

Box 4

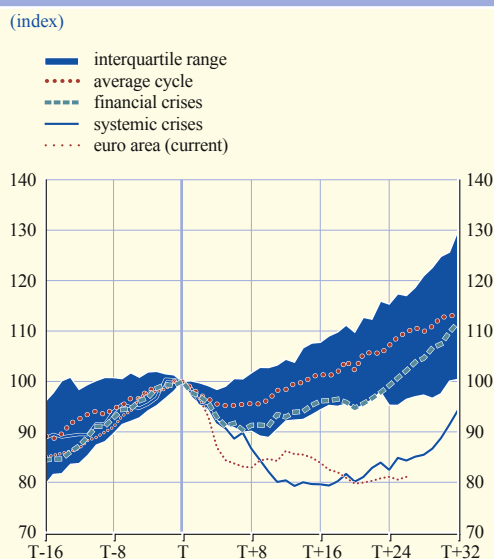
THE CURRENT WEAKNESS IN EURO AREA INVESTMENT COMPARED WITH PAST CRISIS EPISODES

The current weakness in euro area investment is pronounced when seen in a historical context. This box compares the trends in investment – as well as in some related macroeconomic variables – with the experience of previous “financial” and “systemic” crises.¹ In general, the recovery in investment seen to date has been considerably weaker than in previous financial crises, but more similar to that witnessed after systemic crises.

A comparison with previous financial and systemic crises

The level of real investment in the euro area (as represented by the small red dotted line in Chart A) is currently well below the general level recorded after both “average” recessions and a large number of previous global non-systemic financial crises. The total decrease in investment during the recent crisis period is, however, broadly comparable with the average decline registered in systemic crises. Meanwhile, the pattern of the current recovery is rather distinct owing to the double-dip nature of the crisis. Although investment initially fell more sharply than in previous systemic crises,

Chart A Trends in real investment after crisis episodes



Sources: OECD, Eurostat and ECB calculations.

Note: T represents peak GDP growth in each pre-crisis period. The last peak was registered in the first quarter of 2008.

¹ The set of financial crises referred to here encompasses 11 crises associated with tensions in the banking sector during the 1980s and 1990s, such as the banking crises of Great Britain (1973), Greece and Italy (1992) and Japan (1996). In comparison, the systemic crises involve five large-scale financial crises witnessed in Spain (1977), Norway (1987), Finland (1991), Sweden (1991) and Japan (1992). See Reinhart, C.M. and Rogoff, K.S., “Is the 2007 US Sub-prime Financial Crisis So Different? An International Historical Comparison”, *The American Economic Review*, Vol.98, No 2, May 2008. Note that the term “average cycle” refers to all other recessions observed across OECD countries since 1970, i.e. those that are not associated with financial or systemic crises. Furthermore, some caution is required as systemic crises represent a very small sample of crises and have been influenced by special factors, such as key policy changes relating to financial liberalisation or the relaxation of prudential regulation.

the first trough was less deep than in a typical systemic crisis. Furthermore, following the trough of 2010, investment started to recover at a pace similar to that observed after normal recessions. But less than two years of progress came to a halt with the onset of the sovereign debt crisis, when the level of investment contracted further. Since then, there has been little evidence of a recovery (Chart A). As a consequence, the level of investment presently stands at nearly 20% below its 2008 level.

Factors coinciding with the current weakness in investment

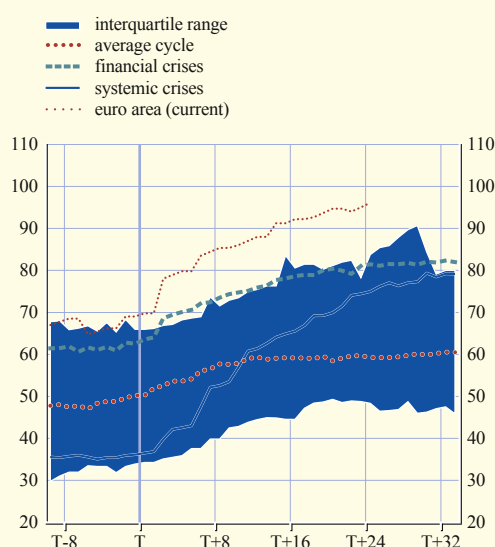
In comparison with previous financial and systemic crises, the slow recovery in investment observed during the most recent crisis has coincided with a number of unique economic conditions.

