

27 September 2019

German investment stimulus hits a bottleneck

Annual change in public construction and private consumption deflators

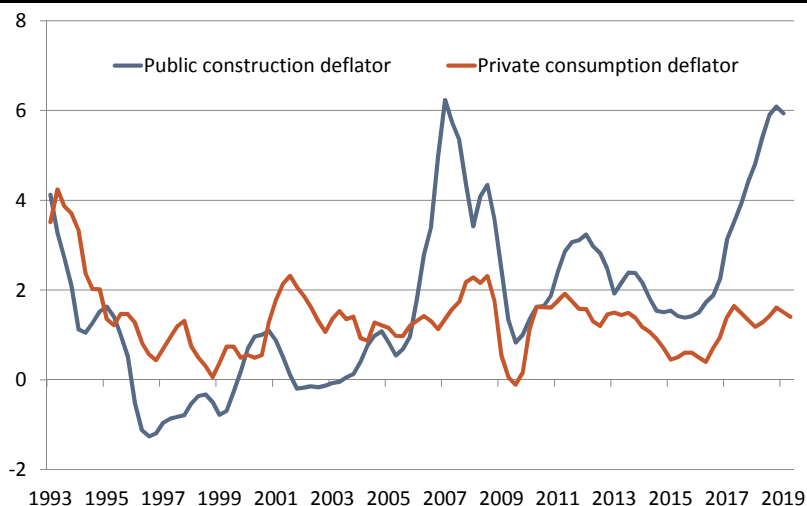


Chart shows yoy change in % based on two-quarter moving averages. Quarterly data. Source: Federal Statistical Office

- **Hitting the limits:** Awash with cash and in need of upgrading its infrastructure, Germany has ramped up public investment during the last five years. It plans to do more. However, long planning procedures for major projects, understaffed local administrations and lengthy court challenges make it difficult to step up spending fast.
- **Supply bottleneck:** Even when a project has overcome all administrative hurdles, a serious problem remains: who can actually do the work? Partly due to a lack of qualified labour, construction prices are rising fast. Most of the 9.7% yoy advance in nominal spending on public construction in H1 2019 was eaten up by a 5.9% rise in prices (see chart). This left a solid but much less impressive real increase of 3.5%.
- **Stimulus logic:** Blessed with a fiscal surplus and negative borrowing costs, Germany has the “fiscal space” to buffer the mild recession into which the country has fallen amid serious external shocks. Many observers are calling for an even bigger boost to public investment.
- **Supply and demand:** In a recession, public spending can narrow the temporary gap between aggregate demand and supply. But this only works for the sectors that have spare capacity due to the downturn. The highly cyclical and heavily export-orientated car and machine tool sectors face a sudden dearth of demand. Construction, however, does not. Putting even more public money to work in an already booming construction sector would raise prices even more. This would be a waste of money rather than an effective stimulus.
- **A strategy for investment:** To upgrade its infrastructure and promote the conversion to clean energy, Germany needs reliable long-term spending commitments. If companies have confidence that the public sector will raise its investment spending for many years to come, regardless of the business cycle, they are likely to build up the capacities to deliver the projects over time. The government is moving in this direction.
- **The right sort of stimulus:** To soften the imminent blow from recession, Germany should first and foremost strengthen its automatic stabilisers. For example, it should provide more generous subsidies to cover temporary shortfalls in workers’ earnings from reduced working hours while the recession lasts. Additional subsidies to switch to lower-emission cars and accelerated depreciation allowances for equipment investment could help the sectors reeling from a temporary drop in demand. Germany should also bring forward to 2020 the cut in the solidarity surcharge to the income tax currently planned for 2021. Reducing the federal corporate tax and making more land available for residential construction to ease that particular bottleneck would also help. All in all, we expect a fiscal expansion of 0.5% of German GDP in 2020, after 0.3% in 2019.

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