Standard Life Investments

Weekly Economic Briefing
Global Overview

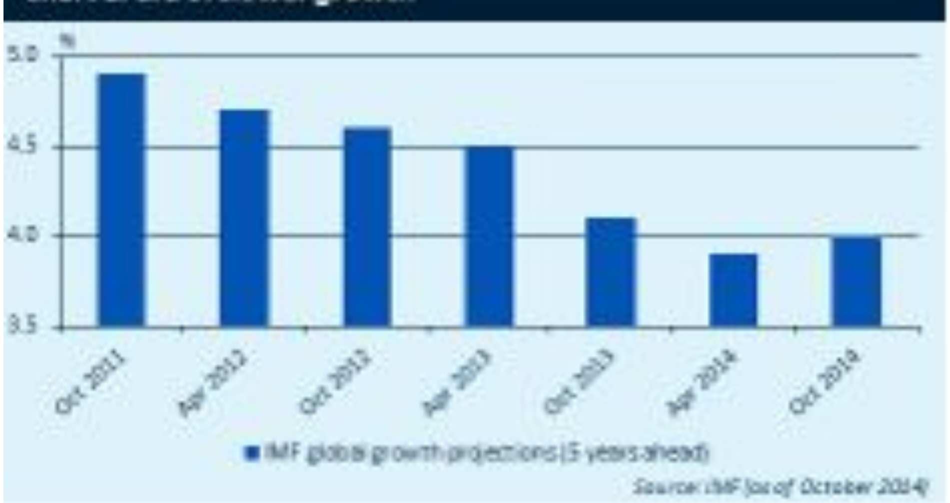
If you build it, they will grow
14 October 2014

The IMF held their annual meetings in Washington D.C. last week. The event concluded on an optimistic note regarding infrastructure investment, despite the gloomy outlook on global growth. **According to the IMF, in our era of high unemployment and sluggish growth, increased public infrastructure investment is one of the few remaining policy options to support growth.** Simply put, it believes that increased infrastructure investment on quality projects will raise output in both the short and long term, without increasing the debt-to-GDP ratio. In other words, efficient infrastructure investment will pay for itself.

In an era of low borrowing costs, there is a strong argument for increasing public investment to generate growth in many countries. If done well this could even reduce debt burdens over the longer term. For example, Brazil would likely benefit from a significant uptick in investment, as it currently invests less than 18% of GDP and suffers from bottlenecks that create massive inefficiencies. Such projects would not only boost growth, but also address the negative side-effects that poor infrastructure has on investment levels in other industries. The heightened need for infrastructure investments is not solely a problem in the developing world nearly two-thirds of U.S. roads are now in disrepair.

Setting aside the political feasibility of a major infrastructure programme, there is also the question of whether the mooted benefits are likely to materialise**. If public investment is to be scaled up, governments need to do more to ensure that it is cost effective. That can be done by making project selection more independent and ensuring that all projects are subject to rigorous cost-benefit analyses.** As a recent IMF report pointed out, growth in public investment can only improve long-term growth prospects if projects are carefully chosen and efforts are made at preventing cost overruns. A large public spending program alone will not pull the global economy out of its slump; governments, in coordination with the private sector, will have to cooperate to ensure infrastructure projects provide the greatest possible return.

Chart 1: Era of slower growth



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The Infrastructure Gap

When economists talk about investment they are usually focused on the private sector. This is because it accounts for the vast majority of overall investment, and is a key cyclical driver of aggregate demand as well as a structural driver of long-term productivity growth. However, public investment is also important. **Governments can boost efficiency in the broader economy by undertaking investments where the social payoff is larger than the private payoff,** or where the rewards are too far into the future to be worth the private sector's effort. Government investment also has a counter-cyclical role to play, helping to boost economic activity at times when the private sector is retreating into its shell.

