



November 8, 2018

Introduction to the U.S. Economy: Business Investment

What is Business Investment?

Business investment is spending by private businesses and nonprofits on long-lasting assets, also known as physical capital, that assists in the production of goods and services. Physical capital is generally grouped into three categories: equipment (e.g., machinery or computers), structures (e.g., offices or warehouses), and intellectual property (e.g., software development or research and development).

Through investment, businesses can build up their stock of physical capital, which increases their capacity to produce goods and services. For example, when a restaurant purchases an additional grill, it increases its capacity to prepare food at a given time. However, over time physical capital tends to become less productive due to wear and tear and eventually must be replaced as it breaks down. This process is referred to as depreciation. For a firm to continually increase its stock of physical capital, and therefore its productive capacity, it must make investments into new physical capital faster than its current physical capital is depreciating. The same goes for the economy as a whole—for the economy's stock of physical capital to increase, the investment rate must exceed the rate at which physical capital depreciates.

Economic Considerations

Business investment is of significant interest to economists because it can affect the short-term and long-term growth of the economy.

In the short term, an increase in business investment directly increases the contemporary level of gross domestic product (GDP), because business investment is included in GDP. Similarly, a decrease in business investment will decrease GDP. Business investment is one of the more volatile components of GDP and tends to fluctuate significantly from quarter to quarter.

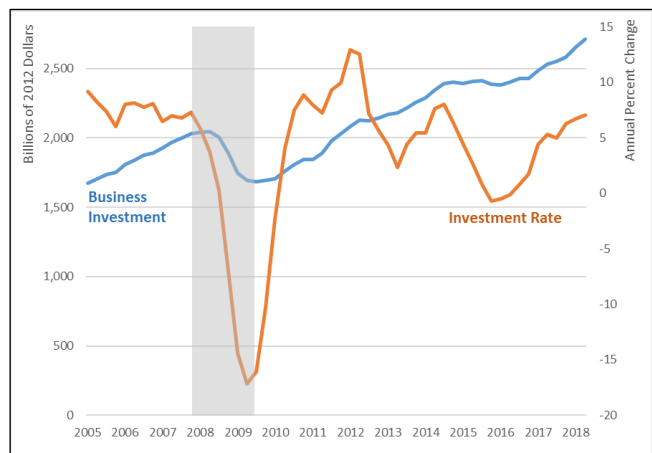
In the long term, business investment, specifically the size of the capital stock, can impact the long-term growth of the economy. A higher stock of physical capital increases the overall productive capacity of the economy, allowing more goods and services to be produced with the same level of labor and other resources. Alternatively, a lower physical capital stock reduces the productive capacity of the economy, all else equal. In the long term, economic growth is generally dependent on growth in the productive capacity of the economy, rather than swings in supply and demand. Faster economic growth generally translates into faster income growth and improved living standards. For additional discussion of the long-term drivers of economic growth, refer to CRS In Focus IF10557, *Introduction to U.S. Economy: Productivity*, by Jeffrey M. Stupak.

Drivers of Business Investment

The main determinants of business investment are broader economic conditions, business confidence and expectations, and long-term interest rates.

As discussed earlier, business investment can affect the economy, but changes in the economy also affect business investment. As shown in **Figure 1**, following the beginning of the 2007-2009 recession, business investment began to decrease sharply. As a recession occurs, businesses tend to see a decline in demand for their products, which leads them to reduce investment spending. Alternatively, during a healthy economic expansion, businesses tend to see rising demand for their products, which leads them to increase investment in order to increase production to accommodate the increased demand. As such, the business cycle is one of the largest drivers of business investment. For more information regarding the business cycle, refer to CRS In Focus IF10411, *Introduction to U.S. Economy: The Business Cycle and Growth*, by Jeffrey M. Stupak.

Figure 1. Recent Business Investment Trends 2015-2018



Source: Bureau of Economic Analysis.

Notes: The investment rate is measured as the year-over-year change in real business investment. Grey bar indicates recession.

Business confidence and future expectations for the economy are also expected to influence business investment. If business owners expect rising sales and improving economic conditions, they are more likely to make investments into their businesses because they anticipate increased demand for their goods and services. Alternatively, declining confidence in the economy will likely result in declining business investment. Business confidence and future expectations can be unpredictable and difficult to influence through public policy.

