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Understanding the differences between German and Italian investment spending

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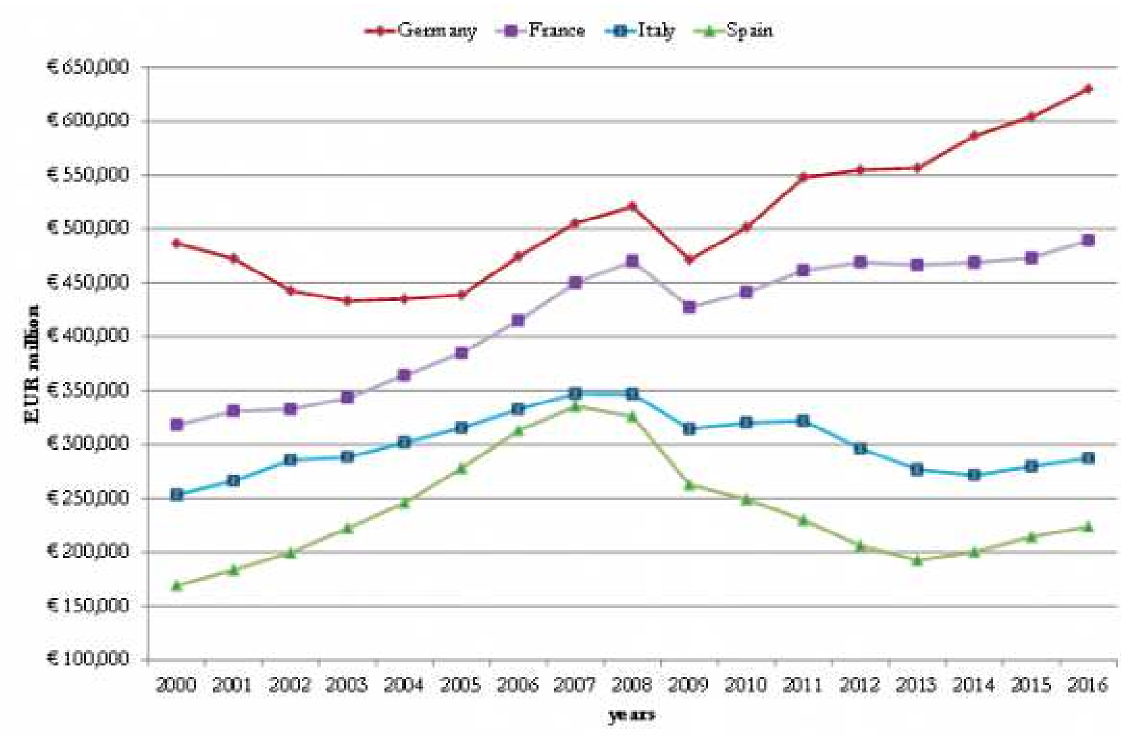
The following guest post on trends in public investment spending is from Marcello Minenna, the head of Quantitative Analysis and Financial Innovation at Consob, the Italian securities regulator. The views expressed here are his personal opinions and do not necessarily reflect the views of Consob.

Investment spending had been rising across Europe until 2008, with capital formation generally rising faster in the poorer countries than in the richer northern ones. This reversed after the crisis hit:



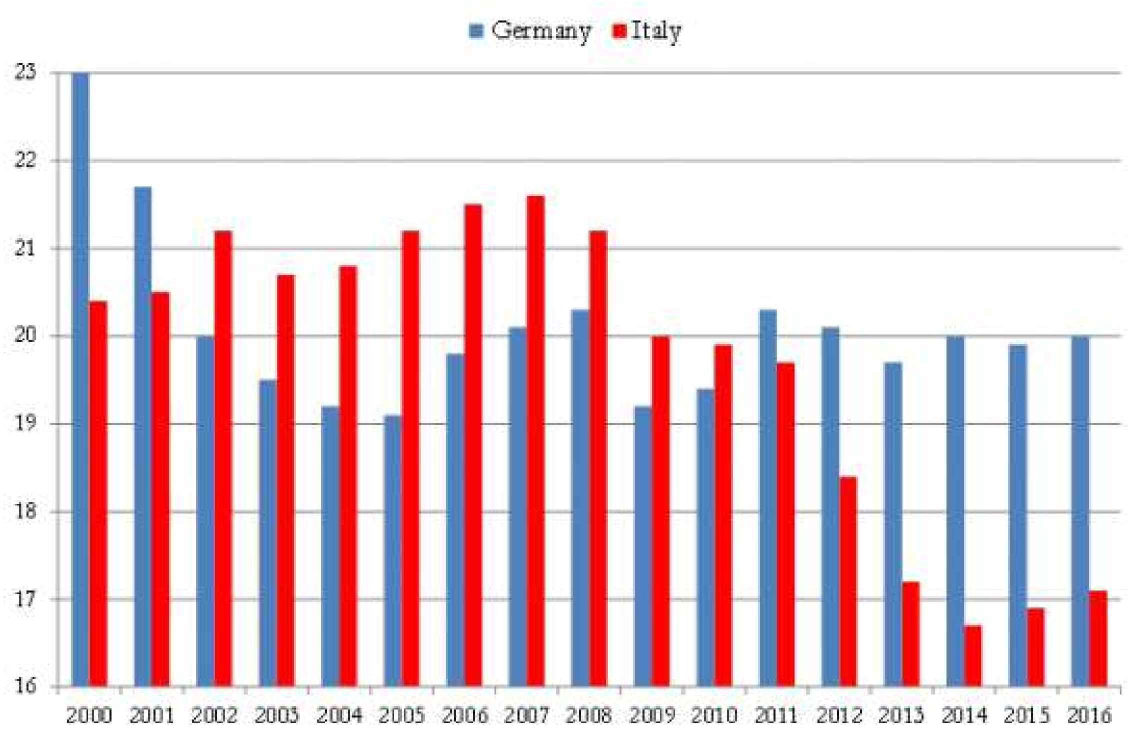
Leaving aside France (soon back on a path of moderate growth) and Spain (which still struggles to return to pre-crisis levels), the difference between spending in Germany and Italy can be considered representative of the impact of measures taken at the national and European level.