Unfortunately, the US government has not been playing these roles effectively in recent years. In 2013, the gross government investment share of national income fell to 3.5%, its lowest share since the 1940s (see chart 2). Taking into account inflation and depreciation, the aggregate public capital stock has barely been growing. The trends in public infrastructure spending are even worse. Real federal spending on highways and streets is lower than it was a decade ago. The American Society of Civil Engineers, which assesses the state of the country's infrastructure each year, recently gave a D grading to American roads, airports, dams, bridges and even drinking water. It also predicts that there will be a $1 trillion infrastructure shortfall by 2020, or around 5% of GDP. No-one that has flown into a US airport recently, or used its public transportation system, will be surprised by those figures. Upgrading the country's ailing infrastructure would confer significant economic benefits. In its most recent World Economic Outlook, the IMF found that in advanced economies **an increase in investment spending of just 1 percentage point of GDP would raise the level of output by about 0.4 percent in the same year and by 1.5 percent four years after** the increase.

If boosting infrastructure spending is such a no brainer, why has it not been done? In recent years, a large part of the problem has been perceived fiscal pressures. **Politicians have been unable to agree on how to address the country's real fiscal problem - excess long-term entitlement spending - and so have instead forced down discretionary spending (see chart 3)**. There has also been an ideological barrier to greater public investment going all the way back to the Reagan years, with many Republicans taking the view that the path to prosperity lies in less, rather than more, government involvement in the economy.

The irony is that there has never been a better time to lift public investment. With interest rates low, and likely to remain so for many years, and a large number of financially sound projects to choose from, **the economic return from an infrastructure programme would be large, and would actually help to reduce the deficit rather than increase it.** Moreover, there is little chance of public investment crowding out private investment in the current economic climate. The question is whether the political class can come to its senses in time to arrest the trend decline in potential growth.

Chart 2: Investment share declining

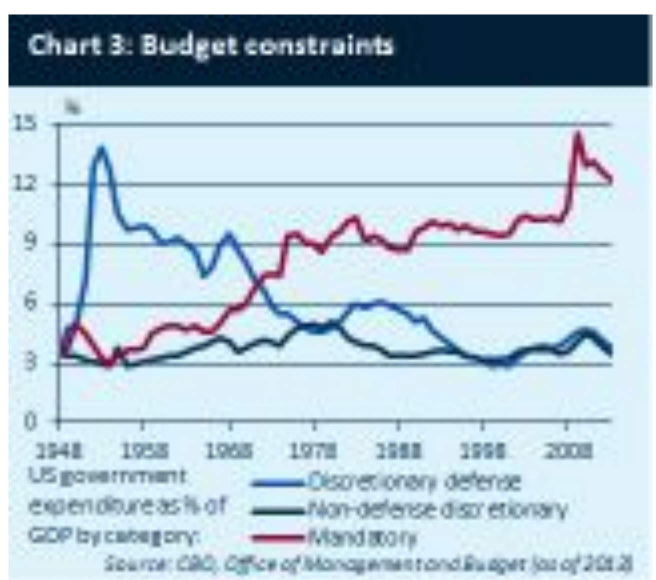


Chart 3: Budget constraints

A free lunch

The debate around how to fix the Eurozone continues to intensify. **With the currency union stuck in a low growth, low inflation environment, the pressure is building for policymakers to deliver a sustained recovery.** While much of the onus thus far has been placed on monetary policy, we are increasingly seeing questions asked of the fiscal policy setting. The IMF's foray into the argument raises a tantalising prospect; by boosting public investment countries can seemingly support short and long-term growth in a fiscally neutral way. We have argued that a combination of fiscal and monetary stimulus, alongside structural reform, offers the best approach in Europe. Perhaps investment in infrastructure can provide one of these building blocks?

The quality of infrastructure varies markedly between Eurozone member states. Looking at the largest member states; Germany, France and Spain all sit in the top ten of the World Economic Forum infrastructure ranking while Italy is clearly lagging (see chart 6). However, this should not be interpreted as a sign that further public investment projects would not reap benefits. **Germany, for example, has slipped down the rankings in recent years, with calls at home that public investment in infrastructure has been insufficient.** Indeed, the German Institute of Urban Affairs estimates that there is a public investment backlog of €118 billion over the past decade. In spite of some provisos within the Growth and Stability pact to protect public investment, this has fallen in Germany and other member states against the backdrop of post-crisis austerity (see chart 7).

