Market Commentary

Will German Election Outcome Boost Infrastructure Spending in Germany?

Highlights:

- The increasing infrastructure spending gap was heavily discussed in the general election campaigns. On September 24 Germany held a General Election as the last country in Europe this year. Besides many other topics in discussion before the election, the declining infrastructure quality and the increasing infrastructure spending gap was one of the topics which received most attention.
- Difficult coalition negotiations with new collation partners will take time. The new German government will probably consist of a three-party coalition. Especially the smaller coalition partners have contrary opinions on many infrastructure sectors. Therefore any negotiation of a new coalition contract will be quite difficult. The need to find sustainable compromises amongst all partners will not support a clear strategic focus or any major shift in infrastructure spending.
- Constitution debt limit remains limiting factor. The most limiting factor for a substantial increase in infrastructure spending is coming from the German constitutional debt limit.
- Infrastructure spending gap will remain. We do not expect a significant boost of infrastructure spending in Germany in the short-term. But we anticipate, that the coalition partners will agree on some relevant non-monetary items that will help to improve infrastructure investment efficiency as well as planning security and support the integration of more private investment in public infrastructure.

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1. Declining infrastructure investments in Germany

Germany's infrastructure is one of the best in the world. In the WEF Global Competitiveness Report 2016-2017, its infrastructure ranked 8th just behind France, but before the UK (9th) and the US (11th). However, the country is falling behind in this area. In the 2009-2010 Competiveness Report, its infrastructure came in first. The decline is in particular noticeable in the quality of road infrastructure. It tumbled from the 5th position in the 2009-2010 report to the 16th place in the latest.

The reason for Germany's relative decline is the lack of investment spending on infrastructure. Following the reunification-related investment boom in the early 1990s, public capital spending has settled at around 2.2% of GDP. This is one of the lowest in the EU. For example, in France, public investment amounted to 3.5% in 2015.[1] Moreover, the increase in the public investment rate elsewhere in Europe in the run-up to the financial crisis was related to the boom in real estate prices. The differences have clearly narrowed in the aftermath of the crisis.

Germany's modest capital spending is hardly enough to compensate for the depreciation of the capital stock. Since 2013, net investment, i.e. gross investment minus depreciation, has been even negative.

In Germany, investment spending by municipalities, which carry out more than 60% of all public investment, has particularly come under pressure. It dropped from 17% of their total expenditure in 1995 to only 9.7% in 2015. This is largely a result of the expansion of municipalities' responsibilities in the area of social security. Between 2002 and 2010, municipal social spending doubled according to the national statistical office. The Federal government has taken measures to reduce the financial pressure on the local authorities, such as taking on the costs of the old-age basic pension. Also outsourcing, for example, in the field of waste management, has played a crucial role. Net capital spending has been in negative territory.

In particular financially-weak municipalities have been cutting back on capital spending. On average, municipalities with a budget deficit invest one third less than those with a balanced budget or a surplus. Local authorities in the wealthier States such as Bavaria and Baden-Württemberg invest considerably more than in the poorer ones. Besides, the tasks for the municipalities were increasing but the revenues were not completely adjusted in the last 10 years, although there is no one-to-one relationship between revenue allocation and infrastructure construction responsibilities. In addition, municipal projects are often not undertaken or start with a certain delay because of uncertainty concerning the division of costs between the state and the municipality, and lack of administrative capacity for the planning and implementation.

As a result of weak investment, the local authorities' fixed assets decreased according to the national statistical office by EUR 60bn between 2003 and 2015 and the total observed backlog – which amounted to over EUR 130Bn - increased. Maintaining the capital stock at the same level requires a permanent increase in spending by at least EUR 4Bn. In order to reduce the backlog, the additional investment would need to rise to close to EUR 8Bn.

Public investment in Germany is likely to come under increased pressure in the coming years because of the application of the so-called debt brake ("Schuldenbremse"). This policy instrument requires structural balanced budgets at national and State level, in accordance with the European Stability and Growth Pact. The debt brake came into force at the national level in 2016 and from 2020, structural deficits will be forbidden for the States. As the States may not borrow anymore for structural purposes, they may have to reduce their investment spending by about EUR 20Bn. This is already affecting their investment spending. Certain States have even renounced tapping federal or European investment funds because they are unable to contribute their share in the co-financing arrangements.

