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Torsten Gruber, Renate Ohr*

Common European Monetary Policy with Different Financial Structures

The Distinctive Nature of the British Financial System

If Economic and Monetary Union comes about, it will comprise countries with different financial systems and financing practices. This implies differences as regards the transmission of impulses both within the financial sector and from the monetary sphere to the real economy. Professor Renate Ohr and Torsten Gruber take the example of the United Kingdom to illustrate the significance these differences could have for the monetary policy of the European Central Bank.

The current debate about Economic and Monetary Union concentrates primarily on the question whether the convergence criteria are an appropriate means of demonstrating on the one hand the homogeneity of potential member countries and on the other the credibility of their willingness to stabilise their economies. It also considers the extent to which fiscal stability, in particular, can be ensured after the start of monetary union.[1] However, another crucial aspect that could cause stability problems in the EMU is barely being addressed, namely the fact that the central monetary policy stands little chance of success if the mechanisms for transmitting monetary stimuli to the real economy differ fundamentally from one country to another. For monetary policy to be effective, both the qualitative and quantitative dimensions of monetary transmission processes in potential member countries must be known precisely. The convergence criteria stated in the Maastricht Treaty are completely silent on this point.

The extent, timing and often even the direction of transmission depend crucially on the financial structures in each country. The banking system, the role of financial intermediaries, the financing habits of firms and households and the composition of private wealth and private debt are relevant in this regard.[2] In Europe these factors lead to differences as regards the transmission of impulses both within the financial sector from money-market rates to short and long-term lending rates and also from the monetary sphere to the real economy. In order to illustrate the point, we first describe the British financial system, as it differs considerably in many respects from the German system, for example.[3] We then briefly examine the problems that such differences could cause for a common monetary policy.

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Features of the British Financial System

Two salient features of the British financial system call for comment. First, the British banking system is characterised by specialisation and a division of tasks, in contrast to the German system of universal banks. Secondly, alongside the normal commercial banks there are discount houses that act as intermediaries between the central bank and the commercial banks (see diagram).

British economic statistics divide the commercial banks into three major groups: British banks, overseas banks and consortium banks. The British banks are further sub-divided into retail banks, merchant banks and British overseas banks.[4] The core activity of the retail banks consists of short-term deposit and lending business. As a result of deregulation, the retail banks have now extended their activities to include large-scale investment banking finance and international banking and have gained a foothold in securities trading. Retail banking is heavily concentrated in the hands of the four largest institutions. This structure, which is extremely oligopolistic by comparison with the situation in Germany, makes it possible for the Bank of England to influence interest rates directly.

[1] See R. Ohr: Implikationen einer zentralisierten europäischen Geld- und Währungspolitik, in: R. Caesar and R. Ohr (eds.): Maastricht und Maastricht II: Vision oder Abenteuer?, Baden-Baden 1996, pp. 110 ff.

[2] See R. Ohr: Monetäre Steuerungsprobleme in einer Europäischen Währungsunion, in: W. Zohlnhöfer (ed.): Europa auf dem Weg zur politischen Union?, Schriften des Vereins für Socialpolitik, No. 247, Berlin 1996, pp. 75 ff.

[3] For the purposes of the following analysis, it is assumed that the United Kingdom will seek membership of EMU in the short to medium term, despite its reservations. Several of the characteristics of the British financial system are also to be found in some other EU countries.

[4] See HMSO: Aspects of Britain: Financial Services, London 1995, pp. 6 ff. and 16 ff.; see also M. Paprotzki: Die geldpolitischen Konzeptionen der Bank von England, Frankfurt am Main 1991, p. 78 ff.

The merchant banks originally financed trading companies, but today they are also heavily engaged in advising companies in the financial sector and in the issuing of securities. Banks in the third group, British overseas banks, have their head offices in London but operate predominantly abroad.

