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NEW REPORT: Monetary policy aimed at easing the effects of a recession may slow down necessary restructuring and productivity growth

A new IZA World of Labor report finds accommodative monetary policy as applied during the 2008 financial crisis may initially increase labor demand but might impede productivity growth and recovery in the mid-term if monetary policy easing persists

By easing financial constraints that affect businesses and households, accommodative monetary policy increased employment during the 2008 financial crisis and its aftermath. But while post-crisis unemployment rates have fallen, labor productivity growth has remained persistently weak. According to the economist Andrew Benito of Goldman Sachs, UK, one reason why productivity growth has been weaker in the aftermath of the crisis is that aggressive and persistent monetary policy actions have weakened underlying labor productivity.

A remarkable feature of the 2008 global financial crisis and its aftermath has been the scale of monetary policy response. Central banks in the US and Europe eased monetary policy through interest rate cuts to historic lows, large-scale asset purchase programs financed by the creation of central bank money (quantitative easing), and credit easing measures that subsidized credit expansion on favorable terms. This relieved financial pressures affecting businesses, primarily by reducing interest expenses and freeing up credit, and supported labor demand and employment.

However, Benito argues, financial pressures are also part of the process that ensures that capital is reallocated from low to high productivity sectors and establishments. This process of restructuring—via new entry and exit of businesses and establishments—represents a quantitatively important part of normal productivity growth. Benito cites among other research a study of a sample of UK firms between 1980 and 1992, which found that around one-half of labor productivity growth resulted from “external restructuring” effects—the closure of inefficient plants and the entry and increased market share of more efficient establishments.

In the US, recessions before 2007 were characterized by periods of accelerated reallocation, which were even more productivity enhancing than out-of-recession periods. In the Great Recession, by contrast, the intensity of reallocation fell rather than rose and the reallocation that did occur was less productivity enhancing than in prior recessions. According to Benito, economic restructuring is weakened when businesses are able to pay near-zero interest rates. The weak productivity performance in the post-crisis period is consistent with this perspective.

Benito agrees with monetary authorities acting aggressively to lower interest expenses for businesses in an economic and banking crisis. They are also right to avoid high levels of financial pressure, which would inevitably weaken the inflation outlook as well as employment. However, the longer that highly accommodative monetary policy persists, the more this may tip the balance toward adverse supply-side effects, especially via persistently weaker labor productivity. Striking this balance is likely to dominate discussions of setting the right monetary policy in Europe for years to come.

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Notes for editors:

IZA World of Labor (http://wol.iza.org) is a global, freely available online resource that provides policy makers, academics, journalists, and researchers, with clear, concise and evidence-based knowledge on labor economics issues worldwide.

The site offers relevant and succinct information on topics including diversity, migration, minimum wage, youth unemployment, employment protection, development, education, gender balance, labor mobility and flexibility among others.

Established in 1998, the Institute of Labor Economics (www.iza.org) is an independent economic research institute focused on the analysis of global labour markets. Based in Bonn, it operates an international network of about 1,500 economists and researchers spanning more than 45 countries.