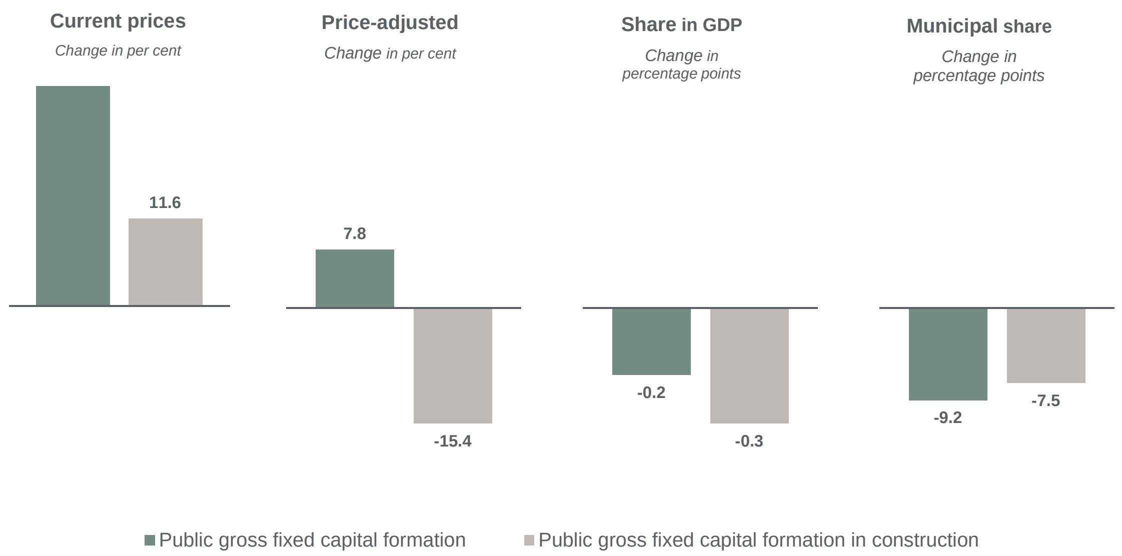
Frankfurt, 21 October 2015

KfW Investment Barometer Germany: October 2015

Public investment: trend reversal not before 2016

- ***The long-term negative trend continues – public investment is down again in the first half of 2015***
- ***However, the course is set for a reversal with first tangible increases since 2011 expected for 2016***
- ***The long-term decline in investment is particularly dramatic in the municipalities, which bear a large portion of infrastructure investment***

Development of public investment since 2000



Source: Destatis, KfW Research

Public investment down again in the first half of 2015

The figures for the first half of 2015 do not yet reflect the decision to expand public investment activity. In the second quarter of 2015, government gross fixed capital formation – adjusted for price, seasonal and calendar effects – fell by 2.4 % on the previous quarter, after already falling minimally in the first quarter (-0.1 %). It was already negative across the year 2014 (-1.6 %) and in all of 2012 (-1.2 %), with 2013 being the only one of the last three years when the national accounts recorded a moderate increase of +0.3 %. The last time government investment increased significantly was in 2011 (+1.4 %).

It will probably not be before the second half of the year that the decision to increase public investment will be reflected in rising figures. However, whether this will ultimately be sufficient to bring the result for 2015 into positive territory after the weak first half-year is quite doubtful.

The long-term negative trend continues

It is true that public investment calculated at current prices ('in nominal terms') has risen by almost 30 % since the turn of the millennium to around EUR 63 billion today (annual period from the third quarter of 2014 to the second quarter of 2015). However, the following is also true (see Figure):

- The nominal increase **conceals the variation in capital goods prices**, which should not be ignored in spite of the long period of low inflation rates. In price-adjusted ('real') terms, the increase in public investment falls to a mere 7.8 % over the very long period of 15 years.
- **The overall economy has also grown** over this period, requiring public services to be adapted accordingly. Gross domestic product (GDP) has increased by nearly 18 % since the year 2000. Proportionally, the share of public investment in GDP has since dropped by 0.2 percentage points. That looks like a small figure but this impression is deceptive when we consider that overall public investment amounts to just 2.1 % of GDP.
- Fixed capital formation in the core area of **public sector construction is even weaker still**. The moderate real growth of public investment since the year 2000 has been sustained only by higher fixed capital formation in machinery and equipment (that is, industrial and business equipment, vehicles, plant and machinery, including military weapon systems: +34 %) and in what are known as other products (+70 %). The latter in particular are a real silver lining as it includes, above all, investment in research and development, which is of enormous importance for Germany's growth potential. Public sector construction, in contrast, which at 56 % accounts for more than half of public investment, is today 15.4 % lower in real terms than in the year 2000.