In the seventies, however, changes began to take place in the British financial system that blurred the clear division on the basis of specialisation.[5] The pace of change quickened considerably in the eighties as a result of deregulation by the Thatcher government, the purpose of which was to maintain the United Kingdom's leading position among the international financial centres by enhancing the competitiveness of the British financial markets. The Stock Exchange was also completely reorganised as part of this process. Since then, some of the large retail and merchant banks have built up large securities trading departments.

Overseas banks also play a significant role in the British financial system. These are the London branches of foreign-based banks. The large number operating in the United Kingdom is explained by the importance of London as an international financial centre. Finally, there are consortium banks set up by a number of banks to handle the issue of large-volume Euro-currency loans.

Among the other financial intermediaries, the building societies deserve special mention. They primarily provide home loans, but since they were authorised to hold current accounts and to grant a limited amount of unsecured credit, they have developed into the main competitors to the retail banks. The financial reforms brought the British system closer to the continental pattern of universal banks. The structure of the commercial banking sector would therefore probably not cause serious problems for the effectiveness of a common European monetary policy.

[5] See M. Pawley: Financial Innovation and Monetary Policy, London 1993, pp. 24 ff.

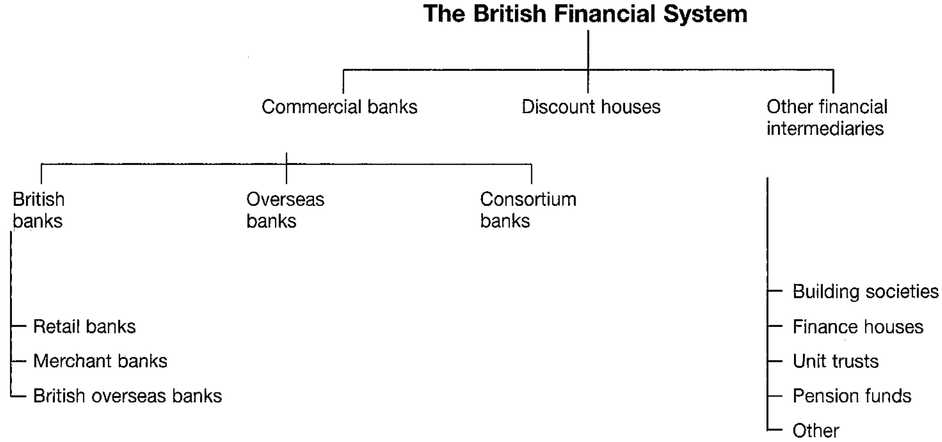
Monetary Policy Stimuli and Financial Institutions

The discount houses, by contrast, are a distinctive feature of the British banking system.[6] The seven discount houses perform a unique function as central players in the short-term money market and are therefore of decisive importance for British monetary policy. They are intermediaries between the Bank of England and the other banks; in other words, the central bank reaches the bulk of the banking system only at second hand. The special position of the discount houses stems from the fact that they are the only institutions able to borrow from the Bank of England. In contrast to German banks, British commercial banks cannot borrow from the central bank direct to fill a liquidity gap that they are unable to cover in the money markets but must borrow from the discount houses. If the discount houses have a liquidity shortage, they obtain refinancing from the Bank of England, which acts as lender of last resort.

In return for the privilege of being able to borrow from the central bank, the discount houses are obliged to subscribe the entire volume of Treasury bills issued each week by the Bank of England for the short-term financing of the government's borrowing requirement. This obligation is extremely important for British monetary policy, as it enables the central bank

[6] Cf. HMSO, op. cit., pp. 17 ff.

The British Financial System



to create an artificial liquidity shortage at any time and thus determine the level of interest rates in the money market.

The discount houses also accept excess liquidity from the commercial banks in the form of call money or very short-term deposits. They either invest these funds in bills or short-term securities or lend them to other commercial banks in need of liquidity. These activities create a market in bills, the discount market, in which bills with a wide range of residual maturities are bought and sold, thus enabling banks to structure their bill portfolios however they wish.[7] As well as bills, the discount houses also deal in short-term government paper, local authority bonds and certificates of deposit (CDs).