The policy goes against the recommendations of the international organisations, such as the IMF and the OECD. They have called on Germany to step up public investment, as this would not only stimulate demand in the near term, but would also improve the growth potential of the economy. Moreover, a temporary fiscal stimulus in Germany could support growth in the rest of the Eurozone and reduce Germany's current account surplus. But, the outgoing German government is extremely reluctant to heed this advice, preferring to stick to the tight budget policy and to use the budget surplus primarily for debt reduction.

2. Infrastructure spending gaps continue to grow with simultaneous regional shifts

Germany is in good company with that situation in which past infrastructure spending has not been enough to meet today's requirements. That is likely true for many countries. And if current rates are maintained, these gaps will continue to grow. Having noticed the problem, the European Commission has proposed an ambitious infrastructure investment programme, known as the "Juncker Plan", to provide a total of €500 billion of investments by 2020. However, the plan is not sufficient to fill the infrastructure spending gaps in Europe. We believe that most countries will need to invest by far more simply to keep pace with economic growth forecasts.

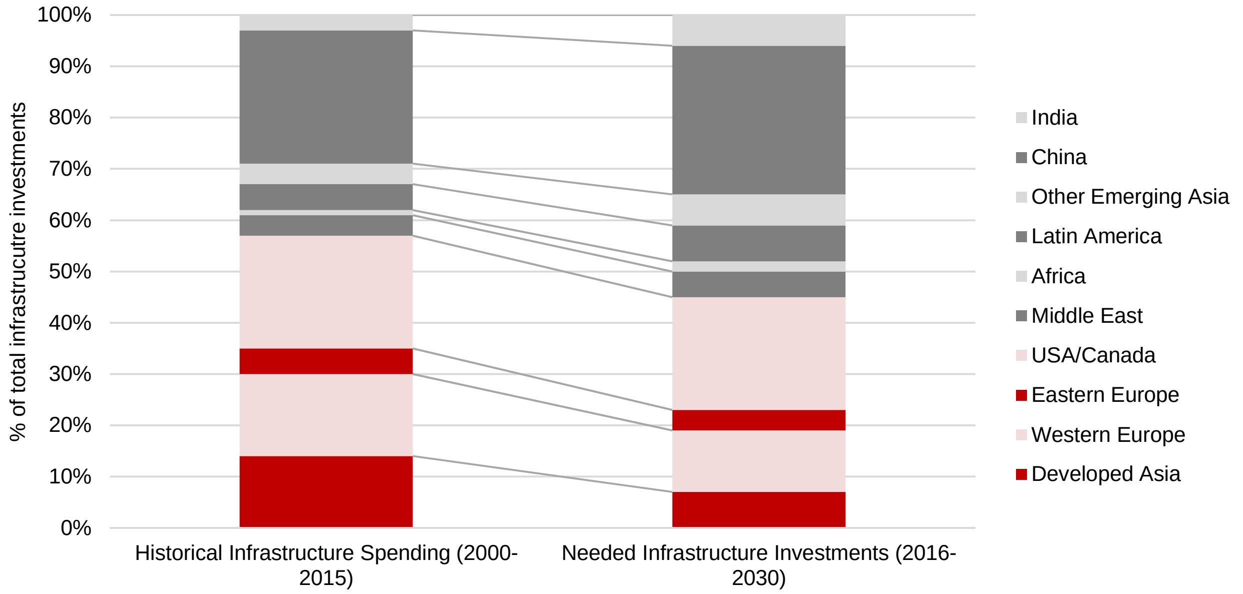
[1] The infrastructure spending gap can be partly attributed to differences in definitions.

If current investment rates remain unchanged, many countries will fall far short of projected needs. To many years of chronic underinvestment in critical areas such as transportation, water treatment, and power grids will have a long-term negative impact on wealth creation capability. If these gaps continue to grow, they could considerably erode future growth potential and productivity. According to international studies, baseline needs already exceed investment by around 0.4% of global GDP, or some USD 350-370Bn annually. In cumulative terms, the gap totals over USD 5Tn globally across the entire period from 2016 to 2030. Many of the world's largest economies, emerging and developed alike, are on trajectories that will produce notable shortfalls.

Additionally, these needs are highly sensitive to growth rates since economic activity increases demand on infrastructure assets as well as generating the funding required to build them. While it is possible for governments to decrease infrastructure investment and maintain economic growth for a certain period of time, this pattern could create a drag on growth in the future; a scenario that is now likely to unfold in some countries.

A comparison of historical infrastructure spending with estimated infrastructure investment needs shows this sensitivity. As a result Western Europe's share of infrastructure investments (even though these investments will grow in nominal terms) will decline as the economic growth relative to other regions can be estimated to be less.

