

Box 5

BUSINESS INVESTMENT, CAPACITY UTILISATION AND DEMAND

Euro area investment has declined substantially during the recent recession there. It has continued to shrink, albeit at a more moderate pace, since the beginning of the upturn in the second half of 2009. This box discusses the prospects for euro area investment in the short term, taking into account capacity utilisation and demand prospects.

Since the beginning of the recent recession, in the second quarter of 2008, the share of investment in GDP in the euro area has fallen by around 2.5 percentage points. As shown in Chart A, starting from a higher level, the investment share in GDP declined by more during the recent recession than during the previous one, in the beginning of the nineties.¹ However, at the end of 2009, it stood at a rate comparable with that in the trough following the previous recession, namely at around 20% (see Chart A).

Looking at the more recent past, the contributions of the components to the growth in the volume of total investment are presented

Chart A Share of investment in GDP

(percentages)



Sources: Eurostat and ECB calculations.

Note: ECB calculations based on Eurostat data and Area Wide Model database (<http://www.eabcn.org/data/awm/index.htm>). The share is computed in real terms.

¹ At the beginning of the 1990s, the investment share in GDP declined by 2.1 percentage points, from peak to trough. For a more detailed historical comparison of euro area investment during downturns, see Box 5, entitled “Euro area investment in the current downturn”, in the July 2009 issue of the Monthly Bulletin.

in Chart B, starting one year before the beginning of the recent recession. The chart illustrates that during the second half of 2009, euro area investment declined mainly on the back of a contraction of construction investment, whereas the two major components of non-construction investment, i.e. metal products and machinery, and transportation goods, remained almost unchanged, after having declined markedly over the previous year.

At this stage of the recovery in economic activity, a large degree of uncertainty surrounds the outlook for euro area business investment. Historical evidence shows that recoveries in investment after a financial crisis tend not to be as pronounced as after a recession that is not linked to a financial crisis, since a recovery in capital expenditure typically requires increased external finance, which may not be forthcoming in the face of tighter credit conditions.² At the current juncture, recent data on earnings expectations provided by financial market analysts suggest that the prospects for internal financing capacities of euro area non-financing corporations have improved, albeit from a low level, possibly reducing the need for external financing for a given level of investment. Nonetheless, since the beginning of the financial turmoil, terms and conditions on bank loans to the corporate sector have been tightened significantly. Although recent indications show that this tightening pressure of credit standards has receded, bank lending is likely to remain somewhat constrained in the economic recovery.³

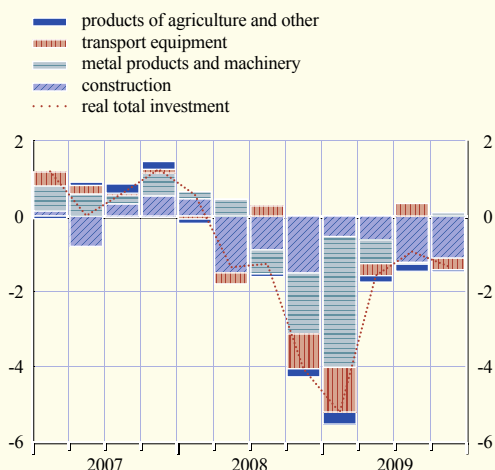
The emergence of spare capacity is another factor dampening the outlook for investment. The extent of such spare capacity reflects the sharp drop in demand against the backdrop of existing productive capacity, as reflected in the capital stock. As the capital stock represents the

2 See the article entitled “The latest euro area recession in a historical context”, in the November 2009 issue of the Monthly Bulletin.

3 The January 2010 bank lending survey for the euro area indicates that the net percentage of banks reporting a tightening in lending standards to enterprises continued to decline from the peak reached in the second half of 2008 (at 64%), but remained at a broadly neutral level (at 3% in the fourth quarter of 2009).

Chart B Quarterly growth in real investment in the euro area broken down by components

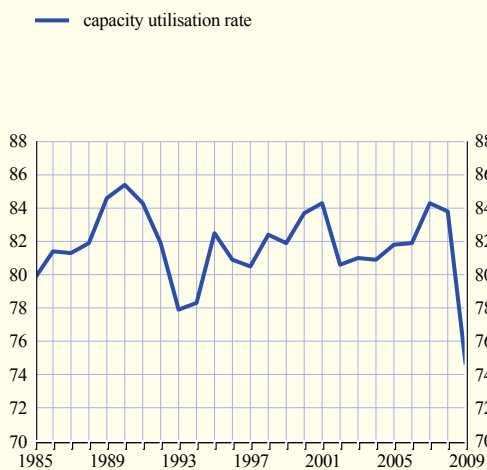
(quarterly percentage changes and percentage point contributions)



Source: ECB calculations based on Eurostat data.
Note: The latest observations are for the last quarter of 2009.

Chart C Rate of capacity utilisation

(percentages)



Sources: European Commission Business and Consumer Surveys and ECB calculations.

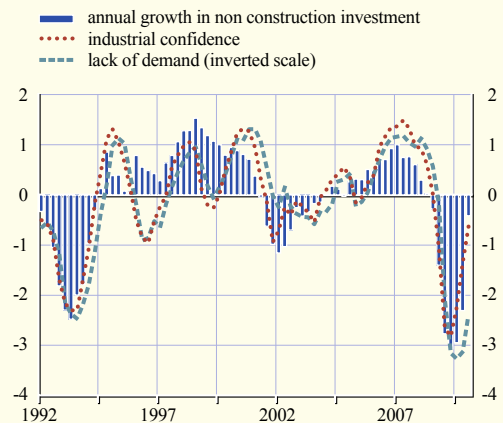
accumulation of past investments, it adjusts only slowly to changes in economic activity. The sluggish response of the capital stock to changes in investment partly explains why during the recent recession, survey evidence on the capacity utilisation rate in manufacturing points to a sharp decline (see Chart C). However, given that the incorporation of investment goods in the existing stock of capital takes time, while the existing capital stock continues to depreciate, the rate of capacity utilisation will most likely rise gradually over time, although it may react more markedly once there is a recovery in demand.

Not surprisingly, a large part of the slowdown in investment during the latest recession was due to a reduction in overall demand. While survey data on manufacturing confidence rebounded in the course of the second quarter of 2009, the latest values remain below the longer-term average, and the European Commission's surveys on limits to production show that the lack of demand is the main factor limiting production (see Chart D).

Looking forward, the low real cost of financing is expected to support business investment. At the same time, in a context where corporations are restructuring their balance sheets, an increased need for external finance could encounter tighter credit conditions. Overall, against the background of uncertainty and moderate demand prospects, euro area business investment is likely to accelerate only slightly in the short term.

Chart D Recent indicators of business investment

(de-measured and standardised from Q1 1992 to Q4 2008)



Sources: European Commission Business and Consumer Surveys, Eurostat and ECB calculations.

Notes: the series plotted on the chart have no unit since they are standardised. For instance, a + 2 indicates that the value is two standard deviations above the mean.