

BUSINESS INVESTMENT IN 2012: EVIDENCE FROM SHORT-TERM INDICATORS AND SURVEYS

Investment plays an important role in determining the euro area business cycle, both as a factor of aggregate supply and as an important component of aggregate demand. An understanding of the determinants and an evaluation of the short-term indicators of investment plans are therefore important for the assessment of macroeconomic developments.

In the rebound following the global economic downturn of 2008-09, euro area total investment has grown moderately. After peaking at a rate of 3.3% year on year in the first quarter of 2011, total investment growth decelerated throughout 2011, broadly stabilised towards the end of the year around a level close to 1% year on year, and fell to -2.2% year on year in the first quarter of 2012 (see Chart A).

This box examines recent hard-data and survey-based indicators of business investment (total investment excluding public and residential investment) – capturing supply and demand conditions – which have helped to shape the outlook for investment growth this year.

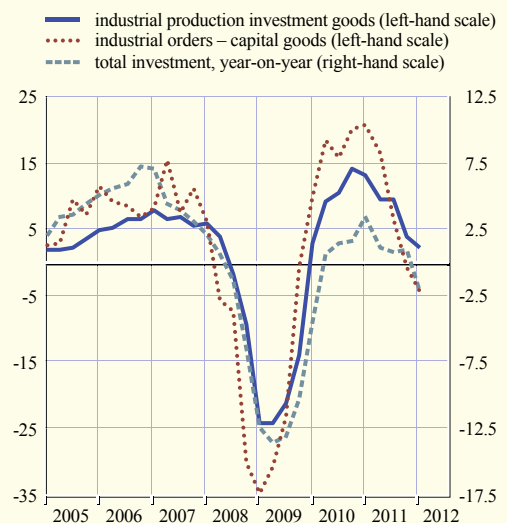
Short-term indicators of business investment – hard data

The most important determinants of business investment identified by the academic literature are the level of output and, to a lesser extent, the user cost of capital. The financing structure and, more specifically, the share of internal finance in firms' investment spending also play a role: companies tend to prefer to finance investment projects using internally generated funds so as to avoid the premia associated with external finance.¹ In this context, the literature has shown there to be a high correlation between movements in gross operating surplus or cash flow and total investment.²

A number of leading short-term indicators, such as industrial production of capital goods and industrial orders for capital goods, suggest a further weakening of euro area investment growth in the first half of 2012. Another indicator, gross operating surplus, suggests that the weakening may remain contained, provided that business confidence does not deteriorate. Gross operating surplus – which gives an indication of internally generated funds and is highly correlated with investment – is growing at a positive, albeit decreasing, pace (see Chart B).

Chart A Total investment and short-term indicators

(year-on-year percentage changes)



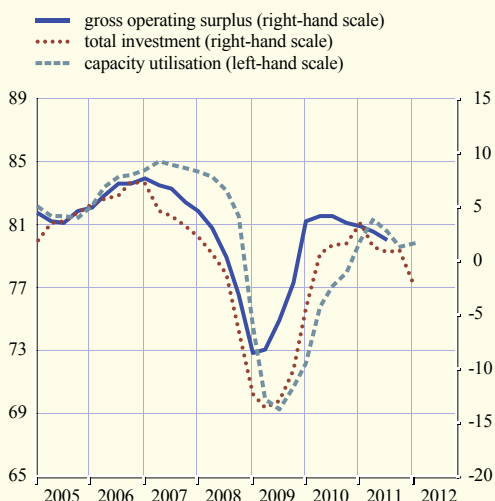
Source: Eurostat.

1 See the article entitled "Business investment in the euro area and the role of firms' investment positions", *Monthly Bulletin*, ECB, Frankfurt am Main, April 2008.

2 Ibid.

Chart B Total investment, gross operating surplus and capacity utilisation

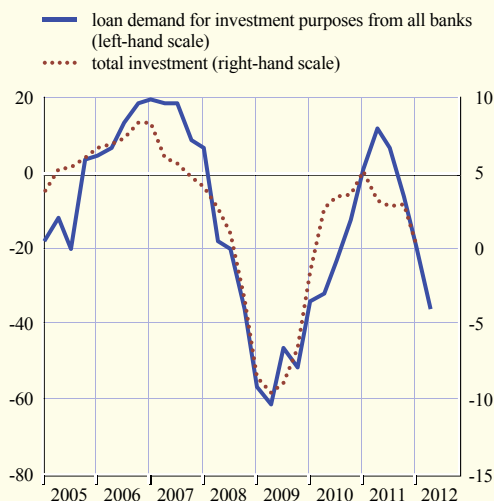
(year-on-year percentages changes; percentages for capacity utilisation)



Sources: Eurostat and European Commission (DG ECFIN business survey in manufacturing).

