Corporate Leverage and Monetary Policy
Effectiveness in the Euro Area

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19 November 2020
Banca d’Italia-SUERF
The effectiveness of monetary policy in a low interest rate environment

The views expressed in this presentation are those of the authors and do not necessarily reflect the position of the Bank of Italy or the Eurosystem
Motivation

• Corporate leverage is key for the transmission of monetary policy to the real economy

• At the **aggregate** level leverage amplifies the real effects of monetary policy through the financial accelerator mechanism (**Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997**):

• At the **disaggregated** level which firms are more responsive to monetary policy is theoretically more ambiguous

  ▶ highly leveraged firms, being more financially constrained, are in principle less reactive …

  ▶ … but they are more exposed to the financial accelerator mechanism
This paper

- **What we do**: Empirical investigation of the relation between corporate leverage and output sensitivity to monetary policy shocks in the euro area

- **How**: State-of-the-art empirical macro approach
  - disaggregated euro-area panel data at country-industry level
  - high-frequency identified monetary policy shocks
  - *polynomial state-dependent* local projections

- **Preview of the results**: Evidence of a *non-linear relation*
  - *concave*: more leveraged industries adjust their production more strongly, but at sufficiently high leverage ratios this positive relation tends to weaken
  - *eventually non-monotonic*: the most leveraged industries do not necessarily display the strongest sensitivity, especially within the *short-term horizon* and in *recessions*
Theoretical insights on the relation between leverage and output sensitivity

- **Positive** *(Bernanke et al., 1999)*
  - more leveraged firms display an excess sensitivity to shocks, because they benefit more from the financial accelerator mechanism

- **Potentially non-linear** *(Ottonello and Winberry, 2020)*
  - low leveraged firms, being unconstrained, are the least responsive to monetary policy
  - high leveraged firms, being more risky, are not the most responsive, as the accelerator effect is attenuated by the presence of tighter financial frictions

- **Dynamic** *(Jeenas, 2019)*
  - in the longer-term horizon high leveraged firms unambiguously benefit from the financial accelerator mechanism and are the most sensitive to monetary policy
Mixed empirical results

- **Ottonello and Winberry (2020):** US listed firms with low default risks, that is with low leverage and high credit ratings, are the most responsive to monetary policy shocks.

- **Cloyne et al. (2019):** in US and UK, younger no-dividend payer firms that on average have lower leverage are more responsive.

- **Jeenas (2019):** US firms with higher leverage or with fewer liquid assets holdings become significantly more responsive to the shock after around 1 year.

- **Anderson and Cesa-Bianchi (2020):** the effects of monetary policy surprises on borrowing costs, debt and investments are larger for US firms with high leverage.

- **Our contribution:**
  - euro-area data which include non-listed firms
  - relax the assumption of a linear relation between leverage and output sensitivity using polynomial state-dependent local projections.
Plan of the talk

1 Data and methodology

2 Are more leveraged industries more sensitive to monetary policy?

3 State of the economy and sign of the monetary policy shocks

4 Wrapping up
Data and methodology
Data

- Three dimensions:
  1. **country**: 7 euro area countries (AT, BE, DE, ES, FR, IT, PT)
  2. **industry**: 22 manufacturing industries (NACE two-digits)
  3. **time**: monthly frequency in 2001-18

- Three main variables:
  1. **Response variable**: industrial production (EUROSTAT)
  2. **Monetary policy shock**: high-frequency ECB shocks from Jarociński and Karadi (2018)
     (poor-man shocks)
  3. **State variable**: leverage as ratio of total liabilities to total assets at book value and at the end-of-year (BACH)
Polynomial state-dependent local projections

- Jordá’s (2005) local projections

\[
\tilde{y}_{c,s,t+h} = \sum_{j=0}^{k} \ell_{c,s,t-12}^{j} \left[ \alpha_{j}^{(h)} + \beta_{j}^{(h)} \varepsilon_{t} + \Theta_{j}^{(h)}(L)X_{c,s,t} \right] + \\
+ \alpha_{c}^{(h)} + \alpha_{s}^{(h)} + \alpha_{t}^{(h)} + u_{c,s,t+h}
\]

for \( h = 0, \ldots, H \)

