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## Investment in an increasingly uncertain global landscape

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## Investment in an increasingly uncertain global landscape

### Key takeaways

- *Private business fixed investment has fallen or remained flat in advanced economies for decades, with a recent levelling-off also observed in several emerging market economies.*
- *The recent increase in uncertainty due to trade tensions will dampen investment while also reducing the effectiveness of monetary policy.*
- *In the long run, the outlook for private business investment depends on the potential need to reconfigure supply chains disrupted by higher trade tariffs as well as governments' efforts to boost public investment and implement structural reforms.*

Business fixed investment relative to GDP has long been stagnant or falling in many advanced economies (AEs) and, after decades of growth, has recently plateaued in emerging market economies (EMEs). The imposition of broad-based tariffs by the US administration and the resulting sharp increase in policy uncertainty risk exacerbate these trends in the near term, dampening investment and output. Higher uncertainty also tends to undermine the effectiveness of monetary policy, potentially amplifying these negative effects. That said, the longer-term outlook offers opportunities for an investment rebound. Private business investment could benefit from greater infrastructure and defence spending, as well as the reconfiguration of supply chains driven by the ongoing trade conflict. Realising this potential, however, will require government efforts to implement structural reforms and revamp existing regional trade agreements.

This Bulletin begins by outlining the long-term trends in business investment, examines the potential impact of the current elevated uncertainty and concludes with an analysis of the key factors that will shape the future of investment.

### Trends in business investments and their drivers

Over the past four decades, global investment rates have varied significantly across regions. In AEs, investment rates have generally fallen or remained flat (Graph 1.A). EMEs have typically maintained higher and rising rates, but recently investment rates have slowed across EMEs (Graph 1.B). Even in countries like China and India – long associated with rising trends – investment rates now appear to be levelling off.

Several structural factors have contributed to stagnant or declining investment levels. These include the falling relative price of capital goods, driven by technological advances and the increasing weight of information and communication technology equipment. In addition, rising incomes and ageing populations have shifted demand from goods to services. At the same time, in several economies rising public debt has often led to higher taxation and lower public investment to cover higher service costs, weakening incentives for private investment. Additionally, rising market concentration and declining

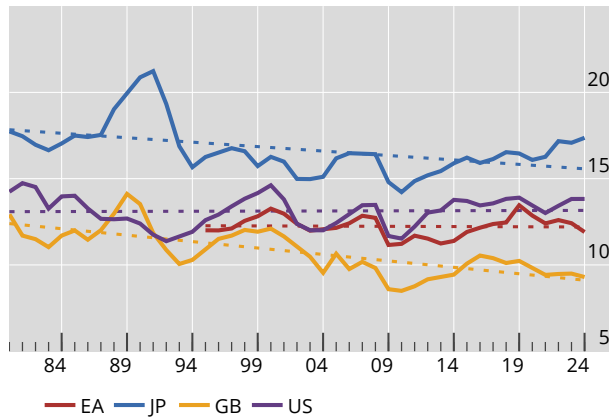
competition – often driven by increasing regulation – appear to have dampened private sector initiative in Europe and the United States (Covarrubias et al (2019); Kalemli-Özcan et al (2024)).

