Guy Quaden: New views on firms' investment and finance decisions

Opening address by Mr Guy Quaden, Governor of the National Bank of Belgium, for the National Bank of Belgium Conference, Brussels, 27-28 May 2002.

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Ladies and Gentlemen,

I am really pleased to welcome you here at the National Bank of Belgium 2002 Conference. My wish, one of my wishes, since I have become Governor, and it is shared by the members of our Board, is to stimulate the scientific co-operation between the Bank and the academic community and more in particular the Belgian academic community in a modus operandi of mutual respect and independence. Two years ago, the National Bank of Belgium organised a conference on "How to promote economic growth in the euro area" to celebrate its 150th anniversary. On that occasion, I announced that the Bank would call an international conference every two years to encourage the debate between academics and professional economists working in central banks and in other policy making institutions. At that time, the Bank also decided that a joint research project between its own economists and Belgian academic researchers would precede the conference. The project started in March 2001 and ends with the current conference where the results of the research are presented.

The Bank requested the Belgian academic community to express its interest in participating in the joint research project by submitting a proposal concerning the content of an analysis on one or several sub-items of the general project, preferably with an empirical content making use of available panel data from firms' balance sheets and other sources. All in all we received nineteen proposals from the academic community. Since at this conference also foreign speakers are invited, we were forced to select a limited number among the proposals we received. This selection was based on a number of criteria but, especially, on their compliance and coherence with the overall research project.

Allow me to explain the reasons that have led to the particular choice of the topic of the conference. Everybody will acknowledge that investment is a key variable in economics. Capital accumulation not only plays a pivotal role in determining the process of long-run economic growth, as was clearly evidenced by our previous international conference two years ago, but it is also an important driving force of business cycles. Although investment represents a relatively minor fraction of GDP, a major part of output fluctuations is driven by firms' investment behaviour. For the conduct of monetary policy, it is, therefore, crucial to understand the mechanisms that drive an essential component of the interest sensitive expenditures, and more in particular, how monetary policy affects investment spending by firms. Given that investment is an important element in the complex transmission mechanism of monetary policy, and given the continuous change of economic behaviour and institutional structures, a continuous interest of the central bank in this kind of research can easily be motivated. Despite the best efforts of economists working in various research institutes and in central banks, it remains, however, imperfectly understood. This is, of course, to a large extent due to the volatility of investment itself, which is many times higher than that of GDP. By choosing it as the theme for its second international conference the Bank wants to encourage further research in this field of economics.

In that respect, after the pioneering work of Dale Jorgenson, analysing the investment decision in a neo-classical framework, and who will speak about taxation issues today, two major strands in the literature have been developed, which examine the implications of capital market imperfections and uncertainty for investment behaviour. Our distinguished invited speakers, Lenos Trigeorgis, Jean-Bernard Chatelain, Charles Himmelberg and Julian Franks, will give an overview of these subjects in their contributions.

The first strand shows that in the presence of information asymmetries firms with weak balance sheets may become financially constrained in the sense that their cost of external funds substantially increases or that they are unable to attract external funds. In these circumstances, the effects of a change in the monetary policy-controlled interest rate will not only be transmitted through an increase in the user cost of capital but also through their impact on the financial structure of the firm. Indeed, an increase in policy rates will result in larger interest payments, hence a worsening of the firm's cash flow and its ability to self finance, and in a decrease in the value of assets that could be used as collateral for new loans. As a consequence, firms that are likely to be more exposed to problems of asymmetric information, will react more to a monetary tightening. Variations in the availability of credit as a result of changes in monetary policy may act as an important channel of transmission, since

these financial frictions amplify the effect of changes in the policy-controlled interest rates. In order to assess the monetary policy stance it is important for the policy maker to know whether these frictions are present or not.

