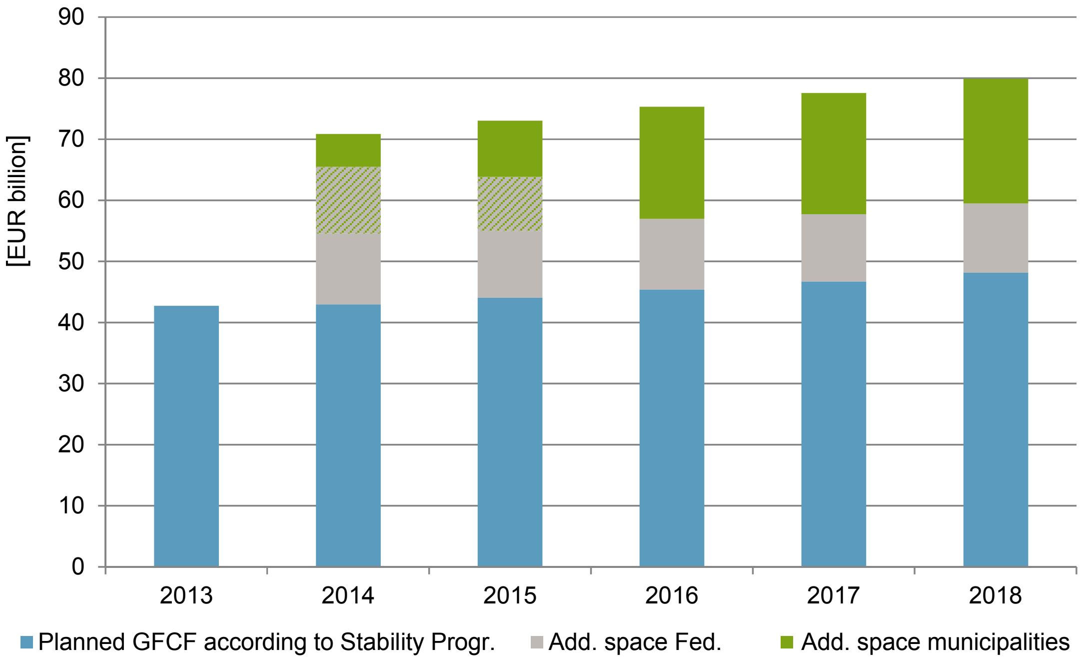
We are resuming publication of the Investment Barometer with a revised format. The first and third issues of each year will look at corporate investment. In the second quarter we will be analysing public investment. We will then finish the year with an analysis of investment in private residential construction in the fourth quarter.

Frankfurt, 10th July 2014

KfW-Investment Barometer Germany – Q2 2014

Public investment: debt reduced despite increase in spending

Gross fixed capital formation by general government, 2013 to 2018



Source: Stability Programme, own calculations

Germany's national debt is set to fall by 10 percentage points, from 78 to 68 % of the country's GDP, in only four years leading up to 2018, if all of the requirements of the national debt brake and the European Stability Pact are applied to the letter. This forecast is based on average annual nominal growth of 3 % (1.5 % real growth plus inflation of 1.5 %) – the same assumptions used by the German federal government for its official 2014 Stability Programme.

The government itself is aiming to exceed the requirements of the debt regulations by 1 % of GDP, by budgeting for a financing surplus of 0.5 % of GDP, while the medium-term objective of the fiscal compact allows for a deficit of the same amount. Under these conditions, the country's debt ratio will be reduced by a further 3 percentage points to 65 % of GDP by 2018 – a relatively inconsequential amount when it comes to the sustainability of government finances. This means that Germany is starting to reduce its debts earlier and more rapidly than any other large euro zone country, exerting even more downward pressure on long-term interest rates.

