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PRESS RELEASE

Why is investment in the euro area continuing to show only weak recovery?
(Article for the September 2016 Economic Review)

Investment in the euro area has fallen dramatically since the financial crisis and its recovery is dragging its heels. As this spending is a highly cyclical component of demand, it explains to a large extent the seriousness of the recession and the uphill struggle to recover of growth in the euro area. Moreover, low levels of capital spending do not merely depress demand but also undermine an economy's long-term growth potential, getting in the way of expansion in capital stock and the spread of innovative technologies and so putting the brakes on wealth and job creation.

The article sets out to explain the recent evolution of euro area investment. More specifically, it explores the factors hindering a capital spending revival and the European policy initiatives that have been taken to remedy the situation.

From both a global and a historical perspective – i.e. compared with previous post-crisis periods – subdued investment dynamics are a highly unusual state of affairs. This weakness may persist as a partial adjustment to previously excessive spending, particularly by households on residential property. That said, business investment has also yet to stage a major recovery.

Drawing on an accelerator model, the article demonstrates that, although GDP remains a key determinant, a set of other factors also help explain continued weak investment. Uncertainty plays a not insignificant role, while limited financing possibilities also serve to squeeze investment plans. SMEs find it hard to meet their funding needs, as they, more than large corporations, only have the banking sector to turn to, and in some countries this is still not on an even keel. Other factors that feed into subdued investment include the process of debt deleveraging of non-financial corporations and the fragmentation of the financial markets, which has resulted in diverging interest rates offered to clients by banks in different euro area countries.

In addition to these short-term factors, a number of fundamental changes have taken place in the past decades that may have triggered more secular trends. This is a complex theme, however, and no clear conclusions can be drawn as to the impact on capital spending of the gradual shift to a more service-based society or the globalisation of production chains in the advanced economies. Demographic trends, and particularly population ageing, are claimed by some to necessitate less investment, but one might equally argue that more capital-intensive production practices should be implemented to offset negative effects on growth.

The euro area would appear to be stuck in both slow economic growth and lagging investment, and a catalyst is needed to reverse this double bind. The Investment Plan for Europe attempts to address these issues by increasing funding capacity through an investment fund and by improving the general investment climate. It focuses specifically on small and medium-sized enterprises and infrastructure, and on selected types of investment of which the risk profiles are too high to be financed by the private sector alone. The same drive envisages a Capital Markets Union leading to a fully integrated European capital market in due course – which should make funding easier for SMEs. This latter initiative still has a long way to go, though.

Communication
National Bank of Belgium Ltd.
boulevard de Berlaimont 14
1000 Brussels
phone + 32 2 221 46 28
www.nbb.be
Company's number:
0203.201.340 – RLP Brussels