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CHANNELS AND TOOLS OF MONETARY POLICY IN FINLAND

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MONEY AND BANKING IN FINLAND: A REPRESENTATIVE SURVEY OF THE LITERATURE IN ENGLISH

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CHANNELS AND TOOLS OF MONETARY POLICY IN FINLAND

The institutional framework for the conduct of monetary policy in Finland differs in many important respects from that in many other countries and in particular from that usually presented in textbooks. Even if this does not necessarily have any impact on the relative role of monetary policy as compared with other small open economies, it has a bearing on the channels through which monetary policy measures are transmitted through to the economy as well as on the monetary policy instruments used by the central bank. This article tries to shed some light on these channels and tools without, however, going into any analytical detail. First, the major features are presented, after which the structure of the financial market is described. Then we examine, with the aid of some diagrams, the transmission of policy measures and finally, some new features in the financial system as well as the links between different interest rates are considered.

Special features

The most striking feature of the Finnish financial system is the small importance of well-functioning markets. Trading in equities is very limited and even if there has been some increase in activity in trade in securities (mostly government papers) in the past few years, the stock exchange is of no macroeconomic importance. The recent period has, however, seen some new features in the trade in short papers; a narrow market has arisen where mainly large firms act as depositors and banks as deposit takers. Even if these transactions take many forms and new debt instruments have been created, there is not yet, at least, a well-functioning money market. Hence the central bank does not carry out open market operations.

The second special feature is to be found in the financial links between the government and the central bank. The Bank of Finland does not handle the government's financial transactions. The government has no automatic access to central bank credit, and the government has obtained funds from the central bank on only a few special occasions. On the whole, the government has to borrow from the banking sector or directly from the non-bank public in order to finance the budget deficit domestically. During the last few years, the government has borrowed to a large extent on the international market.

A third feature is the importance of bank lending in the economy, which is, of course, in part a reflection of the narrowness of markets. It is true that bank loans account for no more than half of the non-bank public's total domestic debt but banks are the only financial intermediaries which have access to central bank credit. The conditions prevailing in the bank loan market will therefore be of prime importance in the creation of liquidity in the economy.

The fourth feature is found in commercial banks' position vis-à-vis the central bank. In many countries the counterpart of outstanding notes and coins are foreign exchange reserves and government debt to the central bank. However, as the latter has been rare in Finland, and the exchange reserves have usually been kept at a relatively low level, the commercial banks have been in almost constant debt to the Bank of Finland.

The last special feature is a marked stickiness in nominal interest rates. Because of the negligible importance of free markets and the dependence of the banking system on the central bank, it has been possible to regulate the interest rates administratively. This regulation has most often taken the form of a stipulated maximum for the weighted lending rates of each bank or banking group. On the deposit side, there has been a cartel agreement which was originally initiated by the central bank in the 1930s. Traditionally, banks' loans and deposits are based on variable rate contracts. As a consequence, it has been felt that the impact on costs is large (both for housing and industry) but the impact on demand small when the interest rate changes.

As in most other Scandinavian countries, it was felt immediately after the war, when the investment requirements were immense, that the markets would push the interest rate too high in relation to the investment needs. Therefore, a low interest rate policy has been pursued, and even if it can be argued that the original needs have in many respects been eliminated, the policy line has so far been maintained. As most of the deposits are exempted from taxation, it has been possible to maintain a reasonable level of savings despite the low level of real interest rates.

Liquidity creation

Diagram 1 collects these and some other features together omitting, however, foreign capital flows. Table 1 gives an idea about the relative importance of different channels. As can be seen, the Bank of Finland conducts transactions with banks, the private non-banking sector and the government. As pointed out, lending to the government takes place only on rare occasions, but the government deposits the bulk of its cash reserves with the Bank of Finland. It is also interesting to note that the central bank carries out a large number of transactions with the private non-banking public. Lending includes different kinds of special credit arrangements such as financing of domestic suppliers' credit, new-export credit and short-term export credits. Private deposits mainly consist of different deposit schemes which have been established to enlarge the arsenal of counter-cyclical instruments. These include investment and counter-cyclical deposits, some of which are made on a voluntary and some on a compulsory basis and decided by the government. In practice, these funds operate as selective monetary policy measures as they usually squeeze liquidity in some well-defined sectors or branches.