The Bank of England derives two benefits from the discount house system. First, the obligation for the discount houses to subscribe the entire Treasury bill issue means that it has no problem financing short-term government borrowing.[8] Secondly, the limited number of discount houses makes it easier for the Bank to influence money-market target variables. On the other hand, the disadvantage is that it has only an indirect market link to the rest of the commercial banking sector, which impedes the targeted and efficient use of its monetary policy instruments to influence the macro-economic target variables.

Apart from the discount market, which can be regarded as the basis for monetary policy measures in the United Kingdom, there are also a number of parallel markets in high-liquidity securities. One of these is the interbank market, in which large claims are traded, not only between banks but also with and between industrial companies, pension funds and insurance companies. There are other parallel markets for short-term securities issued by local authorities, instalment credit institutions and industrial companies. The Euro-currency money markets should not be forgotten in this context. The money markets as a whole play a far more important role in the British financial system than in continental Europe, probably mainly because of the lack of direct commercial bank access to central bank credit.

Membership of EMU would necessitate a few structural changes here. An independent European Central Bank would automatically reduce the importance of the discount houses as they could no longer be obliged to subscribe short-term government securities.[9] To the extent that the discount houses nevertheless retained their special position as intermediaries between the central bank and the commercial banks, they could cause interest rates within the monetary union to react differently (as regards the speed and scale of adjustment), as the impact of interest rate policy on the overall interest rate level in the United Kingdom would diverge from that in EU countries where the provision of liquidity is decentralised.[10]

Different Acceptability of Interest Rate Policy

Differences in financing practices in Europe could have even more serious consequences for the common monetary policy. In the United Kingdom corporate loans and private real estate loans are not long-term fixed-rate loans, as they are in Germany, but loans with a short initial term or long-term loans with a variable interest rate tied to money-market rates, such as LIBOR. For example, more than 90% of private real estate loans bear a variable interest rate.[11] Consequently, short-term interest rates are more significant for corporate and household credit demand in the United Kingdom than in Germany, Belgium, the Netherlands or Austria. Short-term lending also has a fairly high importance in Italy, Spain and Sweden. In so far as longer-term loans are granted in these countries, they also predominantly bear a variable interest rate.[12]

As short-term financing and the use of variable interest rates is prevalent mainly in countries with less experience of price stability, the differences in

[7] In view of the small turnover of the discount market, it is being considered whether the Bank of England should also operate in the repo gilt market in long-term government bonds, which was established on 1st January 1996. This would be a further step towards the continental European pattern.

[8] In this connection it should also be pointed out that the Bank of England is not at present an independent central bank but is accountable to the Treasury, which has powers to give the Bank instructions. In addition, there is no legal regulation of or limit on government borrowing from the Bank. By the start of the third stage of EMU these provisions would have to be brought into line with Article 108 of the EC Treaty, in other words they would have to be repealed, and the Bank of England made fully independent.

[9] In EMU, all lending by the European Central Bank or national central banks to bodies or institutions of the Community, national governments or local authorities is strictly forbidden.

[10] See C. Borio and W. Fritz: The Response of Short-Term Bank Lending Rates to Policy Rates: A Cross-Country Perspective, in: BIS (ed.): Financial Structure and the Monetary Policy Transmission Mechanism, Basle 1995, pp. 105 ff.

[11] See M. J. Artis and M. K. Lewis: Apres le Deluge: Monetary and Exchange-Rate Policy in Britain and Europe, in: Oxford Review of Economic Policy, Vol. 9, No. 3, 1993, pp. 52 ff.; and C. Goodhart: Financial Innovation and Monetary Control, in: Oxford Review of Economic Policy, Vol. 2, No. 4, 1986, p. 88.