First, public investment spending – including investment in infrastructure – has been subdued owing to fiscal consolidation and the need for public debt deleveraging. After the emergence of the Great Recession, the ratio of government debt to GDP was at levels above 90% in the euro area, which is much higher than what was seen on average before previous crises (Chart B). This limited the already small fiscal space to stimulate investment, and rather induced governments to consolidate public finances relatively early on.

Second, in line with previous systemic crises, housing investment has contracted significantly, but there is still virtually no sign of a recovery (Chart C). It should be noted that the initial level taken as a benchmark, i.e. the peak in GDP growth in the first quarter of 2008, reflects

Chart B Government debt after crisis episodes

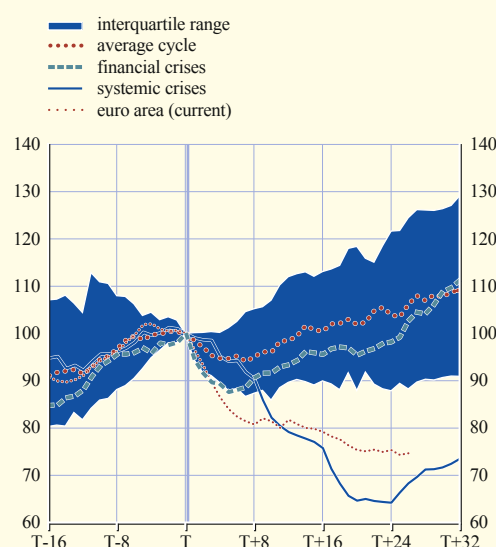
(percentage of GDP)



Sources: OECD and ECB calculations.
Note: T represents peak GDP growth in each pre-crisis period. The last peak was registered in the first quarter of 2008.

Chart C Level of real housing investment after crisis episodes

(index)



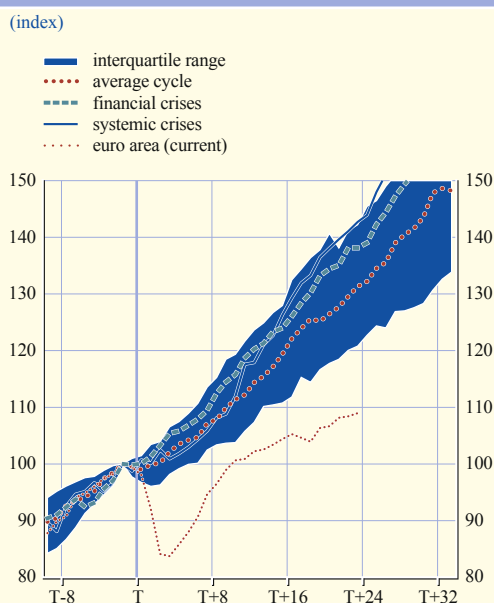
Sources: OECD, Eurostat and ECB calculations.
Notes: T represents peak GDP growth in each pre-crisis period. The last peak was registered in the first quarter of 2008. For past crises, housing investment data are taken from the OECD database. For the most recent crisis episode, euro area housing investment data from Eurostat are used.

the unsustainably high pre-crisis housing investment in a number of euro area countries. Furthermore, the ongoing adjustment in housing investment is expected to continue for some time, exerting downward pressure on overall investment.

Third, the weak dynamics of business investment during the sovereign debt crisis may be partially related to the pattern of exports.² In the wake of a synchronised global recession, exports decreased significantly in 2008 and then made a more gradual recovery than that seen after normal recessions (Chart D). In general, the previous financial and systemic crises were more geographically confined, with relatively intact global growth creating the basis for a firmer export-led recovery.

