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World of Labor
Evidence-based policy making

How does monetary policy affect labor demand and labor productivity?

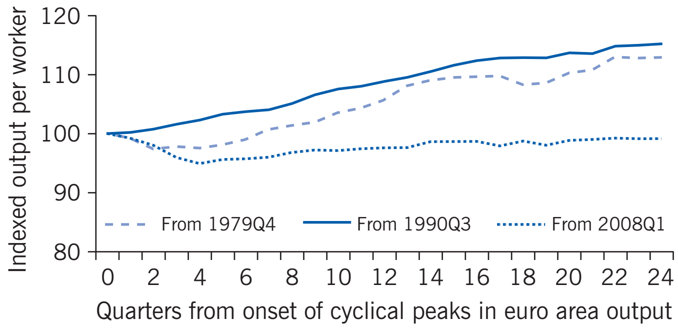
Monetary policy easing initially supports labor demand, but persistent easing may slow down necessary restructuring and productivity growth

Keywords: monetary policy, labor demand, productivity

ELEVATOR PITCH

By supporting aggregate demand, including by easing financial constraints that affect businesses and households, accommodative monetary policy increased employment during the 2008 financial crisis and its aftermath. But, monetary policies that ease financial pressures also reduce necessary restructuring that normally contributes to productivity growth. One reason why productivity growth has been weaker in the aftermath of the crisis is that aggressive monetary policy actions have weakened underlying supply-side performance and labor productivity.

Labor productivity has been persistently weak



Source: Eurostat. Online at: http://ec.europa.eu/eurostat; Euro Area Business Cycle Network. Online at: http://eabcn.org/

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KEY FINDINGS

Pros

- Policy loosening by central banks initially raises demand for labor by reducing the effect of financial constraints on employment through lower interest expenses.
- A severe fall in labor demand and reductions in employment can weaken an economy's supply-side performance through increased long-term unemployment and loss of potentially productive businesses; such effects reinforce the benefits of accommodative monetary policy during a downturn, at least initially.

Cons

- Budget constraints necessitate the reallocation of resources to more productive uses; highly accommodative monetary policies that reduce financial pressures may mitigate this effect and thus weaken the underlying supply side of the economy.
- Monetary policy easing may reduce the positive effects of resource allocation to a greater degree in economies whose financial systems are bank-based as opposed to market-based.

AUTHOR'S MAIN MESSAGE

Monetary policy actions supported economic activity, labor demand, and employment during the 2008 global financial crisis, partly by avoiding the "hysteresis effects" (which raised the unemployment rate persistently) after past European recessions. However, if financial constraints continue to be reduced well into a recovery, this may impede productivity growth, job creation, and ultimately the strength of the recovery. While monetary policy loosening is an essential policy response to a downturn, timely removal of such policy, alongside other policies that raise productivity growth, is necessary for the medium-term strength of the recovery.

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