Ex. 1 Infrastructure Investment Shift towards Emerging Markets

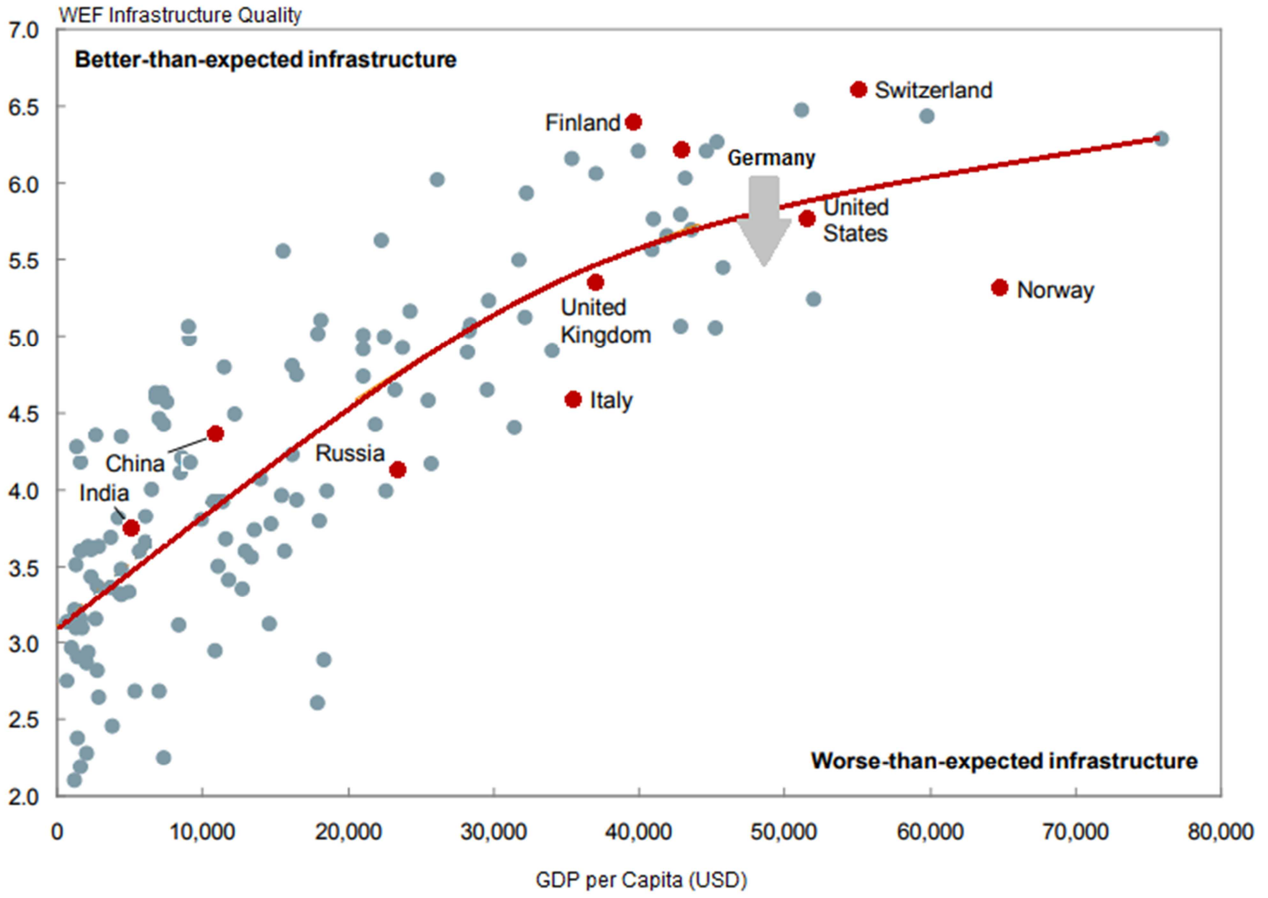


Source: HIS Global Insight, ITF, GWI, National Statistics, Dagong Global.

Therefore, in the next 15 years around two thirds of the investment need will be in emerging economies. Until the end of that period, the infrastructure investment share of regions declining in relative terms (Western/Eastern Europe, Developed Asia and USA/Canada) will have dropped to ca. 45% of the total infrastructure investment respectively.

Finally, infrastructure quality strongly correlates to income level, and many countries typically described as having particularly weak or strong infrastructure seem to be, in fact, simply very poor or very rich. It is instructive to look instead at which economies stand out relative to their income level.

Ex. 2 Infrastructure Quality compared to GDP per Capita



Source: World Economic Forum, World Bank, Dagong Global.