## Investment has been on a declining trend in several jurisdictions<sup>1</sup>

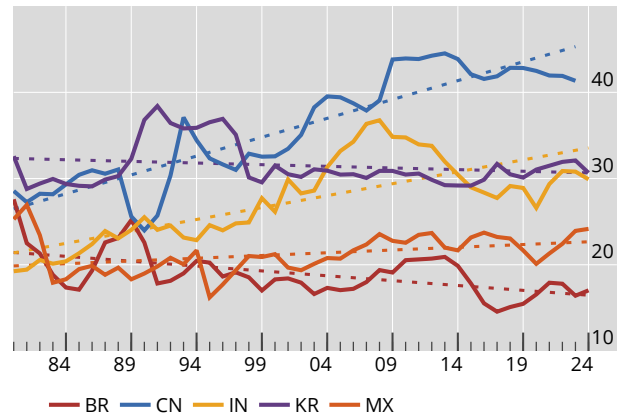
As a percentage of nominal GDP

Graph 1

A. Advanced economies – business investment<sup>2</sup>



B. Emerging market economies – total investment<sup>3</sup>



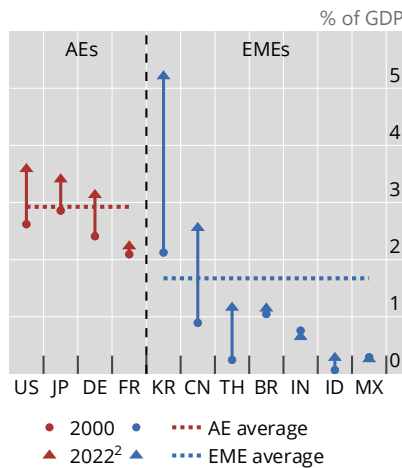
<sup>1</sup> Dashed lines denote the long-term linear trend. <sup>2</sup> Private non-residential gross fixed capital formation. <sup>3</sup> Total gross fixed capital formation, due to lack of historical data on private non-residential gross fixed capital formation for EMEs.

Sources: IMF, *International Financial Statistics*; UN Food and Agriculture Organization; World Bank; LSEG Datastream; national data; BIS.

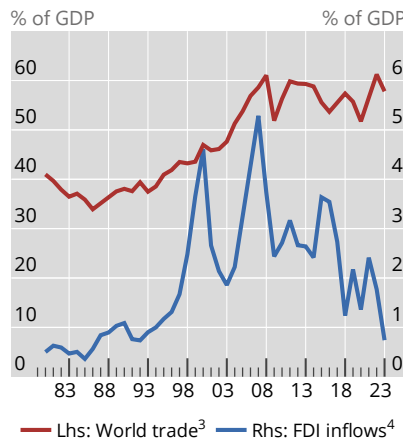
## Structural impediments to investment and recovery from the pandemic

Graph 2

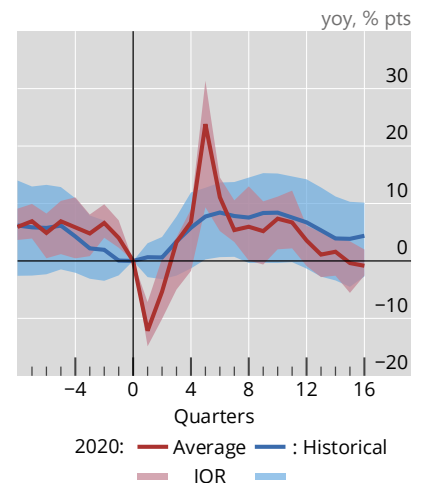
A. Research R&D investment<sup>1</sup>



B. Global trade and FDI



C. Investment growth rate<sup>5</sup>



<sup>1</sup> Research and development expenditures to GDP. GDP-PPP weighted averages for 11 AEs (red dashed line) and 24 EMEs (blue dashed line) in 2022 or latest data available. <sup>2</sup> 2020 values for BR, ID and IN. <sup>3</sup> Sum of global goods and services imports and exports. <sup>4</sup> Global foreign direct investment, net inflows. <sup>5</sup> Year-on-year growth in private gross fixed capital formation volume across 17 AEs and seven EMEs, normalised to zero at  $t = 0$ , which marks the quarter before a business cycle trough, defined according to the OECD classification of turning points in the cyclical component of real GDP. Historical estimates based on recession episodes from 1960 to 2019 with available data. IQR = interquartile range.

Sources: IMF; OECD; UNESCO Institute for Statistics; World Bank; LSEG Datastream; Macrobond; national data; BIS.

In several EMEs, investment rates have slowed as these economies progressed further in the catching-up process. However, the recent loss of momentum also seems to be due to additional factors. Persistently low investment in research and development (R&D) in several economies (Graph 2.A) as well as the

slowdown in global trade following the Great Financial Crisis, coupled with reduced growth in foreign direct investment (FDI), seem to have further constrained private investment (Graph 2.B).

In recent years, business investment has generally tracked pre-pandemic trends with some regional variation. After a sharp rebound from the Covid-19 contraction, the start of the Russia–Ukraine war in early 2022 introduced new uncertainty and drove a surge in commodity prices. As commodity markets stabilised and uncertainty eased, investment growth resumed in most regions but remained constrained by tighter monetary policy aimed at addressing inflation. Investment has since stabilised at rates similar to those seen after past recessions (Graph 2.C).

## Uncertainty and the investment outlook

By late 2024, with a soft landing in sight and ongoing monetary policy easing, investment intentions were expected to improve in several jurisdictions. Strong equity valuations, narrow credit spreads and tight labour markets further reinforced these expectations. However, this positive outlook was overshadowed by recent US trade policy announcements and the massive surge in uncertainty they triggered (Graph 3.A). Both tariffs and uncertainty are expected to weight on business investment, but how?

