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Article

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Strengthen the foundation of the German economy

By Claus Michelsen, Guido Baldi, Marius Clemens, Geraldine Dany-Knedlik, Hella Engerer, Marcel Fratzscher, Stefan Gebauer, Max Hanisch, Simon Junker, Laura Pagenhardt, Malte Rieth, and Thore Schlaak

The German economy remains in a weak phase. After a sharp downtrend of almost one and a half years, industrial production capacities have become underutilized. Initially, this was caused by weak exports—the German economy's specialization in capital goods has become its Achilles' heel due to the current global political environment—but the weakening of the private investment cycle was also a factor. In the meantime, it is domestic orders from Germany in particular that are developing sluggishly.

Countries around the world adjusted their economic policies in response to the slowdown, particularly in the manufacturing sector. As a result, most central banks are operating more expansively. Fiscal policy, too, has responded by increasing expenditure and/or by reducing taxes. As a result, the economic outlook is beginning to brighten. In Germany, the decisions of the Grand Coalition have primarily supported demand from private households and have so far prevented a slide into recession; the stimulus is just under half a percent of GDP. Therefore, DIW Berlin still projects positive growth, albeit at a rather sluggish rate, of 0.5 percent for 2019.

Over the next two years, additional public expenditure will again increase by about half of one percent of GDP. In addition, it is becoming apparent that foreign business will become somewhat more buoyant again, provided the current risks do not worsen further. DIW Berlin expects GDP to grow by 1.2 percent in 2020 and by 1.4 percent in 2021, roughly in line with the growth trend.

Capital goods demand is currently being dampened by the fragile international environment; as a result, the German economy remains in a precarious state. The risks remain that the trade conflicts could escalate or a hard Brexit could occur. So far, this has only affected industry and

related sectors, with private households remaining largely untouched. However, the longer the uncertainty persists, the more likely it is that the labor market will begin to show clearer signs of weakening and that domestic demand will weaken significantly.

However, the fragile international environment is not the only issue. Germany is also being confronted with structural problems; the automotive industry in particular appears to be facing major upheavals. In addition to the technological change, many manufacturers must also tackle the issue of location competitiveness. In the past, above-average wage costs were offset by high productivity and solid infrastructure. However, it is questionable if it will remain this way: over the past few years, some countries have decreased business taxes, thereby increasing the pressure to keep locations competitive. At the same time, location quality has suffered considerably. In addition to a lack of public investment, future needs, for example in digital, social, or transport infrastructure, have been inadequately addressed. These issues are aggravated by the imminent demographic change: a shrinking work force must provide the income for a growing elderly population. Thus, potential growth is set to slow down, from currently 1.5 percent to less than one percent from 2023 onward. This can be countered by expanding and modernizing the capital stock and promoting education and innovation.

In response, budget plans increased investment expenditures substantially. Until 2021, an additional 18 billion euros will be invested in infrastructure, the education system, and decarbonizing the economy. Over the next two years, this investment will cover the additional needs identified; nevertheless, it will not be able to compensate for the lack of investments in the past. Although policy has set the right

course in the short term, there is no long-term plan due to the lack of a nominal increase in the budgetary funds from 2021 onwards. However, such an increase is necessary to encourage companies to invest in expanding their capital stock, which would also benefit economic development in the short term.

A corresponding continuous increase in public investment funds would increase potential growth by an annual average of just under 0.3 percentage points. The government's expenditures will not only increase the public capital stock, but will also stimulate private investment. Moreover, investing in expanding and running all-day schools and daycares could also increase the average amount of hours parents can work. Funds should be invested in material and, above all, human resources, and not in more fee exemptions. Solutions also need to be found for budgets at the local level, as the municipalities are the largest public investors in Germany and their needs are particularly serious.

However, a permanent increase in funds of this magnitude must be financed. The federal budget surplus will be exhausted by 2021. Further additional expenditure

would therefore have to be financed either by reallocating resources in the budget or by planning for higher net borrowing. Currently, the Federal Ministry of Finance is planning on a balanced budget, referred to as a "black zero" (*schwarze Null*). However, this policy is difficult to justify in the current environment. While the Federal Government can borrow at negative interest rates in the long term and the debt brake allows limited borrowing, it seems sensible to discuss further changes in light of the current challenges. It is often suggested that extra budget funds should be utilized to provide higher loan financing, as these would not be a factor in the debt brake. However, this would curtail the Parliament's control over the budget. Reforming the current debt rules, or at the very least adjusting the debt brake to the European stability rules, therefore seems at least worthy of discussion. It would at least be a more transparent approach to overcome the challenges and strengthen the foundations of the German economy in the medium term.

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