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## Research Report

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IW-Kurzbericht, No. 37/2019

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# IW-Kurzbericht 37/2019

## The influence of public investment on the German current account surplus

Sonja Jovicic / Galina Kolev

**The current account surplus in Germany has grown rapidly especially since the early 2000s and this development has been widely criticised. One of the recommendations of the European Commission and other institutions is to increase public investment as a means to reduce the current account surplus. Indeed, Germany needs a broad investment programme in the field of infrastructure, digitalisation and education, and considering the low interest rate there cannot be better times for it. However, as the discussion in this paper suggests, public investment can barely be an instrument to target current account balance. Raising public investment by half of the current level is associated with a decrease of the current account surplus by only 1.3 percentage points after ten years and the effect on the deficit of the trading partners is as low as 0.1 percentage points.**

A rise of current account surplus in Germany especially since the early 2000s has increased interest and fostered a comprehensive discussion about the causes of the persistently high current account surplus and its consequences. Some economists and policymakers argue that the current situation is no cause for a major concern (Matthes, 2014; Felbermayr et al., 2017), whereas others emphasise the need to take steps and implement poli-

cies to reduce Germany's high current account surplus. The European Commission, the International Monetary Fund and the Organisation for Economic Co-operation and Development (OECD) are just a few of the institutions that have criticised Germany for its persistent current account surplus.

One of the recommendations made by international institutions is to increase public investment in order to stimulate domestic demand and to tackle the persisting imbalance (European Commission, 2019). Public investment in Germany is well below the OECD average and lies with 2.2 per cent of GDP also below the EU average of 2.8 per cent of GDP. It is a broadly supported view among leading German economists that public investment in Germany should be increased, especially in the field of transport infrastructure, digitalisation, and education. Furthermore, some economists propose a reform of the current fiscal rule in Germany, the debt brake that sets an upper limit for a structural deficit of the federal budget of 0.35 per cent of GDP, in order to achieve more fiscal room for public investment (Bofinger, 2019; Hüther, 2019). Public investment and a tax reform are needed in Germany to increase its attractiveness and raise private investment by both international investors and local companies.

## Simulation results: Effects of public investment on the German current account

Deviation from the baseline (defined as annual growth of public investment of 1.0 % over the next ten years, on average); percentage points; constant prices

	Effect after 5 years	Effect after 10 years
Annual growth of 2.5 %	-0.1	-0.3
Annual growth of 5.0 %	-0.3	-1.0
Annual growth of 7.5 %	-0.6	-1.7
Immediate increase by 50 %	-1.0	-1.3
Immediate increase by 100 %	-2.0	-2.5

Source: German Economic Institute (IW); Oxford Economics

Public investment can have an effect on the development of the current account, both directly and indirectly via increasing attractiveness. There have been several attempts to estimate those effects and the results indicate that increasing public investment by 1 per cent of GDP can indeed reduce the current account in the range of 0.5 percentage points (BMW, 2015) to 0.7 percentage points (Deutsche Bundesbank, 2016).

The present paper investigates the effects of public investment further by assuming five different scenarios for the next ten years. In the first three scenarios public investment increases at a constant rate of 2.5 per cent, 5.0 per cent and 7.5 per cent over ten years. In scenario 4 and 5 an immediate increase of public investment by 50 per cent (amounting to roughly 1 per cent of GDP) and 100 per cent is implemented. Although the increase of 1 per cent of GDP has been investigated by several authors, it has to be stressed out that it is barely possible to implement an investment programme of this size considering the current capacity restraints (Bardt et al., 2017) as well as the slow decision-making process of German policy-makers.

The results presented in the table stem from simulations with the Oxford Economics Global Economic Model. They are broadly related to the simulations presented in Hentze and Kolev (2018). The numbers in the table represent the deviation from the baseline scenario assumed by Oxford Economics, in which public investment grows by 1.0 per cent on average over the next ten years and the current account in Germany decreases from 7.4 per cent of GDP in 2018 to 4.5 per cent of GDP by the end of 2029.

The results indicate that raising growth of public investment to 2.5 per cent per year, meaning that public investment is 28 per cent higher in ten years in constant prices, is associated with a decrease in the current account of only 0.3 percentage points after ten years compared to the baseline. The effect on the current account of trading partners like the US and the Euro area is less than 0.05 percentage points. Raising growth of public investment to 5 per cent can contribute to decreasing the current account by 1.0 percentage points. However, this means an increase of public investment by almost two thirds in ten years and thus, can hardly be implemented

due to both capacity and political restraints. The effect of a public investment growth of 7.5 per cent is related to 1.7 percentage points lower current account surplus. In this case, though, public investment more than doubles in ten years, which is an even more unrealistic assumption.

The effects of an immediate increase of public investment by 50 per cent (100 per cent) are of comparable magnitudes. The current account surplus is by 1.3 (2.5) percentage points lower compared to the baseline. The arguments regarding capacity and political restraints apply here as well as described above. Regarding the development of the current account in other trade partners, in order to have an effect on the trade surplus of around 0.1 percentage points, an increase of public investment by at least 5 per cent per year is necessary in Germany.

The small effects of public investment on the current account are not surprising, since public investment amounts to just above 2 per cent of GDP in Germany. Furthermore, the import content of public investment is with 23 per cent lower compared to the average of aggregate demand (30 per cent, see BMWi, 2015). The results indicate that public investment can hardly be an adequate instrument to target current account balances. Moreover, fiscal policy and public investment in particular are policy instruments with their own specific goals and the current account development cannot be seen as their priority. Nevertheless, public investment in Germany remains low despite above-average growth rates in the past years. Therefore, it is essential to invest in infrastructure, digitalisation and education as well as to create tax incentives to increase spending for research and development in order to secure the future viability of the German economy.

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