Another interesting feature is to be found in the links between the government and the private non-banking sector. First of all, the government extends loans to the private sector on a large scale, and at the end of 1981, the outstanding stock exceeded government debt by a large margin. Some sort of interest subsidization is usually linked to these loans, which are made for housing, agriculture or some special industrial purposes. As can be seen, the loans are quite important to the private sector. On the other hand, the government has tradiationally not borrowed domestically on an extensive basis and the share of government bonds in the private sector portfolio is small.

From the point of view of liquidity creation, the links between the banks and the central bank are the most important. The central bank actively uses these channels to influence conditions in the market. It determines conditions at which commercial banks borrow and deposit at the central bank and within certain limits it decides the cash reserves.

Commercial banks can borrow from the central bank in two ways. Firstly, each commercial bank has been allotted a quota within which the bank receives funds at the base (discount) rate. Secondly, the commercial banks can also borrow at the call money market managed by the Bank of Finland, which also decides upon the interest rate. The central bank acts to eliminate excess demand and supply on this market; if there is net demand for credit at a given interest rate, which is the typical situation, the Bank of Finland fills the gap and, if there is an excess supply of deposits, the central bank absorbs funds.

The central bank tries to influence the banking sector's willingness to extend credits by varying the quotas, the interest rate on the call money market and the cash reserve requirements. Of these, the cash reserves operate mainly to ensure that the banking sector is dependent on central bank finance. As was mentioned, the banks' lending rates are regulated by the central bank and the prevailing rate has normally been well below the equilibrium rate which would bring supply and demand into balance. As a result, there has been almost constant excess demand for bank credit, and actual credit developments have to a large extent reflected the behaviour of the banks.

At the margin, banks have been dependent on the central bank for financing their lending and, by regulating the costs and controlling lending rates, the central bank has been able to influence the profitability of bank lending. If a bank is in equilibrium in the sense that the marginal cost of raising funds (i.e. borrowing at the central bank) equals the marginal revenue from lending to the private non-banking sector, the central bank can change this equilibrium by altering the costs of the funds it extends. E.g. an increase in the call money rate increases marginal costs paid by the banks and reduces the optimal level of bank lending. It is then up to the banks to ration credit and to decide which projects will be supported.

Hence, the operation of monetary policy relies very heavily on quantitative rationing and on the behaviour of the banking system. The role of interest rates is very limited but as a consequence of the low level of rates, there is an almost constant excess demand for loans, which is essential for the existence of credit rationing. The wealth effects, which are so important in the transmission of monetary policy in the normal "textbook case", are virtually absent and one has rather to talk about an availability effect.

Transmission of policy measures

Diagram 2 presents in a schematic way how restrictive monetary policy could be transmitted through to the economy. As was mentioned above, an increase in the marginal cost paid by the commercial banks will reduce the supply of loans. If banks' lending rates are kept unchanged, demand for credit will remain unchanged and rationing in the bank loan market will increase. The full amount of this is not, however, necessarily felt by the banks. It is likely that an announcement by the central bank that credit conditions are being squeezed will influence expectations both concerning the future path of the economy as well as the prospects for receiving a loan. In either case demand for credit as registered by the banks will be reduced.

The central bank could at the same time give recommendations as to which or what kind of projects should be affected by the credit squeeze, or there could exist previuously issued guidelines concerning banks' lending policy. In any case, loan commitments by banks will be reduced and this will have a depressive impact on final demand in the economy. In a closed economy, or if all capital flows were strictly regulated, these effects would be more or less unavoidable assuming the banks were not willing to reduce their profitability.

Capital flows, in particular long-term, are largely regulated by the Bank of Finland, and this, no doubt, supports the effectiveness of monetary policy and also helps to create monetary policy autonomy. In practice, however, all capital flows cannot be regulated and an increase in the use of foreign funds will, no doubt, offset some of the restrictive effects on domestic credit. It is easily seen, that if the foreign and domestic funds were complete substitutes, monetary policy could not influence the total amount of credit, only its composition. This is the normal case for small open economies with fixed exchange rates irrespective of their monetary system.

Recent evolution of the institutional framework

The presentation above gives the basic features of how the system functions with quantitative rationing and sticky interest rates. This has also been typical during most of the post-war period. However, there have been some recent developments which could be important for the future. The most important feature is the increased interest sensitivity of the corporations. As mentioned above, this has during the last few years led to the growth of a short-term wholesale market where interest rates are determined on the basis of demand and supply.