In principle, the effects of tariffs themselves should be distinguished from those of the uncertainty surrounding them. In practice, however, disentangling these two is challenging. In particular, the three key channels through which tariffs influence investment decisions are currently shrouded in considerable uncertainty. First, tariffs are expected to reduce output, particularly in the United States and retaliating countries. However, the extent and duration of this decline are uncertain due to ambiguity around the scale and scope of US tariffs and potential retaliatory measures. Even with known policies, their impact is difficult to gauge given the lack of recent historical precedents. Second, capital goods often have high import content, meaning that tariffs inflate their prices and expose new investment to the risk of supply chain disruptions. Finally, news about tariffs affects financial market volatility, making it harder for firms to predict borrowing costs and access stable financing.

Economic research shows that uncertainty negatively affects investment. Real option theory suggests that uncertainty prompts firms to delay investment when decisions are costly to reverse, given the high irreversibility of many investments.<sup>1</sup> Indirectly, uncertainty weakens demand as consumers delay durable goods purchases and raises the cost of external financing as lenders demand higher risk premia. Empirical evidence supports these effects on business investment, employment and output, though studies often struggle to disentangle the relative importance of these channels.<sup>2</sup> In addition, as uncertainty is inherently elusive and measured through imperfect proxies, estimates of its impact may vary across periods and contexts, making the effects of uncertainty themselves uncertain.<sup>3, 4</sup>

Given this backdrop, what is the impact of growing uncertainty in the near term? Our econometric analysis provides a sense of the magnitudes involved for a select group of economies. By summarising the historical correlations among key macroeconomic variables, the empirical model aims to capture the overall effects of higher uncertainty through all the channels we described above (see online annex for details). The key assumption is that the economic policy uncertainty (EPU) index remains at the average level observed in April and May throughout the entire second quarter, before gradually declining

<sup>1</sup> See Bernanke (1983), Dixit and Pindyck (1994) and reviews by Bloom (2014).

<sup>2</sup> A notable recent exception is Kumar et al (2023), who provide clear evidence of the real option channel in New Zealand, distinguishing it from the financial market channel and other mechanisms.

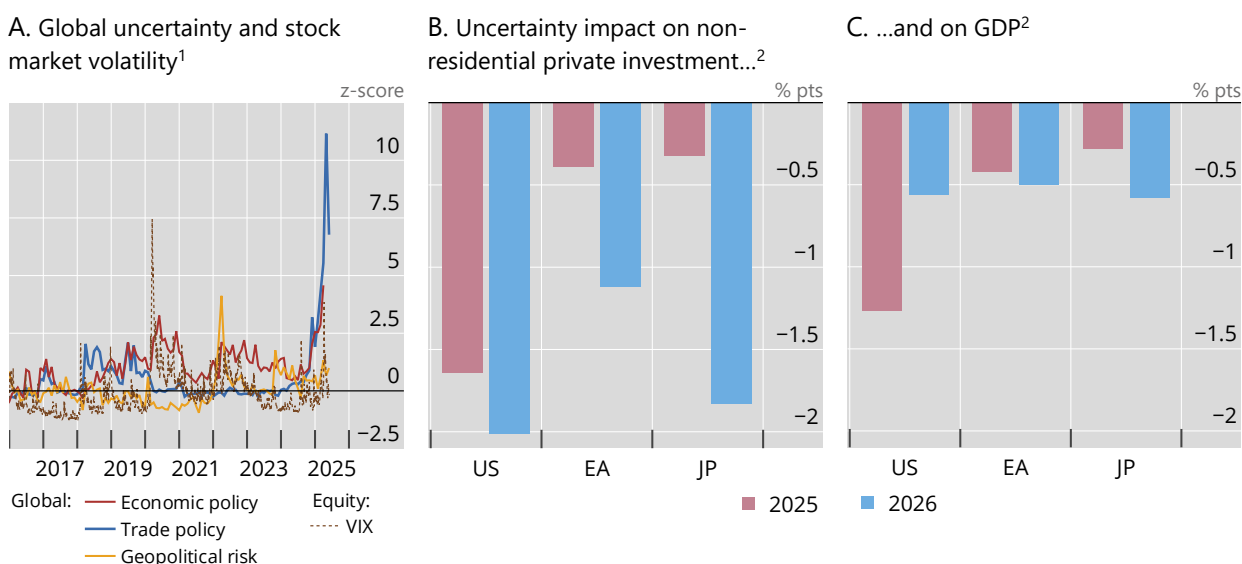
<sup>3</sup> See Cascaldi-Garcia et al (2023) for a recent review of the empirical evidence and the pros and cons of different measures of uncertainty. Caldara et al (2020) estimate that the increase in the trade policy uncertainty index, equivalent to the 2018 spike, reduces business investment between 1 and 2% over the course of a year. Increases in realised stock market volatility also predict lower economic activity, while evidence from forward-looking measures of volatility such as the VIX is mixed.

