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Explaining the Recent Slump in Investment: the Role of Expected Demand and Uncertainty

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ABSTRACT

The recent weakness in business investment among advanced economies has revived interest in investment models and opened a debate on the main drivers of the “investment slump” and what the policy response should be – if any. In particular, it is essential to assess precisely whether the investment slump stems mostly from weak aggregate demand, financial constraints or uncertainty, as these different explanatory factors have different policy implications. This paper presents an empirical investigation of the main determinants of business investment for a panel of 22 advanced economies. The main contribution is that we present results from an augmented accelerator model using vintage forecast data as a measure of expected demand and show that this forward-looking variable goes a long way in explaining the weakness in investment since the Global Financial Crisis. Moreover, our results also underline the importance of uncertainty, whereas measures of capital cost seem to play a more modest role. Finally, we show that systematically over-optimistic GDP growth forecasts since 2008 have supported business investment to a large extent.

KEYWORDS Business investment; aggregate demand; uncertainty; financial frictions; expectations

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