It is, of course, clear that these developments do not depend only on increased interest sensitivity which, by necessity, is rather slow to emerge. There have also been several other factors which contributed to the creation of this market by the end of the 1970s. First of all, the slowdown in economic growth has hampered incentives to invest at the same time as balance sheets have strengthened. Hence, firms are perhaps less dependent on bank loans than in the past and less willing to leave short-term liquid funds on accounts paying low interest, normally more or less a precondition for gaining access to the low interest rate market.

The second reason can be found in the external operations. Firms have gained important experience in managing their exchange risks and have also been prompted by their international competitors to increase returns on financial resources. Thirdly, the control of bank lending rate and the introduction of the cash reserve system in 1979 no doubt stimulated activity in this field. Funds in most unregulated rate channels are not subject to reserve requirements and therefore can earn a higher rate of return than normal bank deposits.

Another stimulus to banks was provided by the establishment of foreign banks in Finland in 1982. These banks are subject to the same rules and regulations as domestic banks but as they lack branch offices, they tend to concentrate on the wholesale market. This, of course, has prompted domestic banks to react to and to anticipate these developments.

Last, but not least, since the end of the 1970's banks have been able to expand the operations of their finance companies, which mainly provide leasing, factoring and the finance of instalment credit. As the activities of these companies are not subject to direct central bank regulations, so that their interest rates are set in light of demand and supply of finance, the banks have had the possibility to channel expensive funds to the public at a profit.

These innovations have so far been concentrated on the corporate sector. An important factor reducing households' interest in these operations is the fact that interest income from the regulated rate market is tax-free, whereas interest income from other sources is subjet to taxation. The unregulated rate must therefore be substantially higher than the regulated rate to make it profitable for a household to invest in the unregulated rate market. But the amount of tax-free investment income that households can receive from other than regulated rate sources has recently been raised, and this has certainly increased the potential demand for unregulated rate issues by the household sector.

As a result of these developments, there is now a dual interest rate system. On the one hand, there is a regulated rate and tax-free part, and on the other hand, an unregulated rate part which is subject to taxation. The central bank has, however, tools to influence interest rate formation in both markets. (Diagram 3)

As already mentioned, the banks' lending rate is controlled by the Bank of Finland while the banks' deposit rate is agreed upon within the context of a cartel agreement among banks. In practice, fluctuations in the regulated rates follow closely fluctuations in the base rate. Hence, a change in the base rate at which the Bank of Finland lends to commercial banks will not only affect bank cost of borrowing from the central bank. As government bonds, which are also tax-free, are close substitutes to longer-term deposits in banks, these rates are usually altered at the same time if not necessarily always by the same amount.

On the other hand, the Bank of Finland can influence the market rate via the call money market. For the banks, borrowing in the call money market is an alternative to taking deposits from the unregulated rate market, and the marginal cost of borrowing from the central bank will create a ceiling for the market rate. On the other part, foreign rates and the covered Eurorate also influence the behaviour of the business sector. There will, therefore, be an interaction in the formation of market and forward rates where the call money rate and foreign rates are exogenously given. The market rate will, in turn, influence interest rates on debentures which are both free from interest rate regulation and subject to taxation. It is apparent that the two parts in the dual system do not operate completely separately from each other; bank lending rates will to some extent influence bank behaviour in the unregulated rate market and the bond rate will affect the interest rate on debentures. These channels are not, however, of prime importance.

However, since May 1983, the market rates have had a direct influence on the banks' regulated lending rates. The banks have since that date been allowed to shift part of the differential between market rates and the ceiling on average lending rates onwards in rates on new loans. On average, this has not raised lending rates by more than one or two tenths of a percentage point, but as adjustment mainly takes place by varying the rates on new loans, these can fluctuate substantially when market rates change. Hence, the fluctuations in the regulated rates have tended to be more "market-oriented" and the behaviour of these rates resembles to some extent the behaviour of rates in a system with fixed rate contracts.