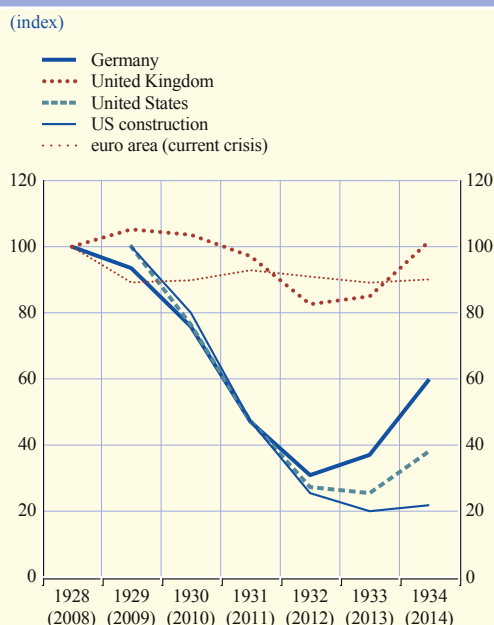
Finally, elevated uncertainty, including uncertainty about the future economic policies of national governments, is an important factor hampering business investment in the present environment. Surveys of policy uncertainty³ in the five largest European economies show that uncertainty has risen since the onset of the crisis and has generally remained at a much higher level than before the crisis. However, owing to a lack of data, it is not possible to compare the present level of uncertainty with that of past recessions.

Chart D Level of exports after crisis episodes



Sources: OECD, Eurostat and ECB calculations.
Note: T represents peak GDP growth in each pre-crisis period. The last peak was registered in the first quarter of 2008.

Chart E Investment during the Great Depression in selected countries



Sources: Berringer, C., *Sozialpolitik in der Weltwirtschaftskrise Die Arbeitslosenversicherungspolitik in Deutschland und Großbritannien im Vergleich 1928-1934*, Duncker & Humblot, 1966; U.S. Department of Commerce Bureau of Economic Analysis.
Notes: For Germany and the United Kingdom, investment in current prices is used, as data on real investment are not available. For the United States, investment equals 100 in 1929. Euro area investment growth for 2014 is obtained by extrapolating data for the first two quarters.

² For a more detailed discussion of the factors behind the decline in business investment, see the box entitled "Factors behind the fall and recovery in business investment", *Monthly Bulletin*, ECB, Frankfurt am Main, April 2014.

³ For example, the Economic Policy Uncertainty Index compiled by N. Bloom et al., which is available at <http://www.policyuncertainty.com/>

For an even longer perspective on the crisis, recent developments can also be compared with the most extreme crisis in modern times, namely the Great Depression of the 1930s. Investment data for this period are scarce. Nevertheless, in the case of the United States, Germany and the United Kingdom, it can be said that the decline in investment during the current crisis seems much less pronounced than that in the Great Depression (Chart E). There are many explanations and theories for this. For example, during the Great Depression, there were a number of bank failures which had a more severe impact on investment finance, as well as a major stock market crash in the United States. It is argued that the Federal Reserve failed to counteract the contractionary effect of the bank failures and that its tight monetary policy contributed to the depth of that crisis.⁴ In comparison, the monetary policy implemented by major central banks since 2008 has been very accommodative.

Conclusion

The substantial decline in euro area investment is a widespread phenomenon across investment components. Government investment decreased as a result of the very limited fiscal room for manoeuvre. As regards housing investment, there is hardly any sign of a recovery and the ongoing adjustment process in the housing market is expected to remain an important constraining factor. Furthermore, the low business investment that has been observed coincides with an exceptionally weak export performance and elevated uncertainty regarding, among other things, future government policies.

Looking ahead, given an environment of modest output growth and the need for further public and private sector deleveraging, the recovery in investment is likely to remain subdued in the near term.⁵ Heightened geopolitical tensions also represent a downside risk. Moreover, the investment recovery will hinge on decisive structural reforms which (i) boost output, (ii) generate demand for physical capital, and (iii) reduce labour and product market rigidities, thereby improving business prospects in the euro area and creating the conditions for a stronger economic upswing.

4 See, for instance, Friedman, F. and Schwartz, A. J., “*A Monetary History of the United States 1867-1960*”, Princeton University Press, Princeton, 1963.

5 See the article entitled “December 2014 ECB staff macroeconomic projections for the euro area” in this issue of the Monthly Bulletin.