8 December 2017

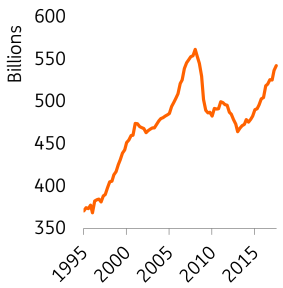
Eurozone

Digital transformer

ECB policy supportive of innovation

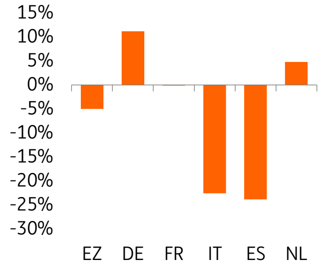
For a long while, investment had been the missing jigsaw piece in the Eurozone recovery puzzle. Investments have finally gained momentum, contributing to the surprisingly strong growth performance of the entire Eurozone. The often criticised QE programme has gradually made its way into the real economy. In fact, low interest rates have been more supportive of investments in intellectual property than in construction. Also, the ICT investment recovery has gained momentum. These are all pieces of evidence that the ECB's QE programme is not only growth supportive but also fostering the structural transition of the Eurozone economy.

Eurozone investment still has some room to catch up



Source: Eurostat, ING Research

Italy and Spain drag down the average



Source: Eurostat, ING Research

Unlike many of the years since 2008, it appears that Eurozone policymakers might secretly hope that this year will never end. 2017 has been the year of strong growth revival. It has seen a recovery that has broadened across countries and sectors, on the back of stronger fundamentals, fading exit fears and ultra-loose ECB monetary policies. This recovery currently seems to get better by the day.

For a long time, investments were the missing piece in the strong Eurozone recovery. Even this has changed this year. Investments have contributed c.0.6ppt to quarterly GDP growth in the first three quarters of the year and previous estimates of investments in recent years have been adjusted upwards. Since 1Q13, investments have increased by a total of 16.8%.

The fact that investments have yet to recover is mainly because of the weak recovery in southern European economies. Huge declines during the crisis have yet to be made up for in Spain, Portugal, Greece and Italy. This is despite the fact that most of the periphery countries have recently seen positive developments in investments.

Contrary to received wisdom, the investment recovery is not mainly the result of more construction activity. In fact, the asset classes experiencing the largest investment growth are intellectual property and ICT equipment. However, this innovation and digital boost is not spread equally across all Eurozone countries. The more digital economies are also the ones that receive the most ICT equipment investment. The gap between leaders and laggards is widening, not narrowing.

Even though it is hard to derive a single causality between the ECB's QE programme and the pick-up in investments, particularly investments in high technology, available data suggest that the ECB has given a helping hand to the urgently needed digitalisation in the Eurozone.

It is clearly not the ECB's task to solve all the structural problems of the Eurozone. While many think that the extreme monetary stance only creates problems, the boost it gives to R&D investments in the Eurozone should not be ignored. Who could have thought that an organization as old-fashioned as the ECB could be supportive of state-of-the-art investment?

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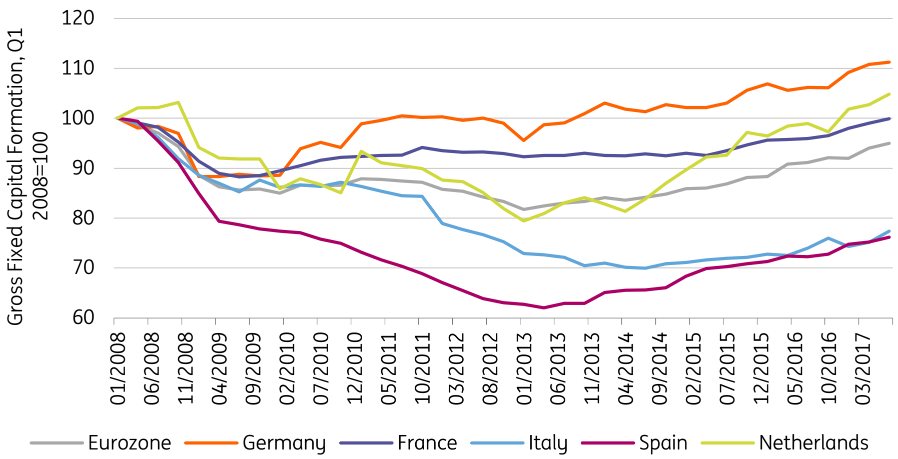
No longer missing: investments

