

## The outlook for private business investment in 2010

In response to falling demand, reduced access to credit and falling profitability businesses have slashed investment spending over the past 18 months. Investment has contracted by 15-20% across the US, Japan, UK, Canada and Spain in 2009, wiping two percentage points off growth. By contrast, investment is estimated to have grown by 12% in China, supported by tax incentives and injection of credit into the private sector. Reduced investment in the advanced economies also reflects the natural response of businesses to conserve cash during periods of extreme uncertainty. Now that financial markets are beginning to normalise and the outlook is less bleak it is a good time to assess whether this recovery is likely to be given a near term boost from revived investment spending.

Business investment is the accumulation of physical assets such as factories and machinery by the private sector and accounts for around 14% of global GDP. In the short term, investment supports economic activity and employment levels. Longer term, maintaining reasonable investment rates is important in renewing the capital stock and supporting growth, as well as being of particular interest to suppliers of capital goods and associated services including commercial property.

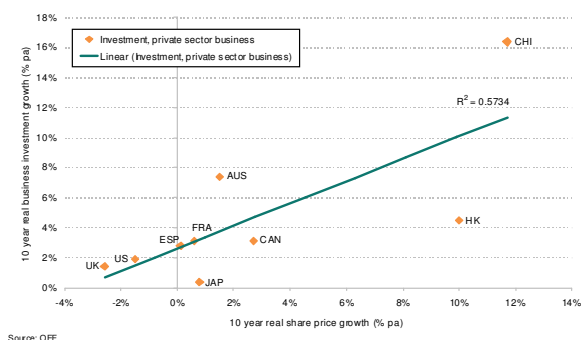
Two opposing forces will determine the direction of business investment this year. On the plus side, the rebound in financial markets has lowered the cost of finance for business. Combined with a much improved economic outlook, more profitable opportunities will emerge over the year, providing support for investment (Chart 1). The rebound in equity prices has also pushed up the value of installed capital relative to its replacement cost, encouraging some businesses to expand production by investment rather than through mergers and acquisitions.

However, large amounts of spare capacity will weigh on investment in the short term. World output levels are around five per cent below capacity (known as the output gap) so many businesses are likely to expand production by re-deploying idle capital and labour. Despite the recovering world economy, profitability will remain under pressure, with output prices being constrained by subdued demand and intense competition. Weak profits and limited access to credit will constrain investment, particularly for small to medium-sized businesses. The positive impact of the stabilisation of financial markets may be negated by governments' borrowing requirements, with risk free rates already drifting higher for economies with large deficits and no credible consolidation plans.

To help determine the shape of the recovery business investment is modelled using interest rates, share price movements, the fiscal deficit and expectations of the output gap. Data from the US, Canada, UK, France, Spain, Japan, China, Hong Kong and Australia was used. The model explains around 60% of investment growth (see table). Consistent theory, the fiscal deficit is found to 'crowd out' investment, with higher deficits leading to lower levels of credit available for private sector use. Investment is found to be boosted by buoyant share prices, low real interest rates and low level of spare capacity. Momentum is also important with strong investment last year leading to strong investment this year.

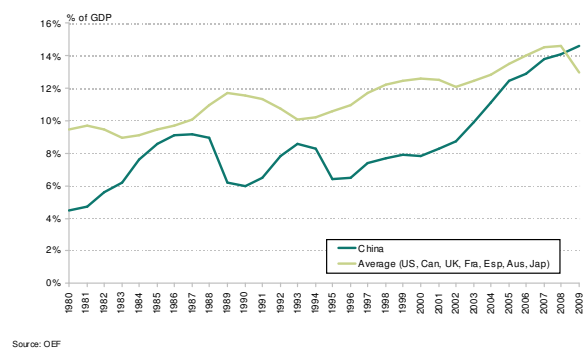
After controlling for cyclical effects the model indicates that OECD countries have been under-investing whilst China has been over-investing. China's decade long investment binge has created excess capacity and deflationary pressures in many sectors (Chart 2). This is one of the main

Chart 1: Equity markets and business investment



Source: OEF

Chart 2: Business investment as % of GDP



Source: OEF

reasons for under-investment in the OECD and will continue to prevent investment from making a comeback in 2010. Even under the assumption that share prices appreciate 15% in 2010 and the output gap in 2011 narrows by one-third the model suggests that world investment will be flat in 2010. The conditions for a full investment revival will not be in place until 2011. So we expect the recovery to weaken in the second half of 2010 and only become firmly entrenched in 2011.

| Variable                                | Coefficient   | Std. Error | Significance |                                |
|---|---|------------|--------------|--------------------------------|
| Constant                                | 0.05  | 0.01       | 0.0          | R-squared (0.6)                |
| Investment growth (-1)                  | 0.27  | 0.05       | 0.0          |                                |
| Investment growth (-2)                  | -0.26   | 0.05       | 0.0          | F-Statistic Significance (0.0) |
| Real share price growth                 | 0.06  | 0.01       | 0.0          |                                |
| Real share price growth (-1)            | 0.07  | 0.02       | 0.0          |                                |
| Real change in long term interest rates | -0.50   | 0.20       | 0.0          |                                |
| Fiscal deficit as % of GDP              | 0.41  | 0.08       | 0.0          |                                |
| Output gap (+1)                         | 0.39  | 0.18       | 0.0          |                                |
| Fixed Effects                           | AUS (0.02), CAN (0.0), CHI (0.08), FRA (-0.02), HK (-0.01), JAP (-0.05), ESP (0.01), UK (0.0), US (0.0) |            |              |                                |