The turn of the millennium serves as a point of reference for these comparisons not only because it marks the beginning of the age of the euro and, thus, the starting point of the current 'rules of play' of economic policy. It is also a good point of reference for comparing trends in the construction sector in particular because the construction boom brought about by German unification had largely subsided again by then.

Focus on municipal investment in construction

Public fixed capital formation in construction includes buildings such as schools and administrative buildings. However, civil engineering works – roads, railroads, bridges, tunnels, waterways, port facilities, airports and similar works – take the lion's share of around two thirds. While the other government levels combined (federal, *Länder*, social security funds) increased investment in construction by nearly 35 % between 2000 and 2014 *in current prices*, municipal investment in construction actually fell in nominal terms (-1.2 %) over the same period – although it has recovered in the last two years. The municipalities' share in public investment in construction subsequently dropped by 7.5 percentage points to just under

55 %. At municipal level, the primary investment needs lie in transport and education and in towns with weak budgetary performance.

Policymakers are responding, with the refugee crisis creating further growing needs

Policymakers have recognised the need for action and taken steps in the right direction. For the years 2016 to 2018, the federal government is planning additional investment in transport infrastructure, energy efficiency, high-speed internet and urban renewal and development under its EUR 10 billion investment programme, or roughly 0.1 % of GDP per year. It has also announced a number of measures that are intended to ease the financial burden on municipalities and free up funds for investment:

- EUR 1 billion is to be provided for child daycare in the current year and a further EUR 1.5 billion from 2017.
- The federal government will contribute another EUR 1.5 billion to the municipalities by offsetting a larger part of their spending on accommodation and heating costs for recipients of Hartz-IV social benefits and by allocating to them a higher share of turnover tax.
- EUR 3.5 billion will be provided specifically to structurally weak municipalities through the municipal investment promotion fund for the years 2015 to 2018.
- As part of the assistance for asylum seekers, the federal government will contribute EUR 670 per month for each asylum seeker (which corresponds to EUR 6.5 billion a year for 800,000 asylum seekers). A further EUR 350 million is available for unaccompanied minor refugees.
- A further EUR 0.5 billion will be made available annually for social housing construction (2016–2019).

These measures are important even if, from a macroeconomic perspective, this financial boost given to the municipalities by the federal government (around 0.3 % of GDP per year) initially represents a mere redistribution of government funds within the public sector – and also finances consumption expenditure to a significant extent. In the short term and in a focused manner, they improve the financial position of precisely the government level that reduced its investment expenditure most of all in the past years, including under the pressure of increasing social costs.

Just as important are sustainable state and municipal finances in the long term, so that new or modernised infrastructure can be operated and maintained. The reform of the fiscal relations between the federal government and the state governments, which is to be completed by the end of 2019, can make a valuable contribution to achieving this. We expect the investment needs for housing and integrating those refugees who are allowed to remain in Germany to further increase in the coming years, especially in the municipalities. Local administrations, particularly the building authorities, must have the capacity to meet this challenge. This is where further action is needed because the planning capacity of municipalities, measured by the number of personnel assigned to ‘construction and housing’, has fallen by almost 10 % in the past three years.

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About the *KfW Investment Barometer*. The KfW Investment Barometer is a quarterly reporting format 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 Federal Statistical Office, but rather KfW uses a separate classification system that is consistent with the national accounts. Corporate investment comprises all investment carried out by the private sector in machinery, commercial construction and other assets (including intellectual property such as research and development as well as software). All investment in the public sector is summarised in its own grouping, as is private residential construction. The KfW Investment Barometer looks in detail at the three components for three of the issues and the fourth issue is reserved for the overall synopsis.