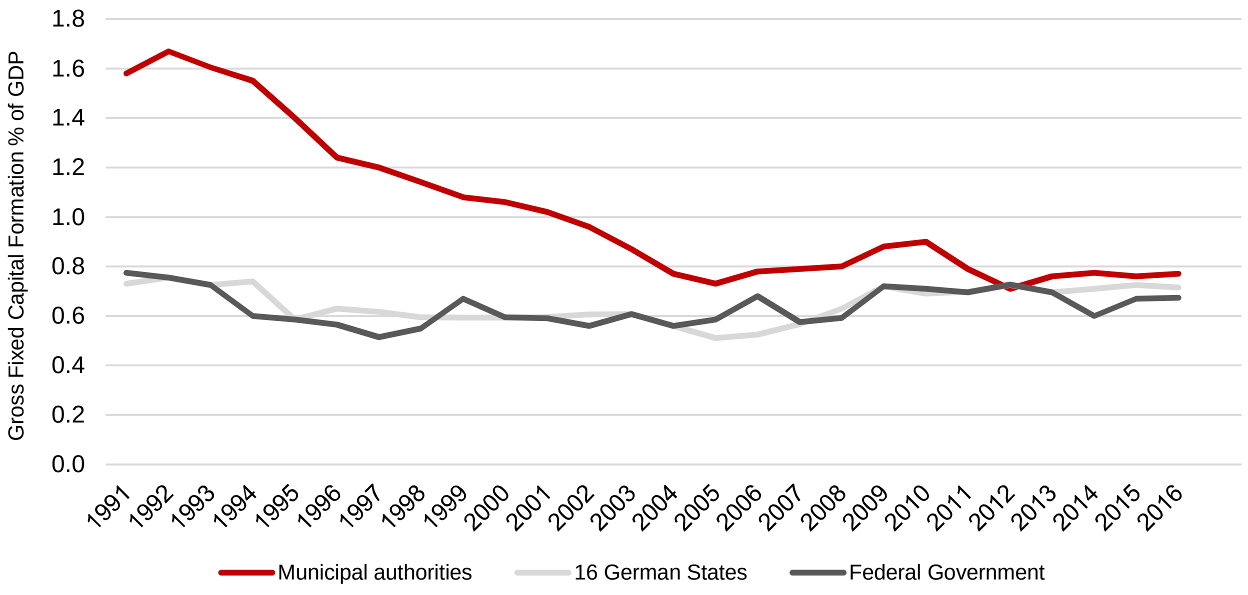
Switzerland, for instance, has the highest-quality infrastructure in the world; it outperforms even among other very high-income peer economies. In contrast, for example, Norway "underperforms." The country has very good infrastructure, but its road network in particular does not attain the quality rating that would be expected for a country at such a high income level (an issue that might relate to the fact that it is thinly populated and has difficult topography). Some countries that have reputations for poor infrastructure are still at very low income levels despite expectations of growth (e.g. India, Indonesia). Considering their actual GDP per capita, their infrastructure is better than might be expected. Historic underinvestment and chronic inefficiency in infrastructure builds have left other countries significantly underperforming relative to its income level (e.g. Brazil). By contrast, certain very low-income economies have surprisingly solid infrastructure for their stage of economic development, and they might provide templates for other countries to follow.

The fact, that in many economies, underinvestment is quite visible in the shortcomings of basic systems, others manage to sustain high quality standards despite relatively low investment, and still others invest heavily but nevertheless wind up with subpar infrastructure quality, suggests significant differences in the productivity of spending, social prioritisation and political support.

Looking at the situation dynamically over time, the curve representing the GDP per capita corresponding infrastructure quality (see exhibit 2) tends to shift upward as more and more countries build out infrastructure systems, even though individual countries do not necessarily move along the same line. But infrastructure quality rankings actually declined since the 2008/09 financial crisis for some countries, such as the United States and also Germany. Such tales of leaky classrooms and potholed roads, as well as patchy internet, are the flip side of today's wealthy, booming Germany. In the World Economic Forum's global competitiveness survey in 2010-11, Germany ranked 5th in the world for both road and railway quality, and 12th for internet bandwidth. The latest survey ranks it 16th, 11th and 29th respectively.

And this produces an increasing public pressure for the government who is affected and which experiences notable deteriorations of infrastructure quality. The German government is increasingly forced to reduce uncertainty to infrastructure development and to take opportunity of the situation. The German public wants that their government goes ahead, boosts the competitiveness of the domestic infrastructure sectors and the industries that use them now, and finally takes care of a sustainable improvement of the quality of life for the citizens and economizes on infrastructure investments in the long run.