- if \( k = 0 \), linear panel LP
- if \( k > 0 \), state-dependent panel LP. Our baseline: \( k = 2 \)
Polynomial state-dependent local projections

\[ \tilde{y}_{c,s,t+h} = \alpha_0^{(h)} + \beta_0^{(h)} \varepsilon_t + \]
\[ + \ell_{c,s,t-12} \left[ \alpha_1^{(h)} + \beta_1^{(h)} \varepsilon_t \right] + \]
\[ + \ell_{c,s,t-12}^2 \left[ \alpha_2^{(h)} + \beta_2^{(h)} \varepsilon_t \right] + \]
\[ + \alpha_c^{(h)} + \alpha_s^{(h)} + \alpha_t^{(h)} + \text{controls} + u_{c,s,t+h}^{(h)} \]

- \( \beta_0^{(h)} \) measures the **cumulative response** of industrial production at horizon \( t + h \) to an expansionary shock hitting at time \( t \)

- \( \beta_1^{(h)} \) measures if the excess sensitivity to monetary policy is positive/negative when corporate leverage is higher

- \( \beta_2^{(h)} \) measures if such excess sensitivity strengthens/weakens/remains constant as leverage increases
Polynomial state-dependent local projections

\[
\tilde{y}_{c,s,t+h} = \alpha_0^{(h)} + \beta_0^{(h)} \varepsilon_t + \\
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- Country, industry and time fixed effect \((\alpha_c^{(h)}, \alpha_s^{(h)}, \text{and } \alpha_t^{(h)})\)
- \(\alpha_0^{(h)} \text{ and } \beta_0^{(h)}\) are absorbed by the fixed effects
Measuring the relation

- **Level effect (sensitivity):** cumulative response of industrial production to monetary policy shocks as a function of leverage

  \[ \psi^{(h)} [\ell] = \beta_0^{(h)} + \beta_1^{(h)} \ell + \beta_2^{(h)} \ell^2 \]

  \( \psi^{(h)} [\ell] \) is estimated up to an unidentified constant \( \beta_0^{(h)} \)

- **Differential effect (excess sensitivity):** differential cumulative response associated with a 10 pp difference in leverage

  \[ \tilde{\psi}^{(h)} [\ell] = \psi^{(h)} [\ell + 10] - \psi^{(h)} [\ell] = \beta_1^{(h)} 10 + \beta_2^{(h)} (10^2 + 20\ell) \]
Are more leveraged industries more sensitive to monetary policy?
Evidence of a negative differential effect at sufficiently high leverage ratios...
...that fades at longer horizons
Is it leverage or other factors?

- Results may be driven by **group-specific factors** unrelated to financial frictions but correlated with leverage (e.g. heterogeneous demand elasticities, fiscal reaction function) ...

- ... or **other corporate balance sheet indicators** (e.g. liquidity, bank credit)

- Estimate the model augmented with the **monetary policy shock** interacted with a set of **country and industry dummies** and with other balance sheet indicators.

- The exercises might absorb valuable information also linked to financial frictions, but the analyzed **relation does not change meaningfully**
Group-fixed characteristics

![Graph showing cumulative differential effect over months after the shock for different percentage comparisons: 55% vs. 45%, 65% vs. 55%, 75% vs. 65%, and 85% vs. 75%. The graphs display the cumulative differential effect in percentage terms over 24 months following the shock, with lines representing baseline, country-fixed sensitivities, sector-fixed sensitivities, and both country- and sector-fixed sensitivities.](image-url)
Balance sheet characteristics

- 55% vs. 45%
- 65% vs. 55%
- 75% vs. 65%
- 85% vs. 75%

Cumulative differential effect (%) vs. months after the shock

- Baseline
- ctr. for liquidity
- ctr. for profitability
- ctr. for working capital
- ctr. for maturity
- ctr. for debt service
- ctr. for bank credit
Robustness

- shocks
  - daily frequency
  - sign restrictions to control for information shocks
- smaller samples
  - fully-balanced
  - ending in 2011 or 2014
  - remove one country or one sector at a time
- measures of leverage
  - narrower (loans & debt securities as a ratio of net assets)
  - structural (median leverage ratio over time)
- approaches to assess the non-linear relationship
  - threshold approach
  - two-step approach
State of the economy and sign of the monetary policy shocks
Good and bad times

• In **bad times** highly leveraged companies are likely to
  ▶ be perceived as **more risky** *(Bernanke and Gertler, 1989; Kiyotaki and Moore, 1997)*
  ▶ feel a **need to repair** their balance sheets *(Myers, 1977; Occhino and Pescatori, 2015)*