[12] See C. Borio: The Structure of Credit to the Non-Government Sector and the Transmission Mechanism of Monetary Policy: A Cross-Country Comparison, in: BIS (ed.): Financial Structure and the Monetary Policy Transmission Mechanism, Basle 1995, pp. 69 ff.; and BIS: 64th Annual Report, Basle 1994 (p. 151 in the German edition).

methods of financing could set up strains between the more stable and the less stability-oriented countries, which could limit the scope for action by the European Central Bank. For example, if the yield curve becomes inverted, as occurred in Germany in 1994, it can have different real economic effects in the various countries. If, for example, a tightening of monetary policy in order to combat inflation causes money-market rates to rise, it can lead to a fall in long-term rates if the measure is considered credible and hence reduces longer-term inflation expectations. This would boost investment in Germany but depress it in the United Kingdom (or Italy), where the propensity to invest is determined by short-term interest rates.[13] Moreover, as a change in interest rates affects only new loans in the case of long-term fixed-rate financing but also impinges upon existing ones in the case of short-term or variable-rate financing, certain interest rate policy measures could have differing acceptability in different countries.

The differences in loan duration are also important for the efficiency of central interest rate management in a monetary union. A central bank operates initially almost exclusively in the money market, where by using its instruments it can influence the interest rate relatively effectively. The scope for affecting long-term rates in the capital market is far smaller, as here factors such as inflation expectations play a dominant role. This means that the Bank of England, for example, can influence the investment behaviour of the British corporate sector much more directly than the Bundesbank can affect German investment. The Bundesbank has to steer long-term as well as short-term rates in the desired direction, a rather uncertain and protracted undertaking. Even if the yield curve is not inverted, this difference alone means that a centralised interest-rate strategy has differing effects.

There are also structural differences between Germany and the United Kingdom as regards the financial situation of private households;[14] households in the United Kingdom have a higher debt ratio owing to the large volume of mortgage loans on owner-occupied housing, which was encouraged as politically desirable. In view of the variable rate of interest on mortgage loans and the large number of households with such debt, reductions in interest rates tend to lead to a relatively rapid improvement in disposable incomes. In Germany and a number of other EU countries, on the other hand, interest-bearing assets (primarily savings deposits) make up a relatively high proportion of household wealth, and private debt is not only comparatively low but also bears a fixed rate of interest, so that interest rate reductions have an adverse overall effect on incomes in the household sector.[15] These differences also suggest that both the effect and acceptability of interest-rate measures differ from one EU country to another.

Evidence of Differences of Impact

A few empirical studies have now been carried out on the effects of different financial structures on the transmission of monetary policy. According to a study by the BIS,[16] lending rates react very strongly to changes in money-market rates even in the short term in the United Kingdom (and in the Netherlands), whereas in Germany (as in Spain and Italy) the response is hesitant. These differences in the transmission of interest rate changes are significant mainly in the first one to three months but less so in the longer term. They are also reflected partly in the differential between money-market rates and general lending rates, which is relatively large in Germany, Belgium and Spain but only marginal in the United Kingdom.[17]

The structural differences in the borrowing practices of households and firms and in the asset position of households can also lead to differences in the transmission of monetary policy stimuli to the real economy. There is relatively little empirical evidence so far on the extent to which these structural characteristics at the macro-economic level have led to differences in the monetary policy transmission mechanism. However, studies by the BIS conclude that a change in interest rates has a much stronger and more rapid impact on gross domestic product in the United Kingdom than in Germany, France or Italy.[18]

[13] See R. Ohr: Implikationen..., op. cit., p. 116.

[14] See R. Ohr: Monetäre Steuerungsprobleme ..., op. cit., pp. 6 f.

[15] See J. T. Kneeshaw: Analysis of Answers to the Questionnaire on Financial Structures. Non-Fiscal Sector Balance Sheets in the Monetary Policy Transmission Mechanism, in: BIS (ed.): Financial Structure and the Monetary Policy Transmission Mechanism, Basle 1995, pp. 1 ff.