Investment has finally joined the recovery wagon…

While hardly noticed, investment has recently become a significant source of Eurozone growth. In 2016, investment contributed 0.9% to GDP growth, up from 0.6% in 2015. However, investment still has not (yet) returned to pre-crisis levels. Currently, quarterly investments (gross net investment of fixed capital assets) are still c.4% off their last peak in 1Q08. Both private and public investments were impacted negatively by the crisis, with austerity playing an important role in lower public investment. Now, the investment climate has changed. Capacity utilisation is above its historical average, and there are increasing signs that inadequate equipment is hampering production. Combined with low-interest rates, the peak of 2008 should be surpassed in the next year or two. The near-term outlook for investment is positive.

Fig 1 Eurozone investments have yet to return to its pre-crisis peak



Source: Eurostat, ING Research

…but almost unnoticed on the back of data revisions

Improvements in investment have passed under the radar as much of the recent recovery has only become apparent in revisions to the GDP data. Investment revisions since 2Q16 amount to an extra 0.5% in GDP growth, a substantial increase. Many of the improvements have come from the countries with more severe recessions, a clear sign of catch-up growth in these economies. Netherlands, Spain and Portugal lead the way in terms of investment growth over the past two years, but investment improvements are broad-based. Especially France and Italy saw a significant acceleration in investment in the most recent years of the recovery.

As so often, there are stark differences across different countries

Still, there is a sharp division between northern and southern countries as the Eurozone's southern economies saw a much sharper decline in investment during the crisis years. While Germany and Netherlands have surpassed their pre-crisis peak in investment, Spain, Portugal, Italy and Greece are still far below this level, and it could still take years to recover. France is now back at the pre-crisis level of investment, after a long period of stagnation at a low level.

It's not a construction recovery; it's a high-tech boom

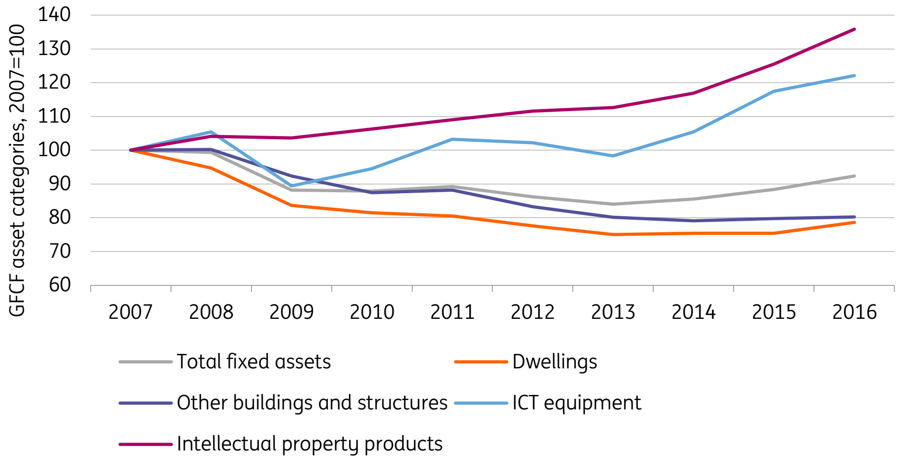
Contrary to received wisdom, the investment recovery is not mainly driven by the construction sector…

It's sometimes suggested that the investment recovery is mainly the result of a booming housing market on low-interest rates. We argue that this is not the case. Investment in construction is still down more than 50% on the 2007 levels, probably a positive sign given the overinvestment in some markets before the crisis. Investments in dwellings and other real estate have bottomed out and are more than 20% weaker than pre-crisis levels. Data for investment in manufacturing only runs through 2015 when it almost exceeded its 2008 peak. With about 70% of data available for 2016, it seems that annual growth in manufacturing investments has reached double digits.

...but by ICT and innovation...

The big and surprising winner in the investment recovery, however, is the information and communication industry. Investments in intellectual property and ICT have boomed in the post-crisis years and are 36% and 22% higher than in 2007. Of course, price effects play an important role for ICT investments and the nominal effect is smaller, given the deflation in ICT assets. Even so, the results are impressive. Investment has become more focused on the digital and knowledge economy over recent years. This trend was already visible pre-crisis, but the current asset mix suggests that it has recently sped up.