The benefits of an infrastructure-driven stimulus are potentially large. In the short term, this stimulus would boost employment and activity. This could be particularly powerful at present, with fiscal multipliers found to have been larger in the aftermath of the financial crisis. Furthermore, public investment may "crowd in" private investment given the complementary nature of infrastructure services. If this stimulus is directed towards the right projects it will also generate long-term benefits as the higher capital stock boosts the productive capacity of the economy. This combination of short-term fiscal multipliers and higher long-term potential growth means that effective public investment can pay for itself.

So what's the catch? Fiscal positions are already stretched, meaning that any misspend risks exacerbating already high debt burdens. Indeed, we have already seen some policymakers take a firm line against further fiscal expansion – German Finance Minister Schauble commented last week that "writing cheques" was not the way to boost growth. Ironically, Germany has most scope to independently take a more expansionary stance on public investment which would help both domestic and regional activity. **Other countries are not in the same position. Some could achieve this through a relaxation of the fiscal rules agreed under the Fiscal Compact to allow great public investment spending. Alternatively, we could see action at the Eurozone level to boost infrastructure investment across the region.** There have been proposals to bolster the role of the European Investment Bank in this process. However it is achieved, policymakers should not miss this opportunity for a free lunch.

Chart 6: Infrastructure ranking

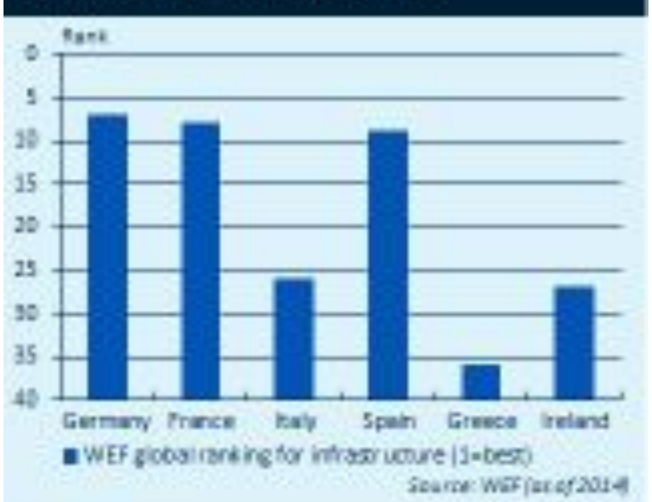
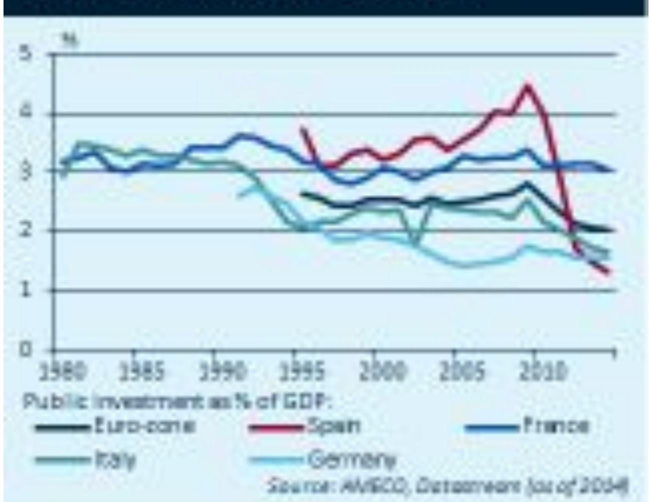


Chart 7: Falling public investment



Roads to growth

Across emerging markets there is a dire need for infrastructure investment. **The severe lack of investment in ports, roads and other infrastructure has created bottlenecks that are preventing many emerging economies from achieving higher growth.** After decades of underinvestment, many emerging markets are underequipped to compete from an infrastructure perspective (see chart 10). Furthermore, with growth slowing across most emerging markets, a push for additional investment in quality projects will undoubtedly boost short and long term-growth. Considering the substandard levels of infrastructure investment across major emerging market economies, it is not a question of whether they need investment (see chart 11). Rather, the key issue is choosing projects that offer high potential returns, and starting them now to take advantage of low borrowing costs.

