

Tightening Monetary Policy and Investment Dynamics in the European Monetary Union: Firm- and Country-Level Heterogeneity

Abstract

We employ firm-macro matched data on small and medium-size enterprises in the European Monetary Union to study the investment response to firm's financial condition when tight monetary policy shocks occur. We show that firms with higher financial expenses, higher leverage, and longer debt maturity are more negatively responsive to monetary restrictions. Capital structure significantly affects monetary policy transmission: a leverage ratio one percentage point larger than average implies a semi-elasticity of investment to a nominal interest rate hike approximately one-tenth higher two years following the monetary shock and, overall, four years more persistent. We further argue that the investment response to monetary contractions is heterogeneous not only with respect to the firm-level financial structure but also in relation to the country-specific financial and productive conditions. First, we show that the investment semi-elasticity to rate hikes significantly increases in countries characterized by higher frictions in accessing the credit market (countries' cost of borrowing and countries' loans-to-deposit ratio). Moreover, the same results are obtained focusing on stressed countries, i.e., countries that benefitted more from the Outright Monetary Transaction (OMT). Focusing on market structure, the propagation of monetary shock on investment when financial structure worsens is more pronounced in countries featured by either a larger share of small-size firms or a larger share of intangible assets.