Ex. 3 Gross Fixed Capital Formation



Source: National Statistical Office, Dagong Global.

3. Increasing European criticism on low German public spending

Not only the public in Germany, but also the other European countries look carefully at the German infrastructure gap. An ECB's research paper published in 2016 opined that Germany's investment policy (or the lack thereof) is at fault. The Bank reasons that a shortage of public investment into the country's infrastructure, research and development, and German consumer spending in general is holding back the German economy. However, in a time, where the ECB is keeping interest rates low, it would be much easier for the German government to take on cheap loans - something which it could easily do, since it has a budget surplus and national debt is declining fast - and invest, thereby boosting the domestic economy.

The outcome of the debate between the ECB and the German government is all the more important because Germany has a current account surplus thanks to its strong exports. If these could be replaced partially, the economies of other European countries where those products partly would be produced or assembled would benefit, thus lifting the entire European economy. The ECB's reasoning in this case fits right in with what many economists have been saying for years: that Germany needs to boost all of Europe by "buying European". So far the outgoing German government has resisted pressure to dig into its pockets and boost domestic spending. An increased sustainable infrastructure spending would definitely be a good option to help the European economy as well as to support the maintenance and modernisation of Germany's infrastructure.

4. Substantial scope to increase infrastructure investment

Against that described background and at a time where there is plenty of liquidity in the market, with investors seeking stable long-term returns it should not be an unmanageable task for the German government. Nevertheless, it is not easy to get finance flowing into urgently needed projects sticking to the tight budget policy.

There is - in general - substantial scope to increase public infrastructure investment. The German government could increase funding streams by raising user charges, capturing property value, or selling existing assets and recycling the proceeds for new infrastructure. In addition, public accounting standards could be brought further in line with corporate accounting so infrastructure assets are depreciated over their life cycle rather than adding to deficits during construction. This change could also reduce pro-cyclical public investment behaviour.

Furthermore, in order to attract more private funding of infrastructure the sector requires regulatory certainty and the ability to charge prices that produce an acceptable risk-adjusted return. A possible solution for involving private funding for the infrastructure sector would be the more thorough setting up of public-private partnerships (PPP) and a clear political support of PPPs. Public-private partnerships have already assumed a greater role in infrastructure in Germany, although there is continued controversy about whether they deliver higher efficiency and lower costs (see Berlin International Airport or Stuttgart Main Station). Either way, they will continue to be an important source of financing in the future. But since they account for only below 10% of total investment, they are unlikely to provide the overall solution that will solve the infrastructure funding gap in Germany. And especially in this country for example in the case of motorways, such financial constructions have been met with great resistance in the past, as the population is fiercely opposed to the introduction of tolls for passenger cars. Moreover, many fear that the involvement of private capital in the provision of public goods will result in these goods being subject to profit considerations.

International institutional investors and banks who hold trillions of EUR in assets that could partially support infrastructure projects are still not investing in full speed. Matching these investors with projects requires more advanced project standards as well as solid cross border investment principles and an improved pipeline of really bankable projects for all types of infrastructure and project sizes. Impediments that restrict the flow of financing, from regulatory rulings on investment in infrastructure assets to the partially absence of efficient markets, have to be addressed by the German government.

Finally, beyond ramping up finance, there is another big potential in making the existing and potential infrastructure spending more effective and help to close the gap. Accelerating productivity growth in the construction industry, which has in many respects been neglected in the past and not supported by the politics, might play a larger role in this effort. Additionally, more public support in improving project selection, delivery, and management of existing assets could translate into significant savings that could be used to initiate further infrastructure projects.

5. Does the outcome of the German general election change the situation?

A series of elections and referendums across Europe in 2017 could have plunged the EU into chaos as a wave of populism sweeps the continent. The Brexit vote and the Trump victory in the US have fuelled a wave of anti-establishment sentiment that could have seen several key elections won by right-wing populist parties. Finally, politicians such as France’s Marine Le Pen and the Netherlands’ Geert Wilders did not manage to win power. Nevertheless, after decades of a liberal world order, these right-wing parties could still put an end to multiculturalism and open immigration in Europe and change the way of the European Union as well as the European economy.

On Sunday September 24, German citizens headed to the polls to elect their new government in the last in the string of pivotal national elections to be held across Europe this year. Besides the immigration policy, another crucial topic in the pre-election public discussion was the current quality of Germany’s infrastructure (especially, roads, bridges, railways, schools) and the presumed spending gap. Public support for German Chancellor Merkel was quite stable, according to the number of opinion polls, provided in the previous months. But there was growing uncertainty on her continued reign and the potential composition of her coalition ahead of the country's national elections.