Fig 2 Investment in intellectual property and ICT is a main cause of recovery

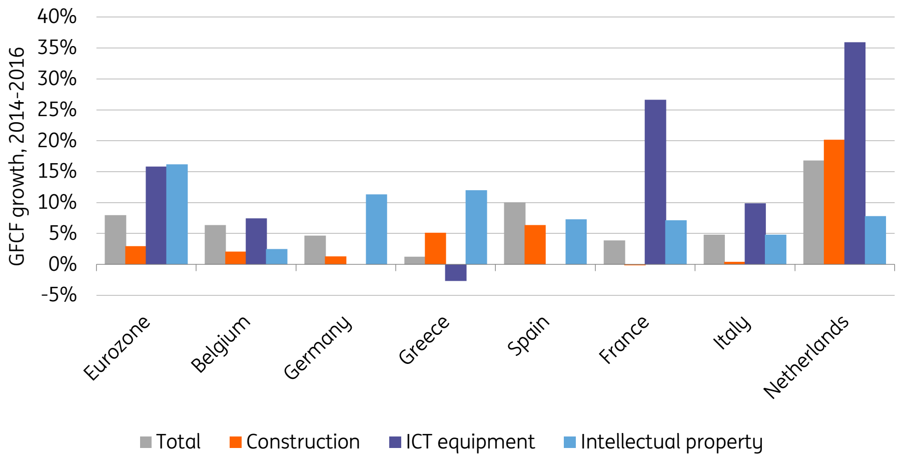


Source: Eurostat, ING Research

...boding well for a structural improvement of the Eurozone economy

While ICT investment remains a small percentage of the total investment amount, intellectual property investment is now over one-fifth of all Eurozone investments, up from just 14% in 2007. This shift in assets of Eurozone investment could potentially have a positive impact on productivity growth in coming years and could therefore structurally improve the Eurozone economy.

Fig 3 Recovery by asset types differs largely by country



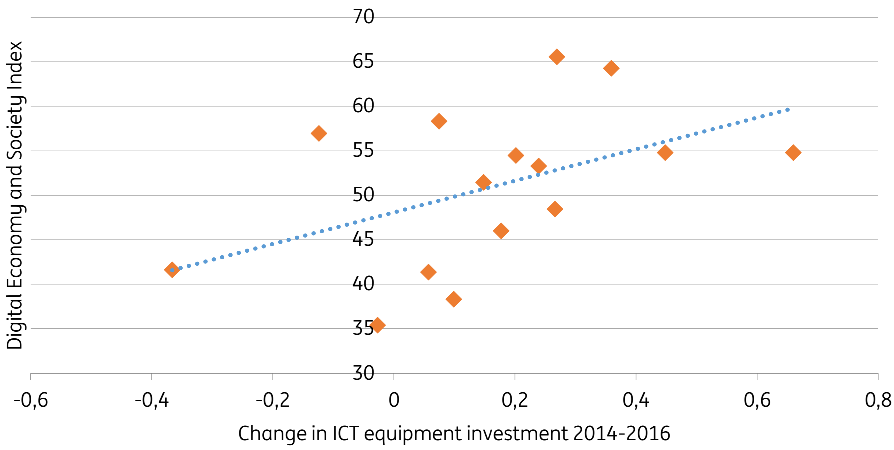
Source: Eurostat, ING Research

Laggards are not catching up in terms of ICT investment

Laggards remain laggards, leaders remain leaders...

The question is which countries are benefiting? In terms of digital adoption, there are large gaps between European countries. This stems from factors including a lack of access to digital technologies, low use of the internet, and weak integration of digital technologies into business. Unfortunately, it does not look as if there is any digital catch-up happening at this stage in the recovery. The European Commission's ranking of digital economy and society index (DESI), indicates that the laggards in terms of the digital economy are also the ones that see the smallest growth in ICT equipment. In fact, Greece and Cyprus have seen a decline in investment since 2014. The countries with the strongest growth in ICT investment are the usual suspects - Ireland, Estonia, Netherlands and Finland, which are already highly digitised economies. This suggests that the digital champions have further increased their lead on the rest of the pack.

