FINANCIAL STRUCTURE IN THE EU COUNTRIES

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Introduction

- Key issue for EMU entry is the monetary transmission mechanism
- Financial structure - the pattern of financing relations - is important determinant of this
- UK traditionally seen as “market oriented” and Continent as “bank dominated”
- We probe levels and changes in sectoral balance sheets to assess whether reality corresponds to this stylised view

Paradigms of financial structure

- Relationship banking systems are thought to have the following features
  - banks dominate the financial sector, while institutional investors play a minor role
  - capital markets are underdeveloped
  - household accumulation is mainly in the form of claims on banks and insurance companies
  - external financing of firms depends on long term bank loans, underpinned by close relationships;
  - pension reserves are an important source of internal financing of companies;

- cross shareholding among companies is high;
- most companies are not quoted; those that are, are held by few large shareholders;
- shareholders are joined by other stakeholders (e.g. workers) in corporate governance; stakeholders are encouraged to make firm specific investments;
- external control by the capital market is low

- Arms' length (market oriented) systems have the following, contrasting features
  - institutional investors dominate the financial sector, while banks play a minor role
  - capital markets are highly developed
  - household accumulation is mainly in the form of capital market investment, directly or indirectly via institutional investors

- external financing of firms depends on capital markets, directly (new issues of debt or equity) or indirectly (securitised loans), and institutional investors are major suppliers of it
- bank credit is short term and at arm’s length
- most companies are quoted; and are widely held; cross shareholdings are rare;
- corporate control is directed to shareholder value via market mechanisms (take-overs)
- external control by the capital market is high
- relations with other stakeholders are based on explicit short term contracts, which does not encourage firm specific investment

- Some existing research suggests Germany and the UK most correspond to paradigms, France and Italy intermediate
- Scepticism on some of the implications (e.g. whether German banks provide “credit insurance” to firms in downturns)
- France seen as in transition, (growth in securities, state control in corporate governance diminished but not yet replaced)
- Issue whether “bank relationships” are robust to growth of securities markets and institutional investors

Balance sheet structure and convergence in the EU-4

- Focus is on portfolio shares and size of assets and liabilities relative to GDP (data from national sectoral balance sheets)
- Balance sheet data omit key aspects such as maturity of debt, collateral, negotiability and corporate governance
- Also provide solely stock and not flow (issuance/financial investment) information

- Household sector data not consistent with simple divide UK/Continent, e.g. high equity share in France
- Some convergence in portfolio shares e.g. for deposits and mutual funds, but not institutions or total assets/GDP
- If institutional assets are attributed to households, Germany as outlier and marked resemblance France and UK
- Household liabilities mostly housing loans, Germany comparable to UK. Convergence in relative use of consumer and mortgage credit but not in overall debt/GDP

Household sector assets

		UK	Germany	France	Italy
Deposits	1980	42.8	64.2	66.7	65.9
notes, coins	1990	31.9	52.1	40.3	4.5
	2000	**22.1**	**36.2**	**26.4**	**24.9**
Money	1980	0.1	0.2	0.0	9.5
market	1990	0.1	0.4	2.1	12.7
	2000	**0.1**	**0.0**	**0.4**	**1.0**
Bonds	1980	5.4	12.7	10.2	8.2
	1990	1.2	15.2	4.0	18.9
	2000	**1.0**	**10.8**	**1.9**	**17.9**
Equity	1980	13.7	4.8	13.3	10.3
	1990	17.5	6.0	26.8	20.6
	2000	**17.8**	**16.7**	**38.4**	**26.0**
Mutual	1980	1.1	0.0	2.5	0.0
funds	1990	0.6	4.5	14.0	2.2
	2000	**6.1**	**12.1**	**9.0**	**17.6**
Life and	1980	36.8	18.1	7.3	6.1
pensions	1990	48.7	21.8	12.8	8.5
	2000	**52.9**	**24.2**	**23.9**	**12.7**
Total assets	1980	117.3	93.7	94.8	84.8
(% of GDP)	1990	195.8	121.7	137.3	166.2
	2000	**294.4**	**167.7**	**229.6**	**225.1**

