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European Economic Perspectives

Weak Investment Could Hurt Europe's Long-Term Growth

The weakness of fixed investment in the euro area is a growing cause for concern. Not only is it one of the key factors holding back growth in the short term, but it could also have a very damaging impact on the euro area's long-term supply potential.

The performance of euro-area fixed investment has been disappointing. In spite of a steady improvement in corporate profits and company balance sheets, and despite record low long-term interest rates, euro-area fixed investment rose by only 1.6% in 2004. In part, this was due to continued weakness in the German construction sector. Even so, equipment investment rose just 3.0% in the euro area last year and fell by 0.2% in Germany. In the US, equipment investment rose by 13% in 2004.

The poor performance of euro-area capital spending compared with the US is highlighted in **Display 1**. In the late 1990s, investment spending rose sharply in most industrial countries, reaching a cyclical peak in 2000. Since then, investment trends in the US and Europe have diverged. US investment spending fell sharply in 2001, but has since risen strongly. It now stands 17% above its last cyclical peak. In the euro area, and especially Germany, investment spending is still below its last cyclical peak.

There are a number of possible explanations for the weakness of investment spending in the euro area. It may simply be that companies remain hesitant in the face of ongoing uncertainties relating to the oil price and the euro. If so, investment could be an upside risk to growth once these headwinds clear. Equally, however, weak investment spending may be more structural in nature, reflecting the euro area's fading charm as an investment location.

There is some evidence to support the latter view. For example, gross fixed investment in the euro area remains very low as a proportion of GDP. However, even this does not tell the whole story. Because the working life of new capital spending is generally becoming shorter, depreciation rates have tended to rise[1]. This means that net fixed investment has fallen sharply as a share of GDP and is now at its lowest for several decades **(Display 2)**.

The decline in net fixed-capital formation has had an adverse impact on the capital stock. Over the last ten years, the euro-area capital stock has grown by just 2.0% per annum, well down on the average gain of 3.6% per annum recorded over the previous three decades. In the US, by contrast, the capital stock has grown by 3.2% per annum over the last ten years, slightly higher than its long-term average of 2.9%.

Estimates of depreciation rates and the capital stock are subject to important measurement difficulties. As a cross-check, it is, therefore, worth looking at the recent evolution of capacity use. This shows that, in spite of relatively modest industrial output growth, euro-area capacity use is just 0.1% below its long-term average **(Display 3)**. This is further evidence of the structural weakness of euro-area investment spending.

Conclusions

Recent trends in euro-area capital spending suggest that the economy's supply potential may be falling. This is very worrying given that poor demographic prospects are likely to dampen potential growth in most euro-area countries over the next several years. For some time, our working assumption has been that potential growth in the euro area is around 2.0% per annum. However, poor demographics prospects, the long-term weakness of capital spending and the absence of meaningful structural reforms mean trend growth may be even lower than this.

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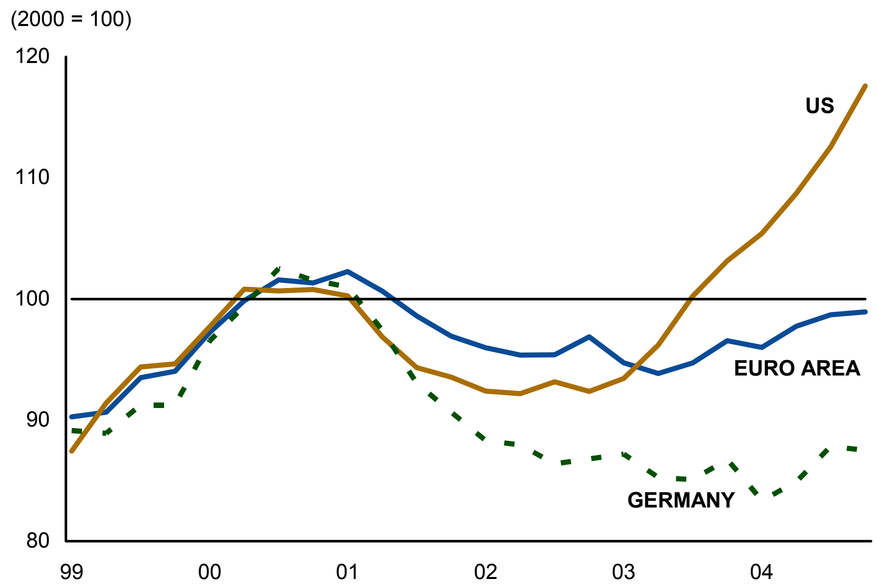
[1] In part, this is due to the growing importance of ICT investment - a computer has a shorter working life than a steel plant and is, therefore, depreciated more quickly in the national accounts.