<sup>4</sup> Brexit offers some insights on the relationship between uncertainty and investment. Following the Brexit referendum, the United Kingdom faced prolonged uncertainty and a gradual investment decline. This extended slowdown was unusual, as it deviated from the typical V-shaped rebound often seen after spikes in uncertainty (Broadbent (2019)).

according to historical patterns. The resulting projections suggest a substantial negative contribution of uncertainty to both investment and output growth in the United States, the euro area and Japan (Graphs 3.B and 3.C). These effects imply a material hit to investment over 2025 and 2026 as well as GDP growth, both induced by uncertainty.

The uncertainty spike subtracts from business investment and GDP forecasts

Graph 3



<sup>1</sup> Z-score from 2000 to present. VIX is daily, while others are monthly. <sup>2</sup> Uncertainty impact on non-residential private investment and GDP is derived from conditional forecasts using the BVAR model outlined in the online annex. This impact is measured as the difference between a forecast conditioned on Q2 2025 uncertainty levels and an unconditional forecast. Specifically, the uncertainty conditions for Q2 are an average over the EPU's for April and May 2025.

Sources: Baker et al (2016); Caldara et al (2020); Caldara and Iacoviello (2022); IMF; OECD; Bloomberg; LSEG Datastream; national data; BIS.

## Implications for monetary policy

What do recent trade news and increased uncertainty imply for monetary policy? For several central banks, including those of the United States and countries that retaliate to US tariffs, these developments are expected to constitute a stagflationary shock. As such, they present a difficult trade-off for monetary policy, requiring central banks to carefully balance the need to cushion the impact on output and employment against the risk that the expected one-off rise in prices morphs into persistently higher inflation. Assessing this trade-off is particularly challenging, given the considerable ambiguity surrounding the combined effect of implemented tariffs and the uncertainty regarding future measures. The initial positive impact on inflation will depend, in particular, on how much tariffs could be absorbed by firms' margins and the response of exchange rates, both of which are hard to predict.

This uncertainty is further compounded by forces that could either amplify or mitigate the initial impact on inflation and its subsequent trajectory. On the one hand, price and wage setters may have become more responsive to new inflation shocks, with households less tolerant of real wage declines following the pandemic-related rise in living costs. On the other hand, a large negative impact of tariffs and uncertainty on domestic output and unemployment could put downward pressure on inflation. Additional disinflationary forces may stem from declining commodity prices, particularly in the event of a pronounced global economic slowdown, as well as from trade diversion and lower prices from tariff-affected countries.

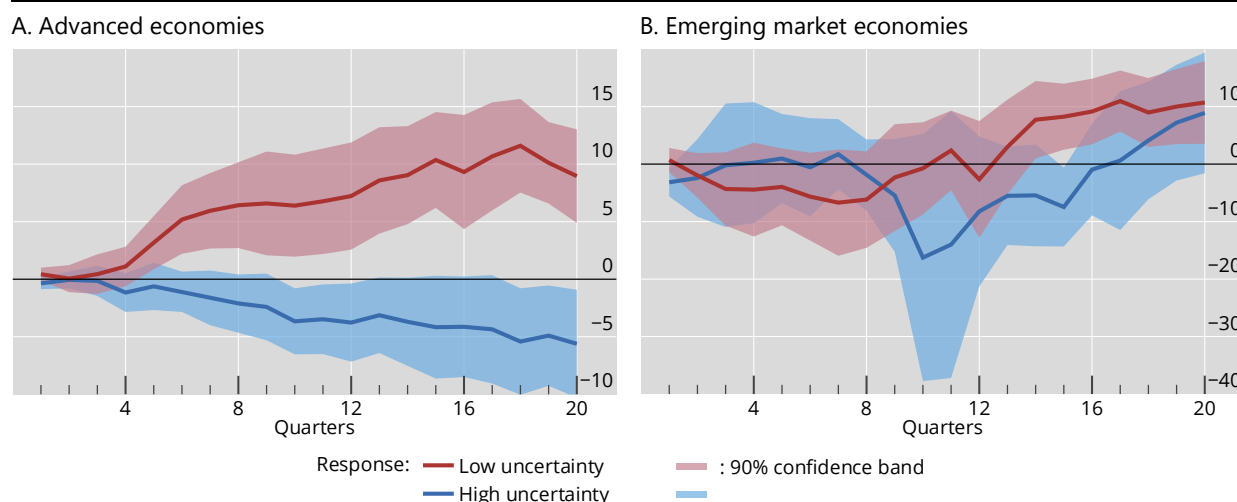
In countries that have not imposed tariffs or retaliatory measures, the trade shock is likely to be more comparable with an adverse demand shock. As a result, the inflationary effects in these economies could be smaller or even mildly disinflationary, reflecting lower prices for manufactured goods and commodities.