Household sector (2000) allowing for institutional assets held indirectly

	UK	Germany	France	Italy
Deposits	25.0	45.2	27.7	25.4
MMIs	0.8	0.1	3.6	1.1
Bonds	15.9	19.1	14.6	24.3
Equities	52.9	27.1	47.8	30.5

Household sector liabilities

Percent		UK	Germany	France	Italy
Consumer	1980	18.3	18.2	10.8	34.3
credit	1990	15.2	20.5	13.5	41.9
	2000	**19.4**	**7.5**	**7.0**	**20.4**
Housing	1980	81.7	81.8	89.2	65.7
loans	1990	84.8	79.5	86.5	58.1
	2000	**80.6**	**91.6**	**93.0**	**79.6**
Total	1980	27.9	50.9	29.2	6.5
liabilities	1990	62.3	55.1	37.2	17.6
(% of GDP)	**2000**	**73.1**	**73.8**	**37.2**	**22.2**

- Corporate sector liabilities mostly in the form of equity in all EU countries (reflects revaluations rather than issues).
- Loan share lowest in France and UK, bonds not very important anywhere (unlike US)
- Trend for share of loans to decline
- Gross and net debt/GDP highest in France and UK
- Marked convergence in loan and equity ratios, potentially important for monetary transmission

Corporate sector liabilities/total

Percent		UK	Germany	France	Italy
Money	1980	0.3	0.4	0.0	0.3
market inst	1990	0.6	0.1	1.3	0.1
	2000	**0.9**	**0.4**	**1.4**	**0.1**
Loans	1980	26.5	68.5	44.6	43.8
	1990	35.7	67.4	25.8	44.0
	2000	**22.5**	**42.8**	**16.1**	**36.4**
Bonds	1980	2.3	2.8	5.2	3.5
	1990	5.4	3.0	4.1	3.5
	2000	**6.5**	**1.3**	**3.4**	**0.7**
Equity	1980	48.4	28.3	50.2	52.4
	1990	58.4	29.6	68.8	52.4
	2000	**70.2**	**55.4**	**79.0**	**62.7**

Corporate sector ratios

		UK	Germany	France	Italy
Total liabilities	1980	71.2	63.7	94.1	102.2
(% of GDP)	1990	165.1	88.7	187.1	106.9
	2000	**292.7**	**147.3**	**371.4**	**148.6**
Memo:	1980	20.7	45.7	46.9	48.6
Debt/GDP	1990	68.8	62.5	58.4	50.9
	2000	**87.4**	**65.7**	**78.0**	**55.4**
Memo:	1980	9.9	22.1	12.5	22.8
liquidity/GDP	1990	23.8	27.2	17.5	12.5
	2000	**31.9**	**22.4**	**21.1**	**14.6**

- Financial sectors’ (banks plus institutions) assets are largely loans and securities
- Overall move to securities reflecting growth of institutional investors
- UK stands out for size of financial sector, even if estimated size of international banking excluded
- Banking sectors more comparable, tend to show declining and converging share of loans
- UK has largest life and pension sector, but small mutual funds (unit trusts)

Financial sector assets

		UK	Germany	France	Italy
Deposits	1980	17.9	4.0	30.4	20.9
	1990	30.1	6.2	28.1	19.4
	2000	**27.6**	**12.6**	**25.1**	**12.6**
Money	1980	2.4	0.4	1.8	7.4
market	1990	4.6	0.4	7.3	3.4
	2000	**3.3**	**0.6**	**8.7**	**0.9**
Loans	1980	56.1	78.4	53.0	43.2
	1990	36.3	69.3	43.0	50.2
	2000	**27.2**	**44.9**	**23.7**	**41.3**
Bonds	1980	12.1	11.3	4.9	20.9
	1990	9.3	15.8	12.0	19.5
	2000	**7.0**	**20.0**	**14.6**	**24.4**
Equity	1980	10.0	2.4	3.7	1.7
	1990	18.1	4.7	5.5	5.9
	2000	**24.1**	**15.6**	**20.8**	**18.5**
Mutual	1980	1.4	0.0	0.0	0.0
funds	1990	1.7	1.6	2.1	0.0
	2000	**2.3**	**5.9**	**6.6**	**1.5**
Total assets	1980	213.2	162.0	202.7	152.3
(% of GDP)	1990	395.5	221.4	268.1	147.1
	2000	**625.6**	**347.7**	**409.7**	**239.9**