In Germany, gross fixed capital formation rebounded as early as 2010. Most of this spending is due to the private sector. Public investment spending was just €70bn in

2017, or only 2.1 per cent of gross domestic product — well below the average for rich countries.

In Italy the picture is completely different. Total investment spending was 17 per cent *lower* in 2016 than in 2008: €287 billion against €347 in 2008.

The chart below compares total investment spending in Germany and Italy as a share of each country's GDP:



German investment spending fell after the end of the reunification boom and the collapse of the tech bubble. Meanwhile, Italians benefited from falling real interest rates in the early years of the single currency. As a result, the investment share of GDP was higher in Italy than in Germany from 2002-2010.

The situation reversed thanks to the progressive deterioration of the Italian data. In 2016, the investment ratio in Germany was around 20 per cent, while in Italy it was just 17.1 per cent — about 4.5 percentage points lower than in 2007.

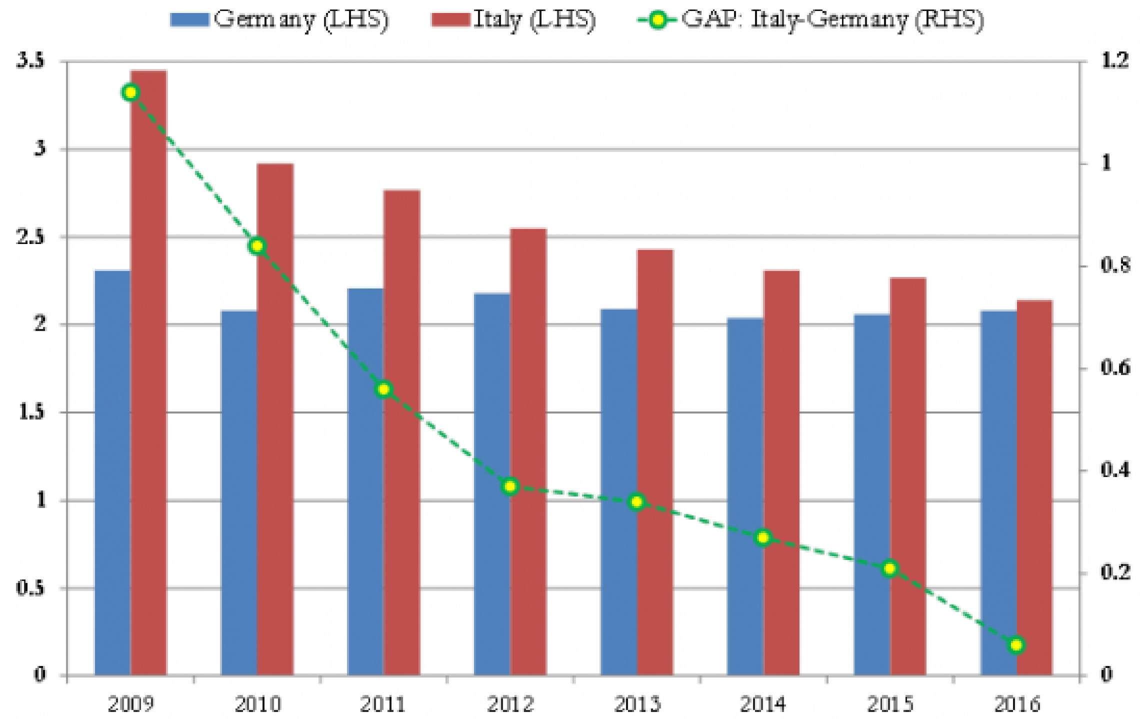
The disappointing performance of investment spending in Italy since 2009 is one of the many faces of that collapse of domestic demand that has also affected imports and consumption.