In order to understand, how political decisions might change after this election, you have to understand the German electoral system. The complex nature of Germany's electoral system means that it is highly unlikely for a single party to secure a parliamentary majority. This means that a coalition deal must be struck with two or more parties. Germany has a multi-party system made up of two large parties, three smaller parties and a number of minor parties. Traditionally, power has either been held by the Christian Democratic Union (CDU) plus its sister Christian Social Union (CSU) party, or the Social Democratic Party (SPD).

This year, however, smaller parties which pass the constitutional 5% hurdle could play a crucial role. They will definitely have bargaining power in the coalition negotiation, as they will help the large party obtain the needed majority to form the new government.

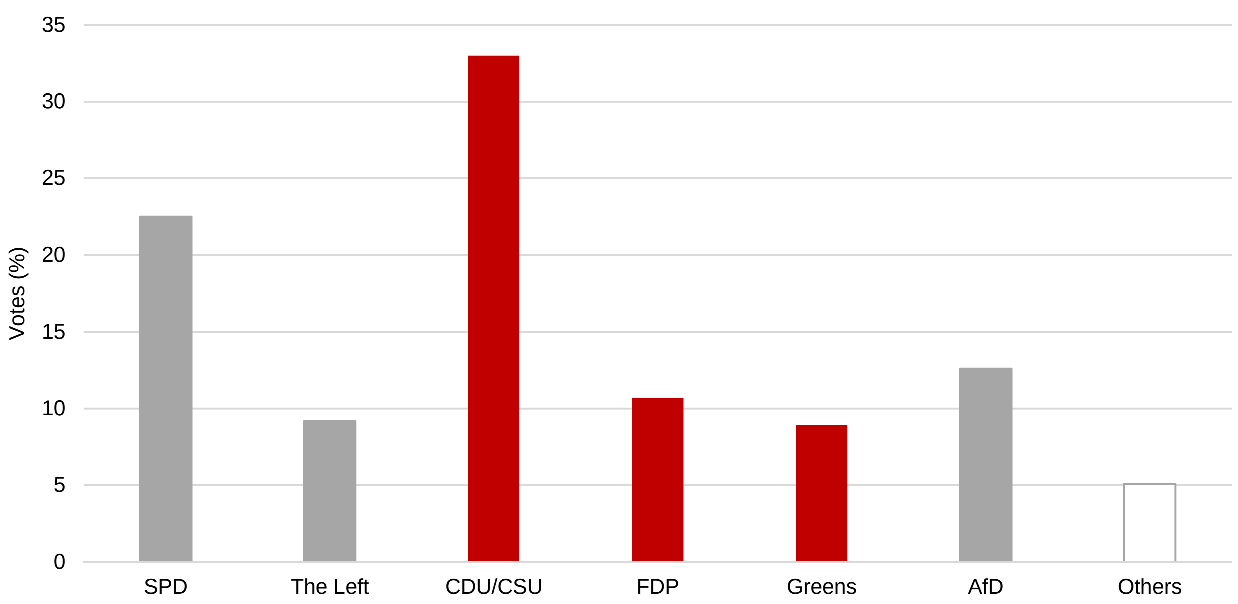
Finally, Merkel is set for a fourth term as Germany’s chancellor after her centre right CDU/CSU won a projected 33% of the vote in the elections, making it the largest party in the parliament with an estimated 218 seats. The CDU/CSU’s score, sharply down on the 41% of the vote it collected in the previous 2013 elections, was widely seen as disappointing and is likely to leave Merkel diminished on the domestic political stage. Her main rivals and outgoing coalition partners, Schulz’s Social Democrats (SPD), crashed to just over 20% and a projected 138 seats. Shortly after the results had been published Schulz confirmed that the SPD would not renew its “grand coalition” with the CDU but head into opposition.

The far-right, anti-immigration, Anti-European Union AfD made a historic breakthrough, winning 13.5% of the vote and a projected 87 seats and becoming the first overtly nationalist party to sit in the parliament in 60 years. The party’s performance marks a major shift in Germany’s post-war politics that is likely to produce a very different tone and dynamic inside the parliament.

6. Only one potential coalition

The SPD's decision to become the official parliamentary opposition leaves the only feasible coalition for Merkel a three-party tie up between the CDU/CSU, the pro-business FDP party who scored 10%, and the Greens, who won 9%: the so-called black-yellow-green, a Jamaica coalition, which has worked at state level but never been tried in federal government.