Fig 4 ICT equipment investment favours the more digital economies



Source: Eurostat, European Commission DGCONNECT, ING Research

...but not when it comes to intellectual property

This is not the case for intellectual property investment. Some of the least R&D intensive economies, like Greece, Malta and Lithuania have seen strong growth in investment in intellectual property. This means that from a low base, their R&D investments are improving. This has the potential to improve competitiveness and to help modernize these economies. Germany, already one of the Eurozone economies with the largest research and development capacity, has seen a continued boom of investment in intellectual property. In Italy, however, innovation capacity has not yet benefited from the recent broader investment pick-up.

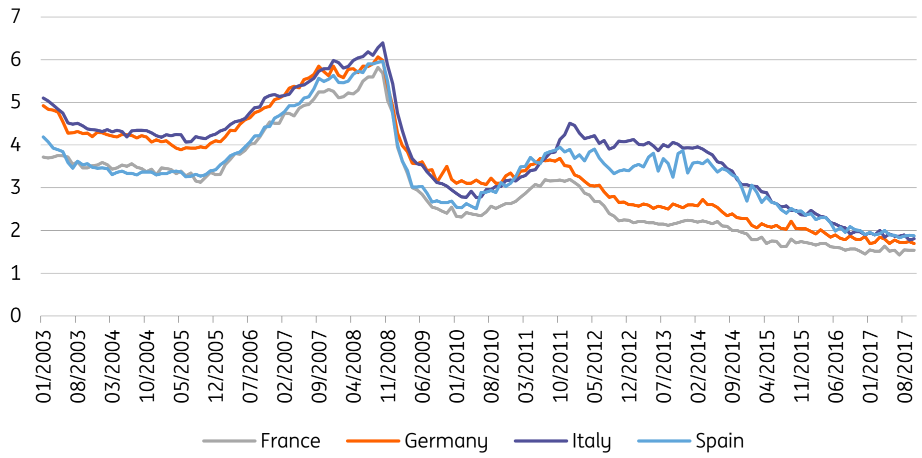
> *"The recent surge in ICT equipment investment has been mainly supportive to the digital leaders, while the laggards see smaller growth. This widens the digital gap between Eurozone economies"*

The role of the ECB

The ECB has played an important role…

ECB Governing Council members have often referred to the importance of the investment recovery and the fact that low-interest rates should support this. In fact, ECB president Draghi considers the return of investment as key in the recovery of inflation to target. Lowered borrowing rates for non-financial corporations have been a key mechanism for the ECB to deliver on its revival of the inflation rate. And this appears to have worked.

Fig 5 Borrowing rates for non-financial corporations have improved significantly over recent years



Source: ECB, ING Research

…also benefitting SMEs in Southern European countries…

Indeed, interest rates have been coming down significantly over recent years. Interest rates for SME loans in Southern European countries seem to have been affected most by the ultra-loose monetary policy. Spain and Italy have seen significant drops in borrowing rates for loan sizes up to 1 million euro.

…and eventually finding its way into the real economy

One contention is that QE has been mainly supportive of financial assets and that it has not boosted investment in productive assets. Looking at the development of investment in innovation and digitalisation and at interest rates, it is hard to call this pure coincidence. In our view, the drop in interest rates has clearly been supportive of investments outside of financial assets.

There is empirical evidence of how low interest rates affect investments in intellectual property and R&D…

In an ordinary least squares framework using supply and demand control variables, we test the impact of non-financial corporations' MFI interest rates on investment by asset type. With this, we find evidence that the most interest rate sensitive asset class is intellectual property, which suggests that the current loose monetary policy has been beneficial to invest in R&D. We estimate that in the past two years, declines in interest rates have boosted investment in intellectual property by 0.7%. The impact of interest rates on ICT equipment, however, is not significant, suggesting that QE has been less relevant for the improvements in ICT equipment investment over recent years, or at least that there were other factors which mattered more.

…confirming our view that the ECB is fostering a structural transition of the Eurozone economy

Looking ahead, accommodative monetary policies will continue to play an important role in the further transformation of the Eurozone economy. With continued asset purchases, albeit at a slower pace in 2018, investments should continue to receive tailwinds from the ECB. For now, the investment impact on the low-interest rate environment has been broad-based in terms of countries and has favoured intellectual property investment. In that way, the ECB might have contributed to the increase in economic potential if indeed the investments in R&D do lead to stronger productivity growth.

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