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Investment and monetary policy in the euro area

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Abstract

This paper analyses the effects of a change in monetary policy on firms' investment in Germany, France, Italy and Spain using a data set which provides aggregated balance sheet and profit and loss account data for 17 different industries and three different size classes. The main findings are twofold. First, in each of the four countries a change in the user cost of capital, which in turn is affected by interest rates, has both statistically and economically significant effects on investment. Second, while the average interest rate on debt is generally higher for small firms than for large firms, there is little evidence that the effects of monetary policy on small firms are larger.

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1. Introduction

A good understanding of the monetary transmission mechanism in the euro area is essential for the efficient implementation of the ECB's single monetary policy. While there is a large literature which focuses on the macroeconomic effects of a change in policy-controlled interest rates in the various euro area countries (Kieler and Saarenheimo, 1998), much less comparative work has been done based on microeconomic evidence. Nevertheless, such evidence is important for at least two reasons. First, it has proven to be very difficult to find significant interest rate effects on investment using aggregate data (Blanchard, 1986). Using the cross-sectional variation

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¹ The views expressed in this paper only reflect those of the authors and not necessarily those of the European Central Bank.

in disaggregated data, it may be easier to empirically identify such interest rate effects. For the euro area there is hardly any microeconomic evidence on the elasticity of investment with respect to the user cost of capital.² Most of the studies that estimate Euler equations of investment postulate a production function that is homogeneous of degree one and therefore impose a unit elasticity without testing it.³ Second, it has been argued that differences in financial systems could lead to asymmetries in the transmission as some countries are more affected by financial accelerator phenomena than others.⁴ Typically, such transmission channels imply that monetary policy has distributional effects, which can only be tested using disaggregated data.

In this paper we analyse industry-specific investment behaviour in the four largest countries of the euro area (i.e. Germany, France, Italy and Spain) using a semi-aggregate data set on firms' balance sheets assembled by the European Commission. The data comprises 17 industries (both manufacturing and services) for each country. For each industry we have disaggregated balance sheet information for three different firm-size classes bringing the total number to 51 "representative industries". Starting from a neoclassical model for investment, we first examine the elasticity of investment with respect to the user cost of capital, we then examine the effects of an interest rate change on the user cost of capital. Finally, we also study to what extent the strength of the effect of monetary policy on industry investment is related to the size of the firms within the industry.

The contribution of this paper is threefold. First, we use a consistent data set and methodology to estimate investment equations for the four largest countries of the euro area. This increases the comparability of the results across countries. Moreover, these four countries cover around 80% of total euro area GDP. Second, while most studies that estimate the effect of changes in the user cost of capital on investment focus on variations in tax rates, this paper is the first one to use a time and industry varying interest rate on debt to build firm-specific measures of the user cost of capital. We find a significant negative effect of the user cost on investment in all four countries. While the short-term dynamics differs across countries, it is striking that the long-run parameters are quite similar. The long-run elasticities of the capital stock with respect to both sales and the user cost are not significantly different from 1, implying that a simple Cobb–Douglas specification of the production function cannot be rejected. This result is in stark contrast with the large literature on aggregate investment functions (Blanchard, 1986) and with one of the major arguments of proponents of the credit channel that the empirical evidence on a sizable impact of the user cost on investment is very weak (Bernanke and Gertler, 1995). Our results

² For example, Bond and Van Reenen (1999) note that "Compared to the voluminous literature on financing constraints and investment there has been a dearth of microeconomic studies that focus on estimating the sensitivity of investment to changes in taxes, interest rates or other compounds of the user cost of capital".

³ See Mojon (2000) for a survey of the empirical literature on investment and liquidity constraints in the euro area.

⁴ See, for example, BIS (1995), Kashyap and Stein (1997) and Guiso et al. (1999).

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