But the Italian government's priorities in recent years have made matters worse. The state has focused on stimulating consumption at the expense of fixed capital formation. This is despite the fact that public expenditure on infrastructure gives greater impetus to growth both in the short-term and over time.

Admittedly, the investment management abilities of Italian leadership are questionable, and the country has often failed to successfully exploit the narrow margins of maneuver offered by the flexibility clause granted by the European Commission.

The Italian ruling class has managed only to curb the fall of public investment, rather than increase it during the downturn, as standard theory recommends. Despite these efforts, Italian government investment spending was more than 35 per cent lower in 2017 than in 2009.

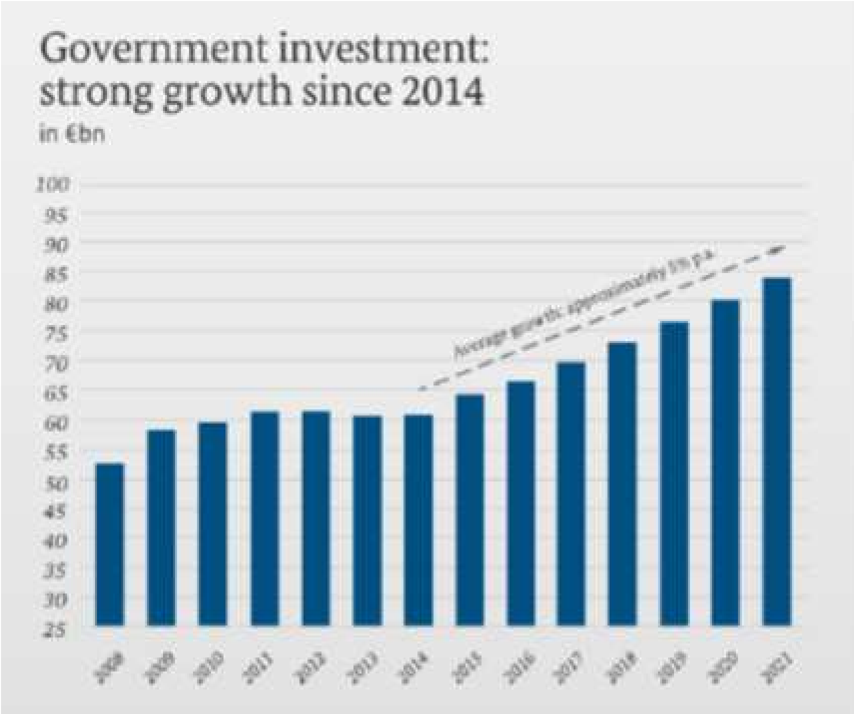
The chart below compares public investment spending in Germany and Italy as a share of each country's output over time, as well as the gap between the two:



From one perspective, Italian government investment spending was "too high" and has since converged to the "benchmark" set by Germany.

There are two problems with this thinking. First, Italy is a poorer country and should be investing more to catch up. Second, the Italian government has been slashing investment at the same time that the economy has been shrinking. German governments may be stingy in their provision of public goods but at least they have been consistent. The Italian government has been actively making things worse in the midst of a downturn.

As it happens, the outlook for German government investment spending is now positive. According to a report released on June 2017 by the German Federal Ministry of Finance, the domestic public sector is "posting solid increases" in investments which are "growing at a faster pace than both total expenditure and nominal GDP". Moreover, the outlook for Germany is quite positive with an expected annual average growth of 5% in the coming years:



The German coalition negotiations suggest the new-found vocation for public investments will continue. Actually, Germany could opt for even larger stimulus as recommended by the International Monetary Fund and the European Commission. Indeed, if one thinks about Germany for itself, the public investment level is still largely subdued and a significant increase would also help making more balanced the country's economy which is experiencing prolonged excessive current account surpluses.

It is much harder to make forecasts for Italy, where the recent election results are an obvious expression of protest against the sacrifices imposed by the strict European rules. Even if the next Italian executive wanted to boost public investment, it would have to do so in a way that respects European constraints that limit fiscal capacity.

The divergence between Germany and Italy will likely continue to increase in the coming years. Such an evolution of gross fixed capital formation in the two countries would make it increasingly difficult to achieve the objectives of shared development and growth, and of the alignment of economic cycles between the different members of the European monetary union.

That's why the ongoing process of Eurozone overhauling cannot ignore the relaunch of investments in peripheral economies, both by taking targeted initiatives at centralized/supranational level and by revising the current fiscal discipline according to a counter-cyclical perspective.

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