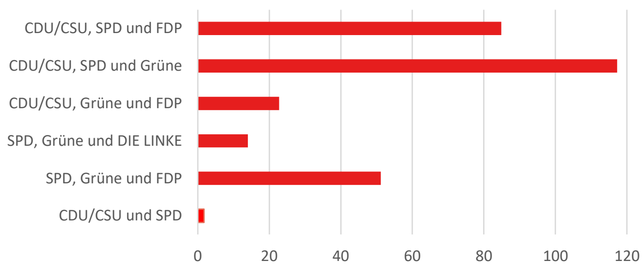


Distribution of seats in the Bundestag
(own calculations based on current polls)



In principle, there are various viable alliances possible that we wish to analyze here in respect to their capital market impact. For investors, the probably most attractive and still realistic prospect would be a coalition of CDU/CSU, FDP, and Green Party. Such alliance could contribute regulatory and economic expertise to achieve realistic solutions for climate and environmental issues. However, possible and probable are not synonyms, and this configuration is not very probable. We consider a coalition of SPD, Green Party, and FDP more likely although it is rather hard to gauge how and under what conditions the FDP would be willing to participate in this constellation. Should the FDP decide to join a ruling alliance, it will probably negotiate for maximum power and put down several bounds that must not be overstepped during the next legislative term. Such non-negotiable items would include nationwide bans on renter protection and wealth taxes. Moreover, the FDP would probably block an accelerated introduction of an EU transfer and liability union. Should the FDP prevail in its agenda such coalition would be a big non-event for the capital markets just like the first variant.

Possible coalitions and seats in the Bundestag
above the absolute majority
(own calculations based on current polls)



The leftist alliance, however, would be quite a different proposition. As the SPD chancellor nominee has been hitherto unable to rule out such a constellation and the SPD leadership rather likes to entertain this idea, there is really no good reason while this coalition should be impossible. Any ideological differences in their platforms can be easily bridged with some good will especially because they do have a lot more in common than in actual disagreement. All the parties are to varying degrees in favor of expropriation, rent control, wealth taxation, EU transfer union, as well as abolishing the stability pact and debt limits. Particularly the introduction of nationwide rent limits would be a red flag signal for investors that would also spill over to the German stock market. Capital markets will probably also fail to enthuse over the introduction of a wealth tax that is to be paid out of a company's assets even if the enterprise is not earning money. The ifo institute recently calculated the possible effect of a wealth tax. Under applicable German tax law, the introduction of a wealth tax would roughly equal the effect of doubling income tax. This would so curtail German corporate profitability relative to the status quo that the net effect would be negative. In other words, introducing a wealth tax would actually lower tax revenue.[1] We assume that this prospect is not resulting in excessive jubilation on the capital markets.

On the debt side, the situation will look rather different, though. Particularly British investors and analysts seem to express a certain fondness for the idea that Germany may lift its debt limits and support an EU transfer union. This is not entirely without merit. Let me demonstrate this with the following numbers. Euroland (excluding Germany) has a debt level of 110% of GDP on average. Germany's debt ratio is 70% of GDP. That represents a 40% difference between Germany and the rest of Euroland. Assuming that the socialist alliance will abolish the German debt limit and agrees to an EU transfer and debt liability union, Germany's debt ratio would gradually fall in line with the rest of the EU. Under this assumption, Germany would amass a new debt load of 1.5 trillion euros over the next few years!! That is a rather sizable chunk of money.

It should not surprise that particularly British market participants who are not known for their regulatory or long-term oriented thinking consider this a good idea. Such an enormous spending potential should ultimately result in more orders and sales in the economy at large and that Europe-wide. Since the ECB – rising debt levels notwithstanding – would do whatever it takes to keep interest rates and yields low, stock market investors would generally have to be pleased as punch with this outlook. Isn't it romantic irony that a leftist policy project could make the stock market soar?

Whether the champagne should keep flowing in the long run remains doubtful, though. Things are always complicated: Euroland currently works despite pronounced disparities in growth and competitiveness because two guarantors are implicitly backing it all. One guarantor is the ECB and the other is Germany. Germany earned its creditworthiness the hard way through fiscal responsibility and risking this safety net for Euroland could be a very bad idea when things go wrong. The implicit scope of this safety net is 1.5 trillion euros as mentioned above. That is the amount of credit Germany could raise for its ailing allies without going further into debt than the rest of Euroland.

It is precisely this creditworthiness and thus implicit insurance that would be gradually eroded if Germany were to lift its debt limits and joined an EU transfer union. Our concern is therefore that there will be painful regrets after the party that may in the extreme case lead to the demise of Euroland. After all, what would European solidarity be worth if all members wind up adrift in deep debt without an anchor to hold them or pilot to guide them through stormy weather? The requisite stability would be missing, there would be no anchor, no navigator, no safety!

That means Germany's upcoming federal elections are indeed likely to be fateful for both Germany and the EU. Any capital market effects are tangential by comparison. Considering the dramatic, structural challenges Germany's next government has to face makes it seem as if the CDU/CSU is not at all unhappy to play the opposition game for a few years. This puts the subdued CDU/CSU campaign into a rather different light, and it may well be smartly played. The next few years could be very interesting indeed!