Ex.4 Preliminary Official Results from Germany's General Election



Source: Federal Election Commissioner.

This collation will prove tricky to negotiate. This three-party alliance would meld the Green's liberal-leaning stance with the FDP's business-friendly policies. Historically such a combination seemed almost impossible given their differences on economic and social policy. Therefore, we think that this deal will force Merkel to make significant concessions. The FDP has partnered with the CSU/CDU in the past and has enjoyed little influence in many policies, finding them instead dominated by a CDU/CSU appointed chancellor and finance minister.

As CDU/CSU are still in power, there will be kind of political continuity. On the other hand, more partners in a governing coalition means that more political compromises will have to be made and decision processes will tend to need more time. The macroeconomic outlook will not change. However, complex structural reforms will have to be done in the upcoming 4 years to secure Germany's competitive position. How big an economic stimulus will be, if the business-friendly FDP and the ecologic party the Greens are both in the government, is unclear at the moment and depends heavily on the outcome of the coalition negotiation that starts probably mid of October.

Nevertheless, it is worth to mention, that comparing the likely policies of a coalition of CDU/CSU, FDP and the Greens with a left-wing coalition led by the SPD would have shown even more significant differences in many policy areas including the long-time neglected infrastructure need in Germany like in many European countries.

7. Different focus on infrastructure

If you compare the recent election or government programmes of the three potential coalition partners you will easily recognise the different views on the infrastructure need and the focus for the upcoming negotiation of the coalition contract. But none of these programmes contains a list of concrete infrastructure areas and related additional spending.

As big people's parties and already having governed for 12 consecutive years the election programmes of the both sister parties CDU/CSU were to the greatest possible extent balanced and tried not to exclude or overemphasise major political topics and were almost free of any extreme ideological orientation. Among many other things (e.g. modest tax cuts, regarding security, upper limit of refugees, unemployment goal), the CDU/CSU was pledging greater infrastructure spending. In sum, an extract of the key words regarding infrastructure in the CDU/CSU so-called government programme 2017-2021 is - although with a low degree of concretisation - as follows:

- Digitalisation (e.g. dealing with authorities)
- Broadband expansion and modernization of high-speed internet access

- Promotion of the 5G-mobile network
- Modernisation and expansion of the transport infrastructure and interconnection of transport systems
- Facilitation of planning and implementation of Infrastructure projects as well as the retrieval of funding.
- Reduce duration of infrastructure planning procedures through de-bureaucratization (e.g. for replacement constructions)
- No general speed limit for German motorways
- More investment in noise prevention and protection (especially railways and motorways with establishment of noise-protection walls and the use of silent asphalt)
- Needs-based expansion and modernisation of the parking offer for trucks on Federal Highways
- Modernisation and digitalisation of harbours and public transport
- Expansion of intelligent traffic guidance and control systems
- Modernize rail infrastructure and accelerate the electrification of smaller railway sections, promotion of accessibility at railway stations
- Integration of renewables, grid expansion and removal of net infrastructure bottlenecks
- Promotion of sufficient and affordable living space in good quality
- Promotion of the energetic building renovation for tax purposes and thereby creating additional incentives
- Support of schools, kindergartens, hospitals and care homes and the integration of different forms of healthcare service provider

The business-friendly Free Democratic Party (FDP), also known as the liberals, has previously partnered up with Merkel but found itself losing voter support when, in 2009, its campaign pledges of generous tax cuts were torpedoed by the more dominant CDU. Nonetheless, deep tax cuts remain front and centre of the FDP's policies, alongside cutting regulation and investing in the modernization of Germany's economy and infrastructure. Regarding infrastructure the FDP mentioned the following topics in their election programme:

- Increase of federal investments in transport infrastructure
- Optimisation of planning for important transportation infrastructure projects
- No introduction of a car toll
- Contemporary legal framework for modern infrastructure operation/business models
- Broader investment opportunities for institutional investors
- Simplify the use of residential living space
- Modernise Public Transport Act
- Free access to international finance and capital markets
- Ensure efficient and high-performance infrastructure, harbours and airports
- PPP in the transportation sector
- Railway net infrastructure of German Railway to become independent
- Expansion of intelligent traffic guidance and control systems
- Digitalisation of transport infrastructure
- IPO for operating company of the German railway (Deutsche Bahn)
- No general speed limit for German motorways
- Autonomous driving as chance for self-determined mobility