Business investment is typically financed through credit markets. As such, interest rates influence business investment decisions by either increasing or decreasing the cost for a business to borrow funds, thus affecting the profitability of making additional investments. When a firm is evaluating a potential investment, it must determine whether the expected benefits will outweigh the cost of the investment. All else equal, a rising interest rate will increase the costs associated with an investment, resulting in fewer investments being undertaken. Alternatively, a falling interest rate will decrease the costs associated with investment, resulting in more business investment. This concept is the guiding principle behind contemporary monetary policy, with the Federal Reserve altering short-term interest rates in order to influence long-term interest rates in an effort to affect business investment (and interest-dependent consumer spending.) The Federal Reserve is currently on a path of increasing interest rates as it attempts to decrease the amount of monetary stimulus in the economy. For additional discussion of monetary policy and the Federal Reserve, refer to CRS Report RL30354, *Monetary Policy and the Federal Reserve: Current Policy and Conditions*, by Marc Labonte.

Saving and Investment

One of the long-term determinants of business investment is the level of savings available to the economy. For financial institutions to loan funds to businesses that the businesses in turn use to make investments, other individuals must be depositing their savings into those financial institutions. Because of the global nature of the U.S. economy, firms in the United States have access to savings from within the United States and from abroad; thus, interest rates in the United States are influenced by the supply of global in addition to national savings. A higher supply of savings results in lower interest rates, and a lower supply of savings results in higher interest rates, all else equal. As such, an increase in the supply of savings should lead to an increase in business investment, due to declining interest rates. For additional discussion of the supply of savings, refer to CRS In Focus IF10963, *Introduction to U.S. Economy: Personal Saving*, by Jeffrey M. Stupak

Trends in Business Investment

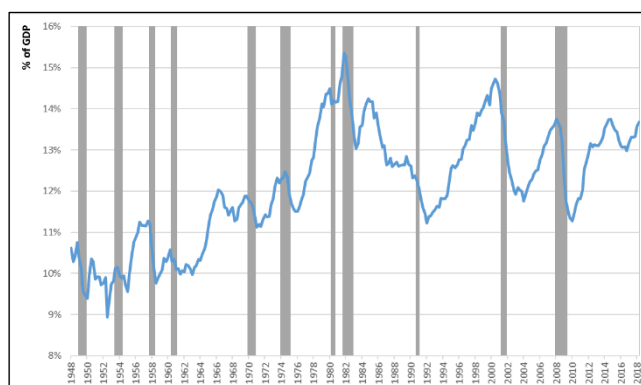
As shown in **Figure 1**, business investment declined sharply during the 2007-2009 recession. Deteriorating economic conditions during the recession reduced business revenues and confidence. The decline in business investment persisted through the third quarter of 2009, despite the Federal Reserve lowering its benchmark interest rate to virtually zero beginning in late 2008. Following the 2007-2009 recession, business investment began rising again, with the year-over-year investment rate peaking above 12% in 2012. This rise in business investment coincided with historically low interest rates, improving business confidence, and broadly improving economic conditions.

Business investment began to slow considerably by mid-2014, remaining relatively flat between 2014 Q4 and 2016 Q2. This decline in investment coincided with a decline in business confidence, as measured by the Organisation for Economic Co-operation and Development (OECD)

business confidence index. Some commentators suggested the decline in confidence resulted from policy uncertainty during the run up to the 2016 election. Beginning in mid-2016, business investment began increasing again, accelerating through 2017 and 2018. The increase in business investment is likely due to increased business confidence and changes to the tax code that made physical capital investment more attractive. For further discussion of the tax changes enacted in 2017, refer to CRS Report R45092, *The 2017 Tax Revision (P.L. 115-97): Comparison to 2017 Tax Law*, coordinated by Molly F. Sherlock and Donald J. Marples.

In general, beginning in the late 1970s, business investment as a percentage of GDP increased and has remained elevated, increasing from an average of around 10.8% between 1948 and 1975 to around 13.0% between 1976 and 2018. As shown in **Figure 2**, after falling to about 11.3% by the end of 2009, business investment, as a percentage of GDP, has risen back to pre-recession levels of around 13.7% as of mid-2018.

Figure 2. Historical Business Investment Trends 1948-2018



Source: Bureau of Economic Analysis.

Notes: Grey bars indicate recessions.

Foreign Investment

Business investment in the United States is made by both domestic and foreign individuals. The United States receives significant foreign direct investment from abroad, amounting to about \$259.6 billion in 2017, according to the Bureau of Economic Analysis. By this measure, the largest foreign investors in 2017 were Canada, the United Kingdom, and Japan. In addition to foreign direct investment, individuals from abroad can invest in U.S. financial assets that can provide U.S. businesses with funds to finance physical capital investment.

Foreign investment in the United States has been trending downward over the past several years, declining from its post-recession peak of about \$439.5 billion in 2015. However, the United States is not alone in experiencing a decline in foreign investment. According to the OECD, global foreign investment declined about 18% in 2017.

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