Chart C Total investment and demand for loans for investment purposes

(year-on-year percentage changes; balances)



Sources: Eurostat and ECB (euro area bank lending survey up to April 2012).
Note: Demand for loans refers to the weighted balances of responses by banks regarding the direction of the impact on demand from the contribution of fixed investment.

Short-term indicators of business investment – surveys

A number of surveys also give indications about firms' investment plans for the current year. An increase in capacity utilisation gives an indication of firms' need to expand their capital stock. According to the European Commission's business survey, the increase in capacity utilisation in the manufacturing sector was interrupted in early 2011 (see Chart B). This may reflect a drop in demand against the existing level of production capacity, as reflected in the capital stock.³

In addition, the results of the euro area bank lending survey conducted in April 2012 suggest that demand for loans for investment purposes, which also helps to predict total investment, continued to decrease in the first quarter of 2012 and is projected to weaken further in the second quarter (see Chart C). The lower demand for external financing may indicate that companies are adopting a wait-and-see approach with respect to their investment decisions in the context of still elevated general macroeconomic uncertainty.⁴ Heightened uncertainty may raise the threshold level of return for undertaking certain types of investment project, for given levels of demand, cost of financing and other determinants.⁵ A deterioration in confidence among companies appears consistent with the latest data from the DG ECFIN survey on the structure of investment. The survey results indicate that a higher than average share of investment is being used to replace obsolete capital stock, whereas investment for the extension of production capacities, which may imply greater

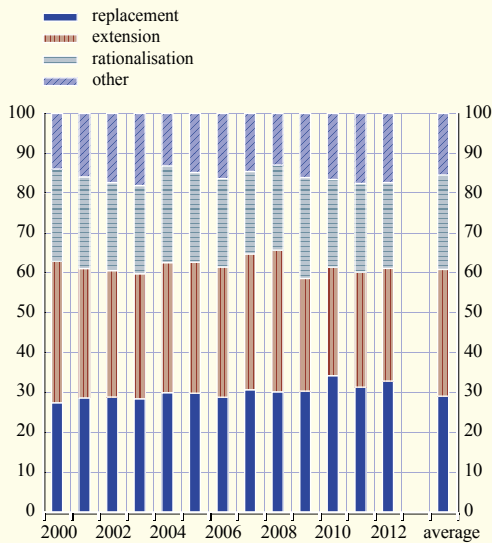
³ See the box entitled "Business investment, capacity utilisation and demand", *Monthly Bulletin*, ECB, Frankfurt am Main, April 2010.

⁴ See the box entitled "Developments in longer-term growth expectations for the euro area", *Monthly Bulletin*, ECB, Frankfurt am Main, June 2012.

⁵ For an overview of the effect of uncertainty on aggregate and disaggregate investment, see Carruth A., Dickerson, A. and Henley, A., "What do we know about investment under uncertainty?", *Journal of Economic Surveys*, Vol. 14, No 2, Blackwell Publishers Ltd, Oxford, April 2000.

Chart D Structure of industrial investment

(percentages of respondents)



