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The recovery of investment in the euro area in the aftermath of the great recession: how does it compare historically?

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In the aftermath of the Great Recession, investment in the United States has recovered, whereas investment in the euro area has remained low following the sovereign debt crisis which temporarily halted the recovery in the euro area. Nevertheless, investment in the current cyclical phase is not unusual as such; rather, it is aggregate consumption that is growing more slowly than usual — a finding which highlights the importance of policies aimed at stimulating aggregate demand.

Why is investment in the euro area so low compared to the US experience? This question matters because of the importance of investment for long-term growth potential. Understanding the causes of low investment is crucial for helping policymakers to decide on the right remedy. Economic literature generally identifies (expected) aggregate demand as the key driver of investment, where interest rates, uncertainty and the availability of credit, play a role as well.^[2] The European Central Bank's very accommodative monetary policy stance directly acts as stimulus for investment by lowering the cost of capital and furthermore indirectly as a result of its impact on aggregate demand. Despite this stimulus, the euro area's low level of investment might well appear disappointing. However, this article shows that the recovery is much less disconcerting than it appears at first sight. The article first explains why euro area investment is low compared to the United States. Thereafter, it argues that the current investment recovery, which has been under way since 2013, is not slow in historical terms, in particular once the pattern of aggregate demand and consumption are taken into account. The article concludes that in this situation the ECB's current accommodative monetary policy stance is warranted.

The United States and the euro area are on different recovery paths

Investment in the euro area fell to exceptionally low levels at the trough of the Great Recession, owing to a combination of financial factors, a drop in aggregate demand and the end of a construction boom in some countries. These factors also played an important role in the US economy.^[3] However, the euro area and the United States are following very different paths in terms of investment recovery. Figure 1 shows a comparison of the real levels of US and euro area investment since 2000.^[4] At the end of 2011, the dynamics of investment in the euro area and in the United States started to substantially diverge.

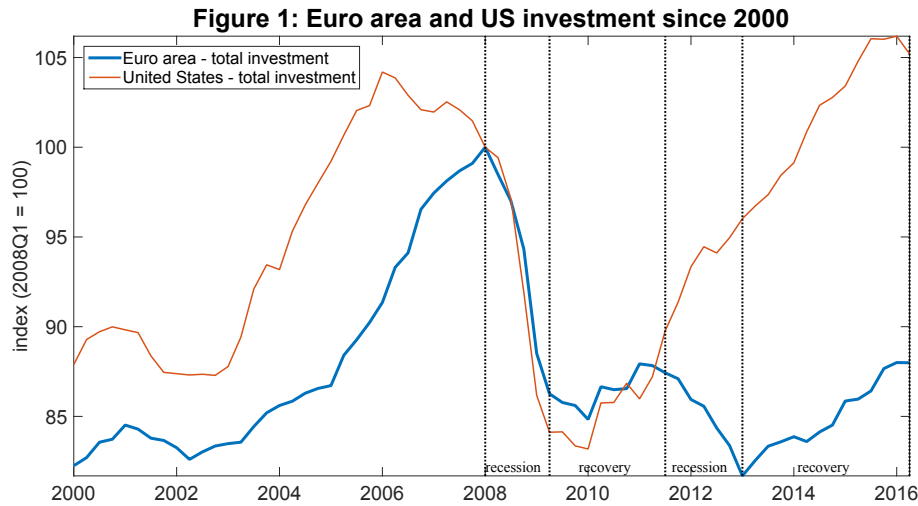
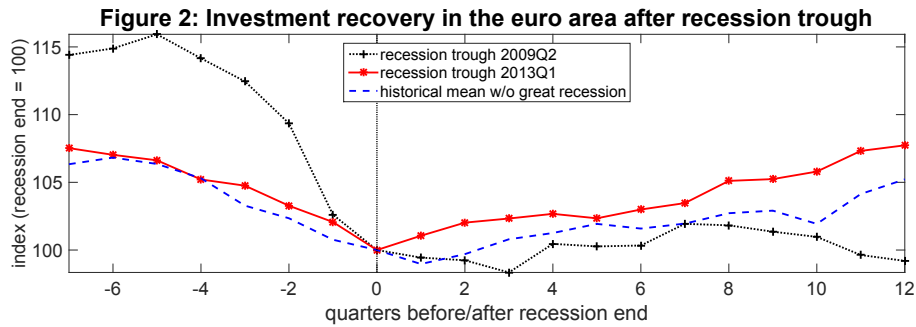


Figure 1 shows that the decline in investment during the Great Recession was roughly comparable across the two monetary areas. Their speed of recovery was also comparable until 2010. With the intensification of the euro area sovereign debt crisis in 2011, however, the recovery in euro area investment came to a halt. The euro area fell into a recession, which lasted from the third quarter of 2011 to the first of 2013. Real investment fell again, to an even lower trough than during the Great Recession. While euro area investment remains well below its pre-crisis peak, US investment has been growing strongly ever since 2010 and now exceeds the pre-crisis levels.