The environmentalist Green party has found support amongst Germany's metropolitan voters and found itself an appealing coalition partner for either the CDU/CSU or the SPD. It focuses on ecological, economic and social sustainability and is promoting greater infrastructure spending over tax cuts. According to their pre-election publications cornerstones of the Greens' infrastructure goals to be considered in the coalition contract are the following:

- Promotion of climate protection/renewable energy and exit from coal-fired power plants
- Promotion of bike-friendly inner-urban infrastructure and E-Mobility including charging infrastructure
- Speed up of fast internet/broadband
- Social Housing Promotion
- School refurbishment program, set-up of all-day schools and a modernization program for university facilities

8. No great encouragement or shift to be expected

What does this result finally mean for the amount and direction of infrastructure spending in Germany and for a greater impetus for the infrastructure sector in Europe as a whole?

To outsiders, Germany can seem like a well-oiled machine. But its reputation as a paragon of efficiency obscures the fact that many roads, bridges and public buildings are in shocking disrepair. Starved of investment for years, a lot of infrastructure is slowly crumbling. Irrespective of the fact, that the issue of Germany's crumbling infrastructure has taken centre stage in campaigning for the election we believe that there will no overall notable increase in infrastructure spending in the medium term. This is mainly because of the country's constitutional debt limit and the complex and lengthy approval process for infrastructure projects. The "debt brake", enshrined in Germany's Basic Law and the state constitutions since 2009, stipulates that the federal government is only permitted to take up new, long-term debt amounting to 0.35% of GDP, while a general prohibition on new borrowing will apply to the states. This effectively does not allow to enter into significant new debt, even if Germany should be taking on some new debt to invest in ageing infrastructure.

Precisely during the financial crisis German politicians found it easier to cut long-term outlays than current spending. Hence, the debt limit today is neither smart nor timely. It isn't smart, because the upper limit of the allowable structural deficit is too low. Even with only moderate nominal growth, the rule leads to a continuous decline in the debt ratio, which is tending towards 0.35%. It isn't timely, because of the favourable budget surplus.

We think, that this underside of Germany's economic miracle will possibly remain: a country with a high budget surplus (EUR 23.7bn or 0.8% of GDP in 2016), with the lowest infrastructure investment rate of any big, rich economy. Therefore, that under-spending will further contribute to the country's excessive savings (and also adding to unbalance global trade).

Some people might ask, why don't German government invest budget surplus in infrastructure? The answer is, the current government has given priority to the debt reduction with budget surplus, and thus has accepted the infrastructure spending gap.

According to a survey this summer, 60% of Germans want the country's budget surplus invested in infrastructure, compared with 19% who want it spent on tax cuts and 17% on reducing state debt. But nevertheless, in the campaign for the national election, politicians clashed over whether to invest the federal budget surplus or to return it in tax cuts. The liberal Free Democratic Party and many in Merkel's Christian Democrats prefer the latter. But we have seen that past tax relief has not fuelled higher investment in Germany; rather it mostly flew in bank accounts. The Greens share our analysis.

Merkel, in contrast to others in her party, seems to prefer a mix of tax cuts and increase of infrastructure investment. But there will not be an increase in the top rate of income tax like the SPD proposed as a means of financing additional infrastructure projects. Merkel mentioned many times, that she believes that the main obstacle to more spending on infrastructure was not the lack of money, but bottlenecks in the planning process. Therefore, we expect, that her new government will concentrate on non-monetary aspects, e.g. speeding up planning procedures, reduce the number of bodies that can appeal against priority projects, changes in the legal framework etc. that will encourage more private investment in public infrastructure. This will definitely help in the medium term, but not provide any major short-term stimulus.

We do not see that a proposal for an "investment obligation" that would require future governments to spend surplus revenues on infrastructure – a cornerstone of the SPD - will be realised by the new government coalition. We also have doubts that the new government will come up with a detailed target-oriented "investment offensive" pouring money on selected infrastructure sectors. It is more likely that the available fiscal space will be used for cautious and limited initiatives that hardly enhance significantly growth potential or lead to a perceptible shift in the overall investment focus. Finally, there will be no significant contribution to a strengthening of the European infrastructure triggered by the German election.

The most interesting infrastructure sectors to look at in the upcoming weeks during the coalition contract negotiations will be energy and utilities and transportation, as in these sectors the ideological distance between the two smaller coalition partners, the Greens and the Liberals, are very obvious and both parties do not want to lose their face. However, as the ruling parties are willing to promote infrastructure construction, we think it's just the scope and the extent of infrastructure constructions that will be different.

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