Economies in this group, particularly Asian EMEs experiencing inflation at or below target, may therefore have greater room to continue supporting growth with monetary easing.

## The effect of a monetary easing on investment depends on uncertainty<sup>1</sup>

In per cent

Graph 4



<sup>1</sup> Estimates from local projections which regress the cumulative percentage change in private investment on monetary policy surprises of 100 basis points. See online annex for details.

Sources: OECD; World Bank; Bloomberg; LSEG Datastream; national data; BIS.

The formulation of monetary policy is further complicated by the potential reduction in its effectiveness when uncertainty is elevated. As highlighted by real option theory, high uncertainty tends to make investment decisions less responsive to both demand conditions and changes in interest rates. This prediction is broadly supported by our empirical evidence in both AEs and EMEs (Graph 4). Cross-country estimates indicate that monetary easing stimulates investment when uncertainty is low, but has no significant effect in the face of high uncertainty (see eg Aastveit et al (2017)).

Whatever course of action they take, central banks should continue to foster a stable economic environment by focusing on price and financial stability. A data-driven approach to monetary policy is essential for navigating uncertainty and preventing negative dynamics from spiralling out of control. However, frequent changes in policy stance could harm central bank credibility. In this context, a “wait-and-see” approach may help mitigate reputational risks until uncertainty is significantly reduced.

## Medium- to long-term outlook for investment

The outlook for business investment beyond a possible near-term contraction is highly uncertain, with risks on both sides. On the one hand, high trade tariffs and elevated policy uncertainty – if persistent – could reduce global trade integration and productivity, and leave excess supply in some countries. Together, these factors could depress long-term investments. On the other hand, changes in trade patterns could lead to a reconfiguration of global value chains, requiring substantial investment over many years.

The long-term outlook for business investment will also depend on government policies, especially in three key areas. The first is public investment, which is essential in many countries to address persistent issues like stagnant productivity and emerging challenges such as defence needs, climate change and shifting trade patterns. Improving infrastructure and promoting research in new areas can lower costs and/or create new markets for firms, thus stimulating private investment. In addition, the extra demand generated by public investment could further boost private investment through acceleration effects.

The German government's recent announcement of a large infrastructure fund is a step in this direction. Similar plans may also be unveiled in other countries with sufficient fiscal space. However, the implementation of large investment plans may not be without hurdles. The public administration may lack the capacity to design and implement large infrastructure projects effectively, as shown, for example, by the low uptake of the European Union's Recovery and Resilience Facility funds in some countries. Moreover, current tight labour markets may constrain public investment and its growth impact.

This highlights the importance of the second key area: implementing structural reforms. Strengthening public administration to execute large investment projects may require attracting top talent and reviewing planning laws and regulations. In tight labour markets, reforms to fiscal incentives, pension systems and immigration policies are crucial to expand the labour supply. Business dynamism could be enhanced by reducing bureaucratic hurdles and offering targeted tax relief.

A third related area is the removal of barriers to trade, both within and across borders. Reducing these barriers, including those preventing the full integration of internal capital markets, can foster business growth and improve credit flow to new investments. Revamping existing regional trade arrangements – such as the Southern Common Market (Mercosur), the ASEAN Free Trade Area (AFTA) or the Regional Comprehensive Economic Partnership (RCEP) – also has the potential to offset the current drop in FDI. Moreover, the trade conflict may accelerate the conclusion of long-stalled trade agreements (eg EU-Mercosur) and the full ratification of repeatedly delayed treaties (eg Canada-EU).

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