Financial Structure and Monetary Transmission in Europe: A Cross-Country Study

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INTRODUCTION

This study examines the relation between financial structure and monetary policy transmission process in Europe in general and in Economic and Monetary Union (EMU) member states in particular. To do so a cross-country perspective is chosen. Financial structure refers to the organisation of the financial system; the universe of financial markets, financial institutions or intermediaries, and financial instruments of all sorts at a given place and time. Several potential differences in financial structure between countries exist following this definition of financial structure. In turn, monetary policy transmission means the way in which monetary policy decisions are transmitted into real economic activity. This definition also allows for many transmission channels and therefore for cross-country differences in the monetary transmission process.

Monetary policy transmission has always been a topic of great interest to economist and monetary policy authorities. In this context a quote of Bernanke and Blinder (1992, p. 901) is illustrative: Does monetary policy affect the real economy? If so, what is the transmission mechanism by which these effects occur? These two questions are among the most important and controversial in macroeconomics. In contrast, the relation between financial structure and monetary policy transmission has been for a long time rarely a topic in the literature because with the assumption of perfect financial markets financial structure has no influence at all on real economic activity. Financial structure, however, plays an essential role in the monetary transmission process if financial markets are imperfect. Nowadays there is more or less a consensus, based on a large body of primarily US studies, that financial markets are not perfect. The macroeconomic impact of financial markets imperfections is empirically, however, still ambiguous.

In Europe, the analysis of monetary transmission received a stimulus by the discussions about the EMU which viability may depend on the extent to which monetary policy effects differ across member states. Differences in financial structure across EMU countries may hamper the implementation of a common European monetary policy. This study focuses on six European countries: Germany, France, Italy, United Kingdom, Belgium and the Netherlands. The first four countries are the largest European economies in terms of gross domestic product and are therefore representative for the whole EU. Besides these four EU countries Belgium and the Netherlands are considered. The choice for the Netherlands as home country is clear. Belgium is examined, because it is just as the Netherlands a small and open economy with a relatively high degree of concentration in the banking industry. Together these countries represent about 80% of the EU-15 in terms of nominal gross domestic product. The advantage to consider these
European countries is that we can take a closer look whether cross-country differences in financial structure have any systematic relation with differences in the monetary transmission process between countries. Therefore, this research can be characterised as a cross-country study. Generally the sample period analysed covers the years 1980-1995, which is a period of financial liberalisation, deregulation and innovation.

Against this background, the objective of this study is to address the issue as to which similarities and differences exist among financial structures in the EU countries considered and whether cross-country differences in financial structure may have an impact on the strength and nature of monetary policy transmission processes in Europe in general and in EMU in particular.

The method of analysis to address this issue, is to examine it from many different sources, quoting Cooley (1995, p. 131): We believe monetary transmission is important, but the evidence is elusive. For that reason it is important that we consider evidence from a variety of sources. Of course, the first source is what the literature says about financial structure (Chapter 1) and about monetary policy transmission in general and the relation between financial structure and monetary transmission in particular (Chapter 2). The second source regards a variety of empirical analyses presented in this study using different types of data and econometric methodologies. Both disaggregated bank-level panel data (Chapter 3 and 4) and aggregated macroeconomic time series (Chapter 5 and 6) are analysed. Using these data this study employs panel data estimation techniques (Chapter 3 and 4), vector error-correction models (VECM) (Chapter 5) and instrumental variables regressions (Chapter 6). If these different sources yield the same answer, it can be interpreted as an indication of the robustness of the answers.

The outline of this study is the following. Chapter 1 surveys one of the most important elements of the financial system of intermediation, namely credit to households and firms. This overview is organized around five distinguished theoretical issues. This is so because a comprehensive and widely accepted theory of financial structure is yet lacking. An overview of the most relevant stylized facts for the six EU countries completes the picture. Chapter 2 introduces and decomposes the monetary transmission channels. Most important monetary transmission channels regarding the relation between financial structure and monetary policy transmission are the credit channels of monetary policy. Theoretical and empirical findings with respect to these credit effects of monetary policy are documented. In addition, the credit channels of monetary policy may be asymmetric. Therefore, a theoretical and empirical background of possible asymmetric effects of monetary policy is also provided. Chapter 3 contains an empirical study about the aggregated off-balance-sheet (OBS) diffusion pattern in five European countries during the years 1989-1995. Because Italian OBS figures are unavailable Italy is not considered
in this chapter. Empirical evidence of OBS diffusion pattern in Europe is particularly important, because financial innovations, of which OBS items are an example, affect the costs and scope of financial intermediation and consequently the process of monetary policy transmission. Determinants of OBS activities analysed are an autonomous speed of diffusion, market forces, captured by bank specific characteristics, regulatory factors and macroeconomic conditions. Chapter 4 examines on the basis of bank-level panel data for the years 1990-1995 the existence of credit channels of monetary policy in a broad sense, considering a bank lending and balance sheet channel. Based on the literature, it is argued that monetary policy matters most for small banks and for banks with relatively illiquid balance sheets (bank lending channel) and as loan demand interacts with bank size and therefore with borrower size (balance sheet channel). Chapter 5 studies the potential and existence of credit channels of monetary policy from a cross-country perspective. VECM with aggregated macroeconomic time series for the years 1980-1996 are used to examine the relative importance of the bank lending vis-à-vis the balance sheet channel. Chapter 6 addresses the issue of the macroeconomic relevance of credit channels of monetary policy. This is executed by examining the impact of the premium between external and internal finance, that may vary over the business cycle, on private consumption for the years 1980-1995. Finally, Chapter 7 concludes with a summary of the main findings and the conclusion.

All chapters in this book except Chapter 7 have appeared before in research memoranda or journals. Chapter 1 appeared in De Economist (De Bondt, 1998a). A forerunner of Chapter 2 is De Bondt (1997a), which developed into DNB Staff Reports 23 (De Bondt, 1998b). Chapter 3 is an extended version of Research Memorandum WO&E 528 (De Bondt, 1997b). Chapter 4 is a revised version of Research Memorandum WO&E 543 (De Bondt, 1998c) and will appear in Banca Nazionale del Lavoro Quarterly Review (De Bondt, 1999b). Also, Chapter 5 and 6, are based on Research Memorandum WO&E 569 and 567, respectively (De Bondt, 1999a and 1998d).