Display 1: Euro-Area Investment Has Lagged the US

Real Equipment and Software Investment Rebased to 2000 = 100

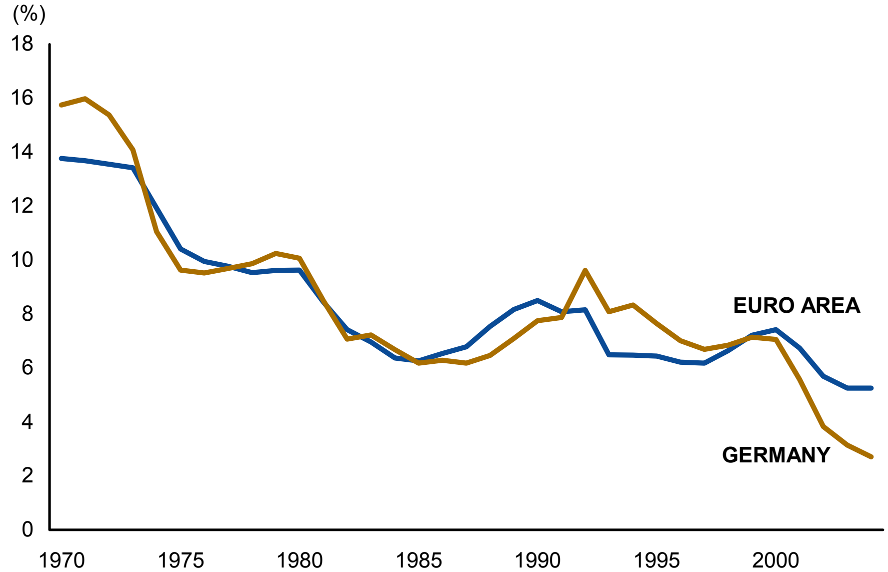


Source: Haver Analytics and Alliance Capital Fixed Income, April 22, 2005

Although US and euro-area investment spending followed similar paths in the late 1990s, they have since diverged quite markedly. While US equipment investment is now 17% above its last cyclical peak, euro-area equipment investment is still below these levels. The picture is even worse in Germany.

Display 2: Net Fixed-Capital Formation at Record Lows

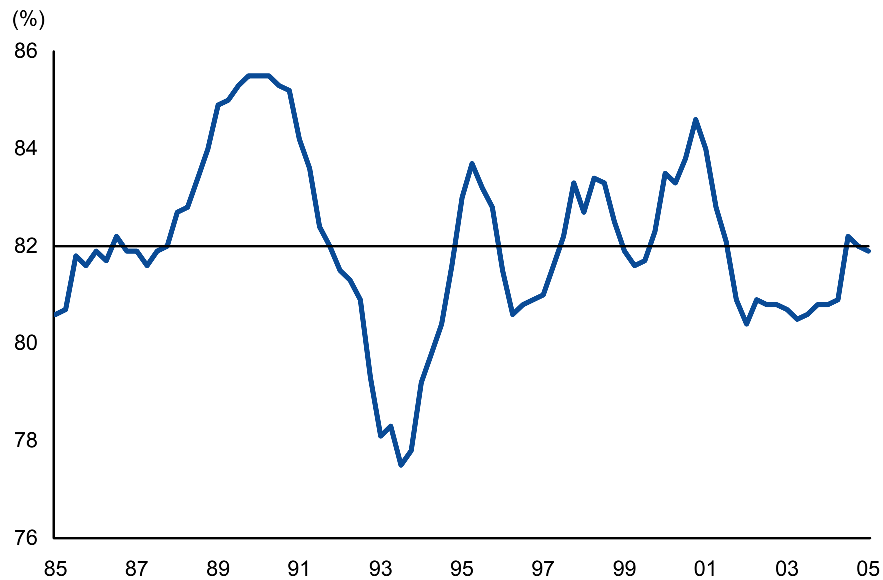
Net Fixed-Capital Formation as a Percent of GDP



Note: Net fixed-capital formation is gross fixed-capital formation less depreciation.
Source: European Commission and Alliance Capital Fixed Income, April 22, 2005

Weak gross fixed-capital formation and rising depreciation rates due to increased investment in new technology have pushed net investment spending to record lows. The performance of Germany is especially disturbing.

Display 3: Capacity Use Is Close to its Long-Term Average
Euro-Area Industrial Capacity Use and Long-Term Average



Source: Haver Analytics and Alliance Capital Fixed Income, April 22, 2005

The weakness of investment spending is evident in the recent evolution of euro-area capacity use. Despite modest growth in industrial output over the last several years, capacity use is just 0.1% below its long-term average. This means there may be less spare capacity than is often assumed.