There are many examples of countries wherein a lack of infrastructure is holding back economic growth. In Brazil, the lack of basic transport infrastructure prevents investment in other industries. For example, it currently costs less to ship soy from a Brazilian port to China than it does to get the soy to the port from the farm. These high costs prevent the agricultural industry from investing in more efficient farming technologies and basic grain storage facilities. There is strong evidence that infrastructure investment can help grow a country out of poverty and deliver years of solid economic performance. China has grown for decades on the back of an investment boom, and while it is most often associated with over-investment, it also still suffers from lack of investment in domestic logistics and transportation. Due to rail under capacity, it can be more expensive to ship coal from Inner Mongolia to Shanghai than it is to transport coal from the West Coast of the US.

It is clear that many countries are in desperate need of additional investment in basic infrastructure; the question that remains is why so few countries have been able to fulfil the need. While every country is different, the lack of infrastructure is often due to local politics and skewed incentives. India followed the lead of the IMF by developing infrastructure projects through public-private partnerships; however, numerous projects stalled, or were even aborted, amid protracted battles over land and the environment. Stalled projects have made overleveraged corporations unable to service their debts, while banks that have lent too much to infrastructure are having difficulty recovering their debts. China has suffered from political control over the direction of infrastructure investment into industries with diminishing returns. Recent IMF and World Bank projects, such as the Global Infrastructure Facility (GIF), are encouraging, and may offer a solution to the lack of infrastructure investment across emerging markets. The GIF will provide a forum to standardise planning, bidding, and financing infrastructure across countries and companies and will allocate money to projects with the appropriate risk-return characteristics. **By forging a greater cooperation between the public and private sectors, and most importantly setting up a mechanism to share best practices for evaluating projects across countries, the next influx of investment spending may stand a better chance of avoiding the political missteps so often seen in the past.**

Chart 10: Big economies, bad infrastructure

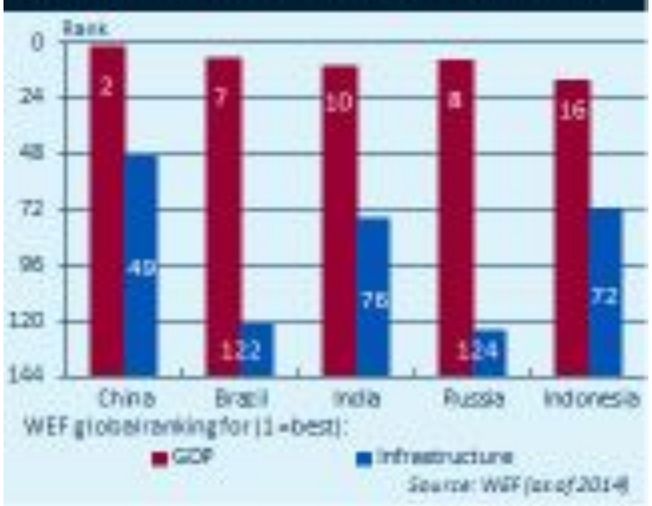
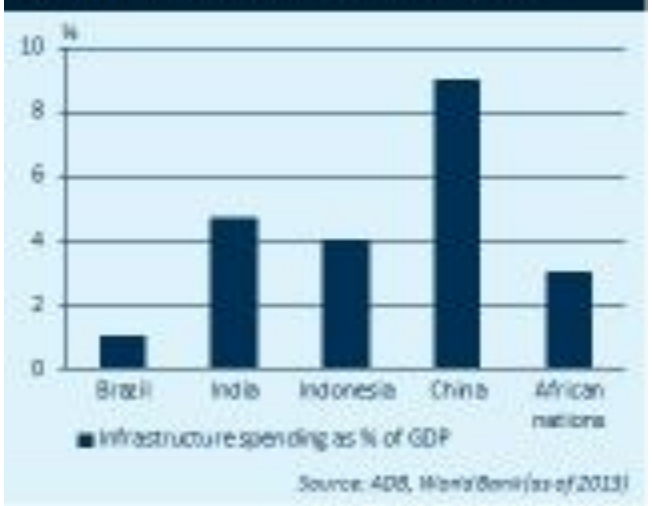


Chart 11: Need for greater investment



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