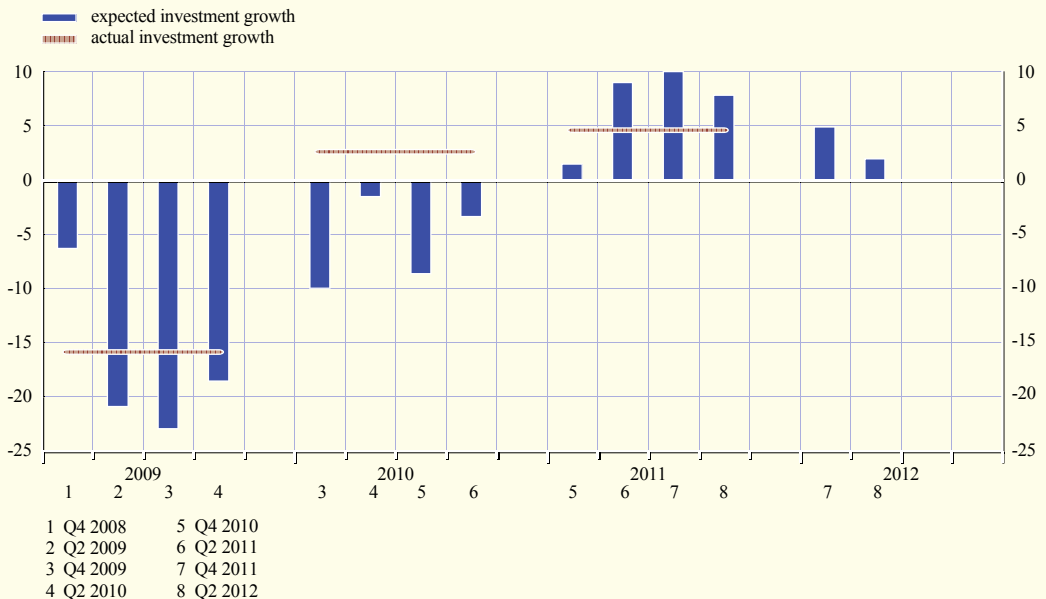
Source: European Commission (DG ECFIN investment survey).

recourse to external financing, is expected to remain relatively limited in 2012 (see Chart D).

According to the European Commission's latest biannual industrial investment survey, investment growth is expected to be weaker in 2012 than was expected in the previous survey conducted in October 2011 (see Chart E); the expected growth rate has been reduced in annual real terms from 5% to 2%. The replies to the question on factors influencing industrial investment, which bring to light what companies perceive to be the main constraints on investment activity, suggest that demand and financial factors, on balance, remain supportive of investment (see Chart F). In spite of a small decrease since 2011 in the net number of firms reporting demand conditions as being stimulating, real demand conditions remain favourable overall, with the balance of answers returning to levels

Chart E Industrial investment survey and outcome

(annual percentage changes in volume)

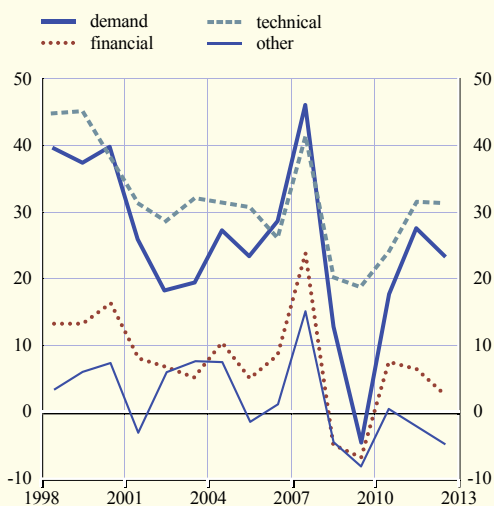


Sources: Eurostat and European Commission (DG ECFIN investment survey).

Notes: The numbers on the x-axis refer to when the survey was carried out. Investment in metal and machinery is used as a proxy for industrial investment growth.

Chart F Factors influencing industrial investment

(balances)



Source: European Commission (DG ECFIN investment survey).
Note: Balances are the weighted averages of the percentages of answers describing each factor as “very stimulating” (coefficient 1), “stimulating” (coefficient 0.5), “limiting” (coefficient -0.5) and “very limiting” (coefficient -1).

and clearly more favourable than in the period following the bankruptcy of Lehman Brothers in September 2008. Looking further ahead, business investment – although subject to downside risks should the sovereign debt crisis deepen – is expected to start growing modestly towards the end of 2012, in line with the expected weak rebound in domestic demand and exports.

associated with “normal” times after the extreme oscillations witnessed in the crisis and post-crisis periods. Financial factors, despite a recent deterioration, remain in positive territory on balance, and far from the levels registered during the global crisis of 2008-09. This would suggest that the decline in investment is not mainly related to external financing constraints faced by companies, but is rather a result of the behaviour of companies in an environment of heightened uncertainty.

Outlook

In general, short-term indicators suggest a continuously slow momentum in investment in the near term. This may be related to cautious investment behaviour of companies in the face of persisting high levels of uncertainty. At the same time, survey indicators show that fundamental determinants (i.e. demand prospects and financing conditions) are still assessed to be relatively favourable