## Box 7

### Factors behind the weakness in investment by type of product

This box reviews recent developments in investment by type of product in order to shed light on the various factors influencing aggregate investment (see Box 6 of the September 2002 issue of the ECB's Monthly Bulletin for a discussion of the data on the breakdown of investment). Data are only available up to the third quarter of 2002. It appears that the weakness in overall investment observed since the beginning of 2001 has been broadly based across the various components. However, the factors accounting for this weakness have differed between products. In particular, both structural and cyclical factors are likely to account for the recent declines in construction investment. By contrast, low growth rates in equipment investment seem to be the result of the current environment of weak GDP growth and uncertain prospects.

**Weak construction investment as a result of structural and cyclical factors**

Starting with construction, housing investment (around half of construction investment and 25% of total investment) fell further in the third quarter of 2002, by 0.4% quarter-on-quarter, continuing a two-year decline (see Chart A). In that quarter, the level of housing investment was 6% below its peak of the second quarter of 2000. Structural factors, in particular the ongoing correction of the post-unification boom in the construction sector in Germany, have dampened growth in euro area housing investment over the past few years. More recently, uncertainty about the economic outlook, and thus about employment and income prospects, may have led households and property investors to defer housing investment decisions.

Non-housing construction, which comprises office, public and industrial buildings and civil engineering, has also shown protracted weakness since the mid-1990s, similar to that observed for housing investment. An overcapacity of office buildings in some parts of the euro area has tended to dampen growth in non-housing construction investment over the past years. More recently, the level of non-housing construction has declined. From the second quarter of 2001 to the third quarter of 2002 it decreased by 2% in cumulative terms. In addition to structural factors, weak activity and uncertain prospects are likely to have deterred companies from seeking new offices and production sites in the past few quarters. Moreover, in some euro area countries, budget constraints may have limited the scope for public investment projects.

**Uncertainty about economic prospects and profits dampened equipment investment**

Turning to non-construction investment (also referred to as "equipment investment"), the latest data suggest that the pattern of weak growth observed since 2001 has continued, albeit possibly to a lesser extent (see Chart A). This reflects a range of factors, in particular low growth in demand and economic uncertainty. Business expectations in the manufacturing sector have remained at relatively low levels throughout the past two years. Moreover, the protracted economic slowdown has adversely affected corporate profits, and thereby internal finance. The problems faced by firms in financing their investment plans may have been compounded by two additional factors. First, raising funds from securities markets or borrowing from financial intermediaries may have become more difficult for a number of firms in recent quarters. Second, companies with a high level of indebtedness may have opted to postpone investment as a means to improve their balance sheets.

As regards developments in investment for each of the main types of non-construction product, investment in metal products and machinery (30% of total investment) increased in the third quarter of 2002, after six consecutive quarters of decline (see Chart B). These results should be interpreted with caution, however. Fiscal incentives raised equipment investment in Italy in the second half of last year, which had a significant positive impact on the euro area figures. Excluding Italy, euro area investment in metal products and machinery decreased slightly further. Similarly, the rise in euro area investment in transport equipment (10% of total investment) in the third quarter of 2002 was largely accounted for by Italy. As illustrated in Chart B, this category of investment is very volatile, which represents an additional difficulty in interpreting the latest

**Chart A: Housing, other construction and non-construction investment**
*(quarter-on-quarter changes; quarterly data)*

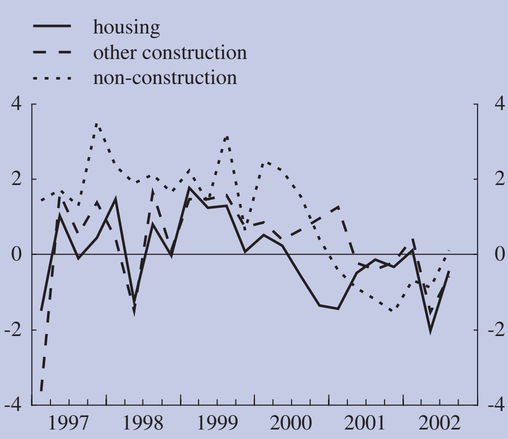
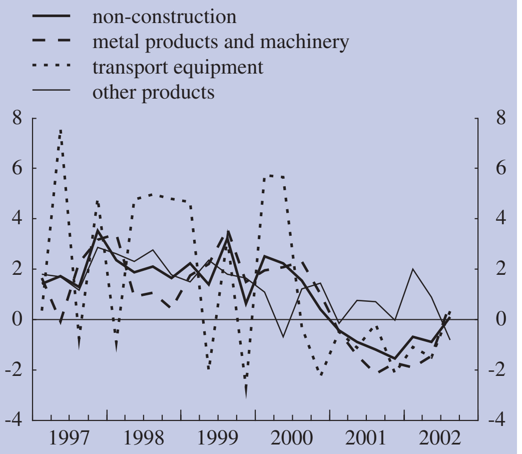



**Chart B: Breakdown of non-construction investment**
*(quarter-on-quarter changes; quarterly data)*




*Source: Eurostat.*

data. Finally, growth in "other investment" (10% of total investment), which, in particular, comprises software, was around zero in the third quarter of 2002.[1] Compared with the other two main types of equipment investment, this category has been relatively resilient throughout the downturn. This may suggest that, for this type of goods, replacement investment was maintained, even during the downturn, on account of the relatively rapid obsolescence of IT products.

Available information on construction investment for the fourth quarter of 2002 suggests that investment is likely to have declined further at the end of last year. Looking ahead, a pick-up in construction investment is conditional on an unwinding of the current high degree of uncertainty. Nonetheless, construction investment is likely to be weak as long as the structural factors hampering growth in this sector remain. As regards non-construction investment, economic and geopolitical uncertainty is likely to continue to negatively affect growth in this sector in the near future. However, there is no evidence at the current stage of any significant overhang of equipment investment. This assessment implies that the conditions are in place for companies to launch investment projects once activity strengthens and uncertainty disappears, taking advantage of the very low level of interest rates.

1 *The breakdown of investment by type of product includes a further component: investment in products of agriculture, forestry, fisheries and aquaculture (e.g. animals and trees, except if raised for slaughter or grown for timber). This category represents small volumes, sometimes negative, and developments are very volatile. It is therefore not commented upon in this box.*