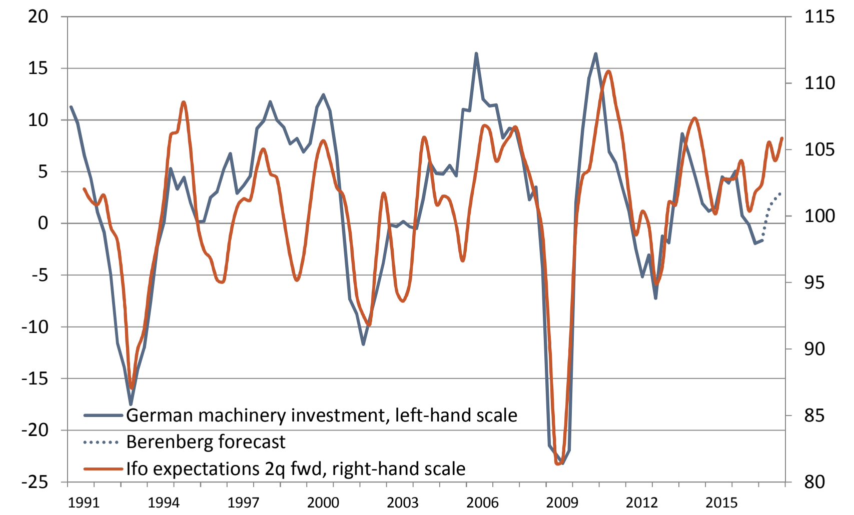
Economics

Chart of the week

26 May 2017

Setting the pace: German investment rebound ahead

German machinery investment yoy (%) versus Ifo expectations (two quarters forward)



German machinery investment, yoy change in %, on left-hand scale; German Ifo expectations, quarterly averages, advanced by two quarters, on right-hand scale. Source: Destatis, Ifo, Berenberg calculations

- **Expectations lead investment:** Businesses invest more if they expect stronger demand for their products. In Germany, forward-looking Ifo business expectations have led the swings in machinery investment by two quarters since the start of pan-German statistics in 1991 (see chart). The recent rise in German business expectations heralds firmer capital expenditure growth ahead.
- **Investment gap:** Our chart also tells a second story. Until the double whammy of the great financial crisis of 2008/09 and the euro confidence crisis of 2011/12, companies often stepped up their investment by more during a cyclical upswing than the simple correlation that we have depicted in our chart seemed to suggest. This is no longer the case. Recently, the blue line for investment has often come in somewhat below rather than above the red line for Ifo expectations. This investment gap worsened last year.
- **The age of caution:** We see three major reasons why businesses in Germany – and much of the developed world – have invested less in machinery during the current cyclical recovery than before. First, in the digital age, firms need to invest ever more in software, which can be difficult to capture adequately in statistics, rather than in traditional hardware. Second, scarred by the experience of crisis, companies have become more cautious. They are more reluctant than before to commit resources for the long term by buying machines. Third, a plethora of risks ranging from concerns about a potential hard landing in China to Brexit, Trump and the French elections, probably weighed on the propensity to invest in 2016 and early 2017.
- **Risks have receded:** Chinese demand has not fallen off a cliff; the emerging-market crisis of early 2016 is largely over; the Brexit vote has not disrupted the European economic recovery in any meaningful way, despite posing serious long-term risks for the UK; the US has not embarked on wholesale protectionism; and France has elected a pro-European reformer as its president. Most of the key risks to the economic outlook for Germany and Europe now loom less large than they did before. We thus expect companies to step up their investment spending soon.
- **Is the age of caution coming to an end?** Probably not. We still look for investment to be less buoyant than it would have been at a similar stage in previous cyclical upturns. But, in response to the strong gains in German Ifo business confidence, we have raised our calls for German investment growth (including construction and software) from 2.0% to 2.3% for 2017 and from 2.5% to 2.7% for 2018. And the chances are that investment could rise even faster than that. As companies become more confident that the cyclical upturn will not be disrupted again by a major political or financial crisis in the next year or two, they may gradually shed some of the unusual caution that has shaped their investment decisions in the last few years.

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