Banking sector assets

		UK	Germany	France	Italy
Deposits	1980	25.0	0.5	31.2	23.0
	1990	38.0	0.3	35.1	27.0
	2000	**34.9**	**9.0**	**35.0**	**16.2**
Money	1980	2.5	0.4	1.9	8.4
market	1990	5.8	0.5	3.5	4.3
	2000	**4.2**	**0.8**	**9.3**	**0.7**
Loans	1980	69.1	83.4	55.9	36.3
	1990	49.9	80.7	54.1	46.5
	2000	**45.8**	**59.5**	**32.3**	**58.9**
Bonds	1980	2.0	10.1	2.5	24.0
	1990	4.8	13.3	5.1	18.3
	2000	**7.0**	**19.5**	**7.6**	**14.6**
Equity	1980	0.0	1.6	1.9	1.5
	1990	1.4	2.4	1.6	1.6
	2000	**2.9**	**7.9**	**13.3**	**7.9**
Mutual	1980	1.3	0.0	0.0	0.0
funds	1990	0.0	0.3	0.6	0.0
	2000	**0.1**	**2.7**	**1.9**	**0.3**
Total assets	1980	134.6	142.5	193.0	128.3
(% of GDP)	1990	263.2	178.2	209.4	98.9
	2000	**346.0**	**251.8**	**276.3**	**151.4**

Institutional investors' assets/GDP

		UK	Germany	France	Italy
Life and pension funds	1980	36.7	19.5	7.6	2.5
	1990	89.6	33.9	18.4	6.9
	2000	**168.2**	**55.9**	**69.3**	**22.6**
Mutual funds	1980	5.7	na	2.7	na
	1990	11.6	9.2	30.4	3.6
	2000	**32.4**	**40.4**	**60.6**	**41.4**

Do stylised paradigms fit the data?

- UK has some bank-related features such as large banking sector, small mutual funds, low household equity holding, low corporate bond issuance
- French share of equity and mutual funds, German household debt tell in opposite direction
- No watertight division, and UK and France have close resemblance in household assets, corporate liabilities

- Germany closest to bank dominated and Italy less developed, but converging rapidly
- Further indicators of market orientation in EMU-3, such as take-overs, development of euro-denominated bond and equity markets, tax reform allowing divestment of cross-holdings, Continental universal banks’ focus on investment banking, pension reforms (e.g. in Germany)
- EMU and Single Market likely to entail further convergence

Conclusions

- Paradigms of market orientation and bank domination do not apply in entirety to any of EU-4
- UK financial system resembles others in several ways notably France
- Key sources of difference are London as financial centre and pension funding - former has little macroeconomic effect, latter will decline as reforms take place elsewhere

- Differences between the UK and Continental countries are not always greater than heterogeneity within EMU itself
- Even Germany shows some signs of shifting towards market orientation, that EMU should accelerate

Complementary results

- Work at NIESR on determination of consumption and investment allowing for financial effects, giving partial view of potential impact of financial structure on transmission mechanism:
- Consumption estimates (Byrne and Davis 2001) show growing influence of illiquid assets (securities and institutional holdings) relative to liquid assets in all of G-7. Cannot reject similar behaviour in EU-4

- Investment estimates 1 (Ashworth and Davis 2001) show common long run negative debt/equity ratio effect (“balance sheet channel”) in UK, France and Germany
- Investment estimates 2 (Byrne and Davis 2002) show that a negative effect of exchange rate uncertainty on investment is common across EU-4, with more tentative evidence for a similar negative effect of long term interest rate uncertainty