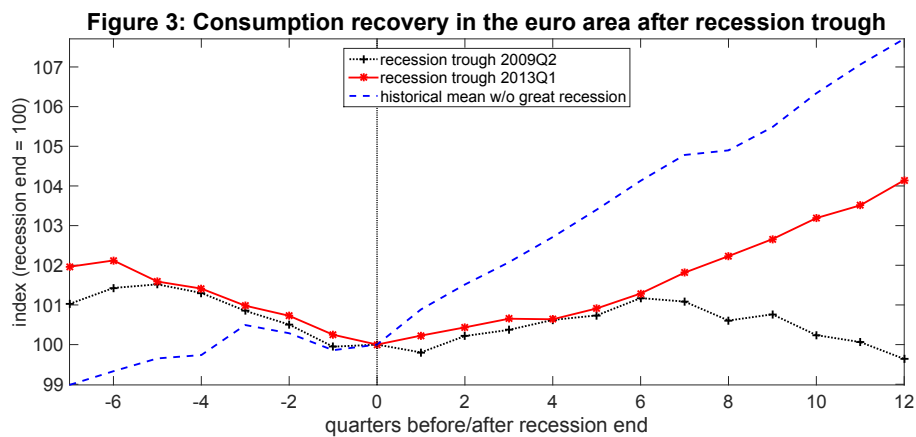
Two factors make developments in euro area investment since 2011 unusual and set it apart from the United States. The first is the onset of the sovereign debt crisis, which tightened lending conditions in stressed countries, led to tighter fiscal policies and elevated uncertainty, which ultimately triggered a new euro area recession. Historically, two consecutive recessions within such a short interval of time was unprecedented in the euro area. The second factor is the different developments in investment in construction. This has been much slower to pick up in the euro area, compared to in the United States. While euro area non-construction investment has started to recover slowly in recent quarters, the dynamics of investment in construction eight years after the Great Recession, essentially remain flat. By contrast, US investment in construction started growing again at the beginning of 2011, although, as of the second quarter of 2016, it was still 10% below the level of the fourth quarter of 2007. Furthermore, euro area construction investment has contributed much less to the recovery in investment than in the United States and as of the second quarter of 2016, it stood 21% below the level of the first quarter of 2008.^[5] An important reason for the faster recovery in US construction investment may be a faster rate of population growth. Since 2008, the US population has grown by 5.6%; by contrast, it has only grown by 2% in the euro area. Any oversupply of housing in the United States was therefore absorbed much more quickly simply due to faster population growth.

Is the current investment recovery exceptionally slow from a historical perspective?

Figure 2 shows that after both the Great Recession and the subsequent recession, which ended in the first quarter of 2013, the investment recovery roughly followed the same historical pattern of the previous three recoveries in the period from 1970 to 2007. Indeed the current recovery has been stronger, with investment dynamics that were actually slightly above the historical norm. Since the first quarter of 2013 to the second quarter of 2016, the recovery brought investment to a level that is 7.7% higher. The average historical increase in investment 12 quarters after previous recession troughs is 5.2%. The current pace of recovery in euro area investment is therefore not unusual compared with historical patterns, which admittedly have also been quite sluggish.



Instead, what is disappointing in terms of any historical comparison is the behaviour of aggregate consumption. This phenomenon is shown in Figure 3, which illustrates that the current recovery in aggregate consumption has been substantially below the historical norm. From the first quarter of 2013 to the second quarter of 2016, it brought consumption to a level that is 4.1% higher; the average historical increase in consumption 12 quarters after previous recession troughs is considerably higher at 7.8%.



All in all, this analysis suggests that the investment performance in the current cyclical phase is not the most disconcerting component of growth; rather, from a historical perspective, it is aggregate consumption that has been growing more slowly than usual. This finding is important for policymakers. The current recovery in investment can only be sustained if aggregate consumption also grows at a sufficiently robust pace in parallel. Policymakers would be misguided to focus on investment exclusively. Instead, policies should aim for a broader recovery of aggregate demand and consumption in particular. The ECB's current accommodative policy stance is therefore warranted, as it provides support for sustained growth in aggregate demand in a context where inflation remains too low compared to a level that is consistent with maintaining price stability over the medium term.

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[¹]Disclaimer: this article has been written by Philip Vermeulen (Senior Economist, Directorate General Research, Monetary Policy Research Division). The views expressed herein are those of the author and do not necessarily represent the views of the European Central Bank and the Eurosystem. The author is grateful to Brian Hallissey for his assistance and Geoff Kenny and Paul Dudenhefer for their helpful comments.

[²]With regard to the role of different factors in the investment recovery, see also the European Central Bank (2015), Box 2 entitled "What is behind the low investment in the euro area? Responses from a survey of large euro area firms", *Economic Bulletin*, Issue 8, Gros (2014), "Investment as the key to recovery in the euro area?", *CEPS Policy Brief*, No 326, and International Monetary Fund (2015), "Chapter 4. Private investment: What's the holdup?", *World Economic Outlook*, April.

[³]The role of financial factors in the Great Recession, in particular, has been examined in much detail in academic literature. See, among others, Campello et al. (2010), Duchin et al. (2010) and Buca and Vermeulen (2015).

[⁴]The beginning and end of both euro area recessions are indicated by the vertical lines, using the CEPR recession dates.

[⁵]With regard to the current recovery of construction investment, see also European Central Bank (2016), Box 4 "Recent developments in euro area construction activity", *Economic Bulletin*, Issue 5.

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