• Allow our baseline model to differ in good and in bad times
  ▶ We employ a **discrete indicator** \( I_{c,s,t} \) which takes value one when an industry is in recession and zero otherwise
  ▶ An industry recession is defined as a **negative year-on-year growth** in the industrial production index \( y_{c,s,t} \) for at least six **consecutive months**
Evidence of attenuation effect at high leverage stronger in bad times
Under expansionary and contractionary shocks

- In theory the attenuation effect at high leverage ratios does not necessarily depend on the **sign of the shock**

- However for particular shapes of the capital supply curve it could be **more likely that the attenuation effect is more intense under expansionary shocks**

- Additional analysis separating the effects of expansionary and contractionary shocks
No evidence of a more pronounced attenuation effect after expansionary shocks.
Wrapping up
Conclusions

- The relation between output sensitivity to monetary policy and corporate leverage is
  - **Concave**: excess sensitivity is smaller at high leverage ratios
  - **Eventually non-monotonic**: highly leveraged firms are not necessarily the most responsive to monetary policy shocks (especially within the short-term horizon and in recessions)

- **Take-home message**: More leverage does not always imply a greater sensitivity of output to monetary policy, as the amplification effect generally associated with the balance sheet channel is attenuated when leverage is likely to be excessive.
THANK YOU!


Ottonello and Winberry (2018)

- a firm produces up to the point at which MC = MB
- the MB curve is *downward sloping*, reflecting diminishing returns of capital
- the MC curve is *flat* when risk premia are zero and becomes *upward sloping* when risk premia start to increase (debt capacity shrinks)
• assume that a monetary policy shock induces only a shift in the MB curve
• constrained firms *react more* than unconstrained firms because the monetary policy shock induces a greater shift in the MB curve
• risky constrained firms *react less* than risk-free constrained firms because they face an upward-sloping and steeper MC curve (*dampening effect*)
• a monetary policy shock, however, also induces a shift in the MC curve
• the shift in the MC curve induces a larger reaction of risky constrained firms and increases aggregate volatility (accelerator effect)
• risky constrained firms are more (less) responsive than risk-free constrained firms if the shift in MC curve is (is not) large enough to compensate for its upward slope
<table>
<thead>
<tr>
<th>variable</th>
<th>description</th>
<th>obs</th>
<th>mean</th>
<th>median</th>
<th>sd</th>
<th>1st pct</th>
<th>99th pct</th>
</tr>
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<tbody>
<tr>
<td>$\Delta_1 \ln y_{c,s,t}$</td>
<td>production growth (%, mom)</td>
<td>27,279</td>
<td>-0.03</td>
<td>0.00</td>
<td>6.55</td>
<td>-16.59</td>
<td>15.95</td>
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<td>$\varepsilon_t$</td>
<td>intraday shocks (sd)</td>
<td>27,279</td>
<td>-0.10</td>
<td>0.00</td>
<td>1.00</td>
<td>-4.81</td>
<td>2.97</td>
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<tr>
<td>$\ell_{c,s,t-1}$</td>
<td>leverage (%)</td>
<td>27,279</td>
<td>63.15</td>
<td>63.20</td>
<td>9.49</td>
<td>40.85</td>
<td>87.86</td>
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<tr>
<td>$l_{c,s,t-1}$</td>
<td>recession (dummy)</td>
<td>27,279</td>
<td>0.29</td>
<td>0.00</td>
<td>0.46</td>
<td>0.00</td>
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</tr>
</tbody>
</table>

- **time**: 179 months (i.e., excluding lags and leads, 2002m2-2016m12)
- **industries**: 22 two-digit manufacturing industries
- **countries**: 7 EA countries (IT, DE, FR, ES, PT, BE, AT)
\[
\tilde{y}_{c,s,t+h} = (1 - I_{c,s,t-1}) \sum_{j=0}^{2} \ell_j^{c,s,t-1} \left[ \alpha_{Ej}^{(h)} + \beta_{Ej}^{(h)} \varepsilon_t + \Theta_{Ej}^{(h)} (L) X_{c,s,t} \right] + \\
+ I_{c,s,t-1} \sum_{j=0}^{2} \ell_j^{c,s,t-1} \left[ \alpha_{Rj}^{(h)} + \beta_{Rj}^{(h)} \varepsilon_t + \Theta_{Rj}^{(h)} (L) X_{c,s,t} \right] + \\
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for \( h = 0, \ldots, H \)