A second recent strand in the theory of business investment addresses the impact of uncertainty on investment. The main insight from this literature is that a firm, being uncertain about the future and knowing that investment is a sunk cost, may choose to postpone investment in order to obtain further information about future market conditions. One can show that, in this case, the required rate of return to undertake the investment project increases. It is clear that, hereby, uncertainty introduces additional frictions in the investment decision process, which are likely to temper the effect of a change in the policy-controlled interest rates. Therefore, also in this respect, the monetary authorities need to evaluate the precise timing and magnitude of these frictions, which are caused by uncertainty.

As to the requirement to use micro data, it is known that aggregation can blur identification of important parts of the behaviour of economic agents. So, studies at the aggregate level often fail to find an economically significant relation between investment and the user cost of capital, a relation of the utmost importance for the transmission of monetary policy. This failure is attributed in literature to the so-called simultaneity bias. Using micro data allows alleviating these problems. Moreover, micro data allow analysing important economic questions that cannot be addressed using aggregate data sets. This is precisely the case if one wants to identify the existence of financial frictions, because here the individual balance sheet position of the particular firm matters.

Next, I want to review the importance of the launch of the euro and of the ECB's price stability policy for investment behaviour.

The introduction of the single currency three years ago provoked fundamental changes in the environment in which the public and the private sector operate. First, the most apparent change has been the elimination of exchange rate risks. Together with the lower transaction costs and more transparent markets, this has created new opportunities for companies within the euro area. Second, the euro has given impetus to the process of financial integration by enhancing the widening and deepening of the euro area financial markets. This evolution may appear to be beneficial for firms, which were or still are financially constrained and unable to execute all their investment plans. Especially young and risky firms often suffer from insufficient tangible assets, that might serve as collateral for external funds, and/or develop activities that are highly risky in terms of future returns. Since these are typically the enterprises which tend to bring new technologies to the market, financial market deepening, as triggered by the euro, may contribute to boost investment and economic growth.

Although with the launch of the euro, the exchange rates of the currencies of the euro area countries became irrevocably fixed and the national currencies were only expressions of the same currency, for most residents of the euro area the euro only arrived with the introduction of the new euro banknotes and coins at the beginning of this year. Since the first of January, more than 300 million citizens in Europe share the same tangible currency. This event will further foster transparency and efficiency.

Not only the mere launch of the euro, but especially the rigorous and credible pursuit of the ECB of its objective of price stability as assigned by the Treaty of Maastricht, can stimulate investment and contribute to sustained long-run economic growth. First, price stability allows changes in relative prices to be more easily observed, since they are not obscured by fluctuations in the overall price level. This enhanced transparency allows economic agents to make better-informed decisions, which result in a more efficient allocation of resources. Second, monetary stability also eliminates some of the uncertainties about the future which private decision-makers face in managing their businesses. If providers of funds are convinced that price stability will be maintained in the future, they will not require a "risk premium" to cover themselves against future inflation. By reducing such risk premia the real interest rate may fall, and monetary policy can give an incentive to invest. Finally, a credible policy of price stability also makes it less likely that firms will divert resources from productive uses to stockbuilding in order to hedge against inflation. In a high inflation environment there is, indeed, an incentive to accumulate real goods since they are expected to become more expensive in the near future.

To sum up, the ECB's monetary policy of maintaining price stability can affect expectations of market participants about future price developments when it succeeds in achieving a necessary degree of credibility. The continuous low inflation expectations reflect that the ECB has been successful in its task, and has created the basis for low long-term interest rates. These have had significant positive effects on the government budget in many countries and have stimulated investment. Stabilising expectations has also shown to be beneficial for the ECB itself, since it enhances the predictability of

the conditional relationships between major macroeconomic variables and diminishes the uncertainties involved in the conduct of monetary policy.

Before leaving the floor to our first speaker, Professor Dale Jorgenson I would like to thank all the invited speakers and discussants for accepting the invitation and for actively taking part in this event. I am also very grateful to the Belgian teams for their research effort in exploring the factors that drive business investment in Belgium. Finally, I want to thank all the participants whose large attendance today will certainly contribute to the success of the conference too. I hope that this conference will help us all to better understand the mechanisms underlying investment behaviour and to discover the policies needed to foster it. I wish you all a very productive conference.