[1] https://www.ifo.de/Standpunkt/ifo-Standpunkt-207-Netto-vermoegensteuer-falsche-Antwort-auf-berechtigte-Frage

Market data

Stock marktes	As of 21.09.2021 12:10	Change versus 14.09.2021 -1 week	20.08.2021 -1 month	18.06.2021 -3 months	18.09.2020 -1 year	31.12.2020 YTD
Dow Jones	33970	-1,8%	-3,3%	2,0%	22,8%	11,0%
S&P 500	4358	-1,9%	-1,9%	4,6%	31,3%	16,0%
Nasdaq	14714	-2,2%	0,0%	4,9%	36,3%	14,2%
DAX	15355	-2,3%	-2,9%	-0,6%	17,1%	11,9%
MDAX	35153	-2,0%	-1,4%	3,3%	27,8%	14,1%
TecDAX	3889	-1,0%	0,3%	11,5%	24,7%	21,1%
EuroStoxx 50	4098	-2,2%	-1,2%	0,4%	24,8%	15,4%
Stoxx 50	3516	-1,6%	-2,8%	-0,3%	18,0%	13,1%
SMI (Swiss Market Index)	11819	-2,3%	-4,8%	-1,0%	12,1%	10,4%
Nikkei 225	29840	-2,7%	10,5%	3,0%	27,7%	8,7%
Brasilien BOVESPA	108844	-6,3%	-7,8%	-15,2%	10,7%	-8,5%
Russland RTS	1714	-2,3%	5,6%	4,1%	39,5%	23,5%
Indien BSE 30	59046	1,4%	6,7%	12,8%	52,0%	23,7%
China CSI 300	4856	-1,2%	1,8%	-4,8%	2,5%	-6,8%
MSCI Welt (in €)	3046	-1,6%	-1,6%	4,5%	29,7%	18,4%
MSCI Emerging Markets (in €)	1258	-2,3%	2,5%	-6,3%	14,4%	1,9%
Bond markets						
Bund-Future	171,55	-36	-560	-105	-252	-609
Bobl-Future	135,41	-9	2	126	32	23
Schatz-Future	112,27	2	-7	11	-2	-1
3 Monats Euribor	-0,55	2	2	2	-4	4
3M Euribor Future, Dec 2017	-0,54	0	0	-1	1	0
3 Monats $ Libor	0,12	1	0	-1	-10	-11
Fed Funds Future, Dec 2017	0,08	0	0	-2	5	0
10 year US Treasuries	1,33	6	9	-11	64	42
10 year Bunds	-0,31	3	23	-6	17	26
10 year JGB	0,05	0	4	-1	3	3
10 year Swiss Government	-0,24	4	16	-2	24	26
US Treas 10Y Performance	706,35	-0,3%	-0,2%	2,0%	-3,1%	-1,3%
Bund 10Y Performance	671,73	-0,2%	-1,8%	0,9%	-1,2%	-1,9%
REX Performance Index	493,96	0,0%	-0,9%	0,1%	-0,9%	-1,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,24	2	14	-2	9	22
IBOXX BBB, €	0,59	1	13	-7	-31	4
ML US High Yield	4,61	7	-8	-4	-127	-36
Convertible Bonds, Exane 25	8223	0,0%	-0,8%	-1,6%	3,6%	-1,3%
Commodities						
MG Base Metal Index	436,33	-1,9%	4,1%	5,5%	37,3%	23,0%
Crude oil Brent	74,62	1,2%	14,3%	1,4%	72,7%	43,8%
Gold	1766,69	-2,3%	-0,9%	-0,5%	-9,6%	-6,9%
Silver	22,30	-6,5%	-3,9%	-14,4%	-17,2%	-15,5%
Aluminium	2844,75	1,2%	11,0%	19,8%	62,3%	44,1%
Copper	9049,15	-4,0%	0,1%	-0,8%	32,1%	16,8%
Iron ore	117,01	-8,7%	-27,1%	-45,4%	-7,9%	-24,9%
Freight rates Baltic Dry Index	4304	2,0%	5,2%	33,7%	232,1%	215,1%
Currencies						
EUR/ USD	1,1736	-0,7%	0,6%	-1,4%	-0,8%	-4,4%
EUR/ GBP	0,8572	0,4%	-0,1%	-0,2%	-6,3%	-4,2%
EUR/ JPY	128,56	-1,2%	0,5%	-2,0%	4,1%	1,6%
EUR/ CHF	1,0857	-0,3%	1,4%	-0,8%	0,8%	0,5%
USD/ CNY	6,4655	0,4%	-0,5%	0,2%	-4,5%	-1,0%
USD/ JPY	109,40	-0,3%	-0,4%	-0,7%	4,6%	5,9%
USD/ GBP	0,73	1,2%	-0,5%	0,8%	-5,3%	-0,1%

Source: Refinitiv Datastream

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