[16] See C. Borio and W. Fritz, op. cit.; broadly similar conclusions are reached in C. Cottarelli and A. Kourelis: Financial Structure, Bank Lending Rates, and the Transmission Mechanism of Monetary Policy, in: IMF Staff Papers, Vol. 41, 1994, p. 587 ff.

[17] A very detailed analysis of the interest rate sensitivity of the British economy is to be found in P. Nölling: Großbritanniens Geldordnung im Konflikt mit der Europäischen Währungsunion, Baden-Baden 1996, pp. 73 ff.

[18] See for example F. Smets: Central Bank Macroeconomic Models and the Monetary Policy Transmission Mechanism, in: BIS (ed.): Financial Structure and the Monetary Policy Transmission Mechanism, Basle 1995, pp. 225 ff.; and EMI: Annual Report 1994, Frankfurt am Main 1995 (p. 37 in the German edition).

Conclusions

The foregoing remarks show that it will not be a simple matter to define a uniform monetary policy that will have the same real economic impact throughout Europe, given the differences in financial structure. The United Kingdom, in particular, will suffer additional economic costs if the common monetary policy of the European Central Bank is geared primarily to the structures prevailing in continental Europe. The financial structures of countries wishing to participate in EMU will therefore have to be examined in greater depth, and it would be wise to incorporate some reduction in disparities in the convergence programme.

The argument that the problem of interest rates being fixed for only short periods will be resolved "automatically" by changes in market practices when countries join the monetary union, as it constitutes an area of stable prices and hence less volatile long-term interest rates, falls short of the mark, as it is based on a purely static comparative approach and ignores the transitional phase of gradual adjustment in structures and conduct. The uncertainty accompanying the transition could create even more problems for the monetary policy of the European Central Bank during its inaugural stage and hence weaken confidence that it can be effective from the very outset.

The fact that the convergence criteria laid down in the Maastricht Treaty demand a certain measure of interest rate convergence is also an insufficient answer to this problem.[19] First, the Treaty's consideration of long-term interest rates ignores the great significance of short-term rates in some EU countries. Secondly, long-term rates are first and foremost a reflection of interest rate expectations. It is only natural for long-term rates in countries regarded as potential members of the monetary union to converge, as inflation in these countries will be the same in future. Hence, the convergence of long-term rates only demonstrates that the countries in question are expected to become members of EMU. The interest rate criterion is therefore more a kind of derived criterion that reflects the fact that the other conditions of membership have been broadly met or even merely the expectation that a "political" solution will be found by easing the criteria, but is far from being evidence of the convergence of financial structures. This analysis also shows that the conditions set out in the Maastricht Treaty for the introduction of monetary union are not sufficient to ensure that the European partner countries have converged sufficiently to cope with a single central monetary policy.

[19] See also P. Nölling, op. cit., pp. 164 ff.

Christopher M. Dent*

Economic Relations between the EU and East Asia: Past, Present and Future

Present economic linkages between the European Union and East Asia are relatively underdeveloped despite the fact that a number of EU member states have deep historical associations within the region. It is imperative that EU business engages itself more intensively in East Asia if Europe is not to become marginalised in an emergent "Pacific century".

As the 1990s have progressed, European Union (EU) governments, companies and other agencies have become increasingly aware of the need to more highly prioritise their region's economic relations with East Asia.[1] This can be mainly attributed to two interrelated factors. First, the dynamic economic growth that has been sustained by numerous East Asian countries in recent decades has created a new important pole of economic power and wealth within the world economy. It has therefore become strategically imperative for EU business to engage itself more actively in this region, not least in order to acquire a wider stake in the new prosperity it offers. Second, East Asia's economic destiny appears to be far more closely aligned to North America's, the remaining "Triad" power. This trans-Pacific relationship has most recently been fostered through the

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[1] For the purposes of this article, East Asia will refer to Japan, China, South Korea, the ASEAN group (Brunei, Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam), Taiwan and Hong Kong.