The International Monetary Fund (IMF) recently advised Germany to abandon its planned surplus and invest its fiscal space in the expansion and maintenance of its infrastructure.[1] The federal government and municipal authorities could invest around EUR 150 billion (5 % of GDP) more than currently planned by 2018 without violating the debt regulations.[2]

According to the Stability Programme, most of the structural surplus is to be generated by the municipal authorities over the next few years, and most likely by those authorities that already are in good financial condition. However, there tends to be more of an investment backlog in the municipalities with the highest levels of debt. In order to avoid putting even more of a strain on those municipal authorities' budgets while still making use of the available fiscal space, the federal government could opt to follow the "adjustment path" provided for by the legislation governing the debt brake in 2014/15. This path allows federal budget deficits of up to 1 % of GDP (2014) or 0.66 % of GDP (2015).

There is little need for correction if growth or inflation turn out to be weaker than anticipated. In the event that deficit targets are not met, the debt brake provides for a "control account" that must be balanced within a short period of time if it goes into the red. Unexpectedly favourable interest rates have resulted in this account accumulating a positive balance of more than 3 % of GDP since 2011. This surplus can be used until 2015 (the end of the transition period) in the event of unexpected economic downturns. The balance of the account will then be set to zero in order to start the regular application of the debt brake with a balanced account at a federal level from 2016 onwards.

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[1] See http://www.imf.org/external/np/ms/2014/051914.htm, item 3.

[2] This is calculated on the basis of the German federal government's medium-term financial planning as presented in its 2014 Stability Programme, which is to be officially submitted to the European Commission every April as part of the European Semester. The fiscal space available to general government – amounting to 1 % of GDP – stems from the difference between the planned structural surplus of 0.5 % of GDP over the planning horizon, which is being projected to be generated mainly by the federal government and municipal authorities, and the structural deficit (also amounting to 0.5 % of GDP) allowed by the fiscal compact, which is broken down to the federal government (0.35 % of GDP in accordance with the requirements of the debt brake) and the municipal authorities (0.15 % of GDP). The federal states and the social security system are not allowed to generate any structural deficits in the medium term. The calculation also takes into account additional, specific regulations of the act implementing article 115 of the German Constitution as well as the fiscal compact (for example, the "1/20 rule"). The positive knock-on effects of the additional investment on growth have been disregarded due to uncertainty regarding their extent.

Arguments in favour of increased investment include:

- Low interest rates. Social and economic returns are likely to be much higher than the financing costs for the vast majority of projects. Many projects have an economic benefit, for example renovating the energy infrastructure of government buildings.
- Public spending on investment has been below the level of depreciation since 2003, mainly due to low levels of investment on the part of municipal authorities.
- Germany is falling behind by international standards. Even in other industrialised countries where the population is set to fall due to ageing, annual government spending is still between 1.5 and 2 points higher as a percentage of GDP than in Germany.
- Savers are looking for a secure investment. German citizens want to save an additional EUR 150 billion or thereabouts every year. However, since the corporate sector is also accumulating financial assets on balance in Germany, this wealth is mainly being invested outside the country. This means that it does not contribute to increase the capital stock in Germany.

In order to succeed in the long term, a public investment programme requires the correct planning of maintenance costs in future budgets as well as the creation of reserves for eventual replacement investment.

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About the *KfW-Investment Barometer*:

The KfW-Investment Barometer is a quarterly series of indicators relating to the three main components of gross fixed capital formation: corporate investment, public investment and private residential construction.

This breakdown is not part of the standard programme for the national accounts prepared by the German Statistical Office, but rather calculated exclusively by KfW on the basis of those accounts by grouping the individual elements of gross fixed capital formation differently. Corporate investment comprises all investment carried out by the private sector in machinery and equipment, commercial construction and other assets. All public investment is excluded and summarised in its own grouping, as is private residential construction.

Of the four editions of the KfW-Investment Barometer published each year, two look at corporate investment (in spring and autumn), one deals with public investment (summer) and the final edition is about private residential construction (winter). These are published in March, June, September and December respectively.