So far the market sector has been rather limited, amounting to only some 10 percent of lending at the regulated rate market and the existence of the market has not had major implications for the operation of monetary policy. However, the evolution and growth of the financial market cannot fail to influence the way monetary policy influences the economy and therefore also the future design of policy instruments. With the growth of the unregulated rate market, availability of finance becomes less important and its cost more important. As a result, the marginal rate of interest for the entire system will gain in importance while the bank-by-bank marginal rates or the quantity of marginal central bank finance will become less essential. Since economic agents can be expected to react differently to the transmission of policy through prices and quantities, the impact of monetary policy measures will tend to change.

The evolution of the financial system is also bound to influence policy planning procedures. As was mentioned, when demand for credit was seen to exceed the supply, attention was focused on credit aggregates. With the emergence of an active and uninhibited financial market, interest rates have assumed new importance. In addition, liquidity indicators may come to be of more relevance than in the past.

Diagram 1

LIQUIDITY CREATION

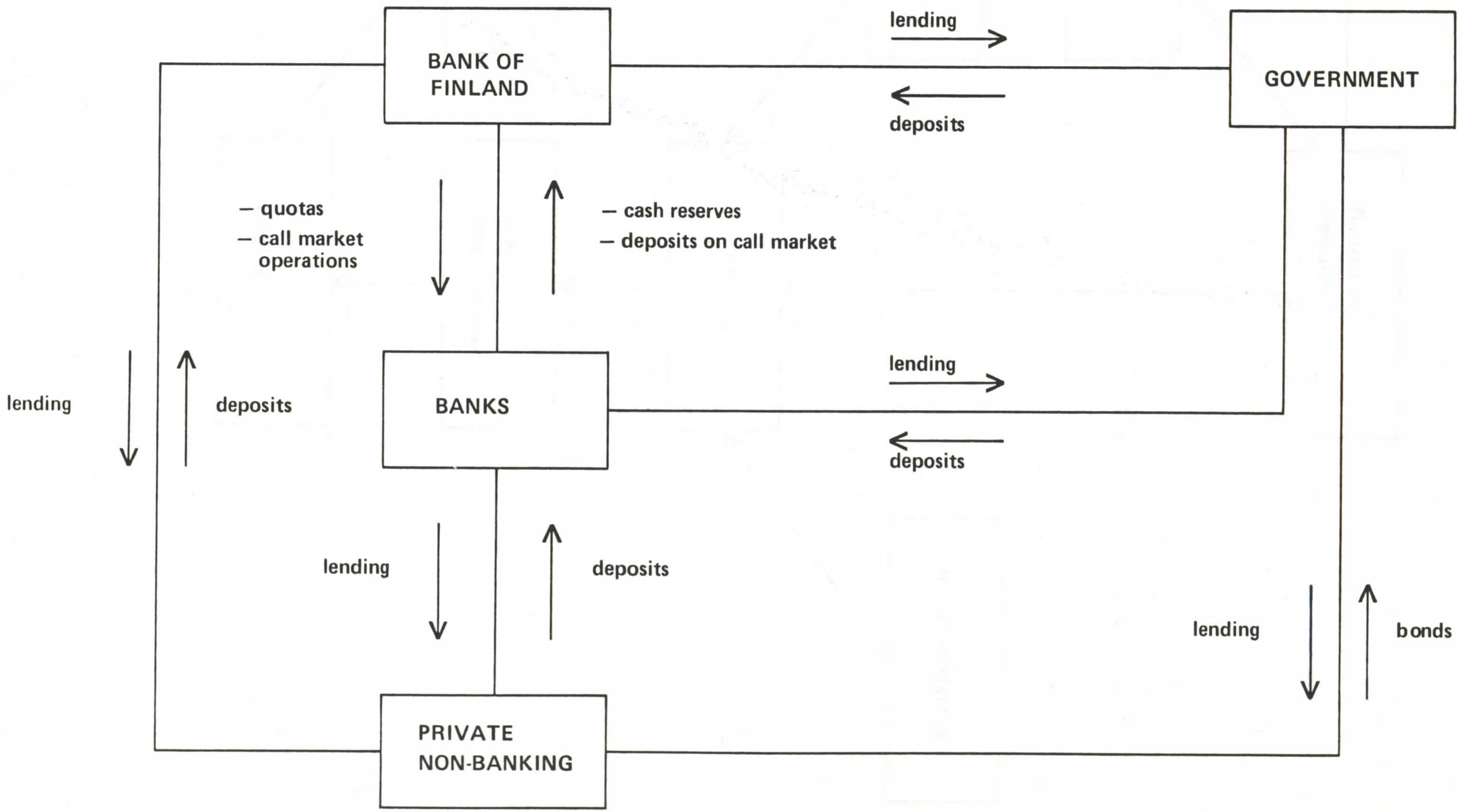

Diagram 2 TRANSMISSION OF POLICY MEASURES

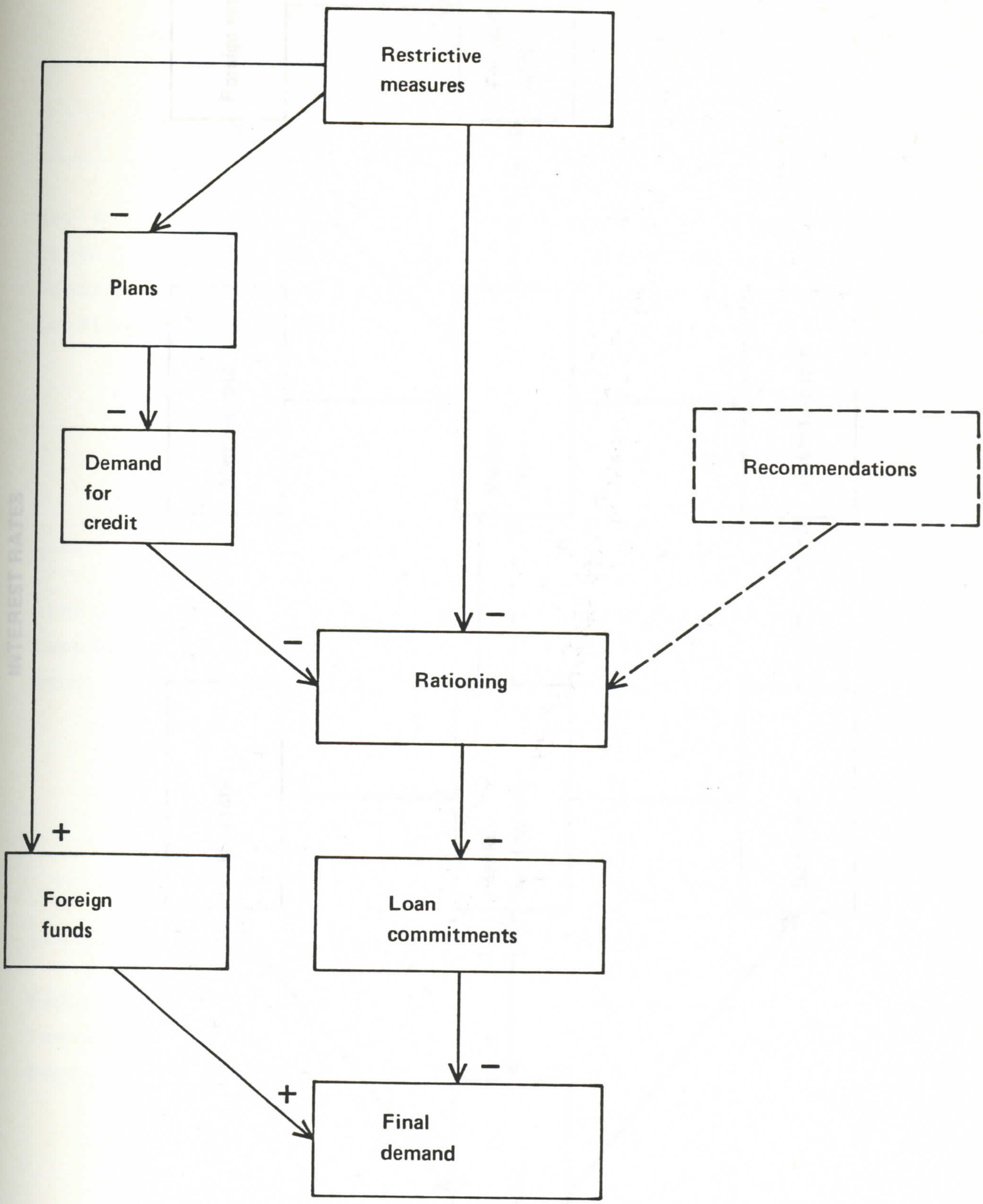

Diagram 3

INTEREST RATES

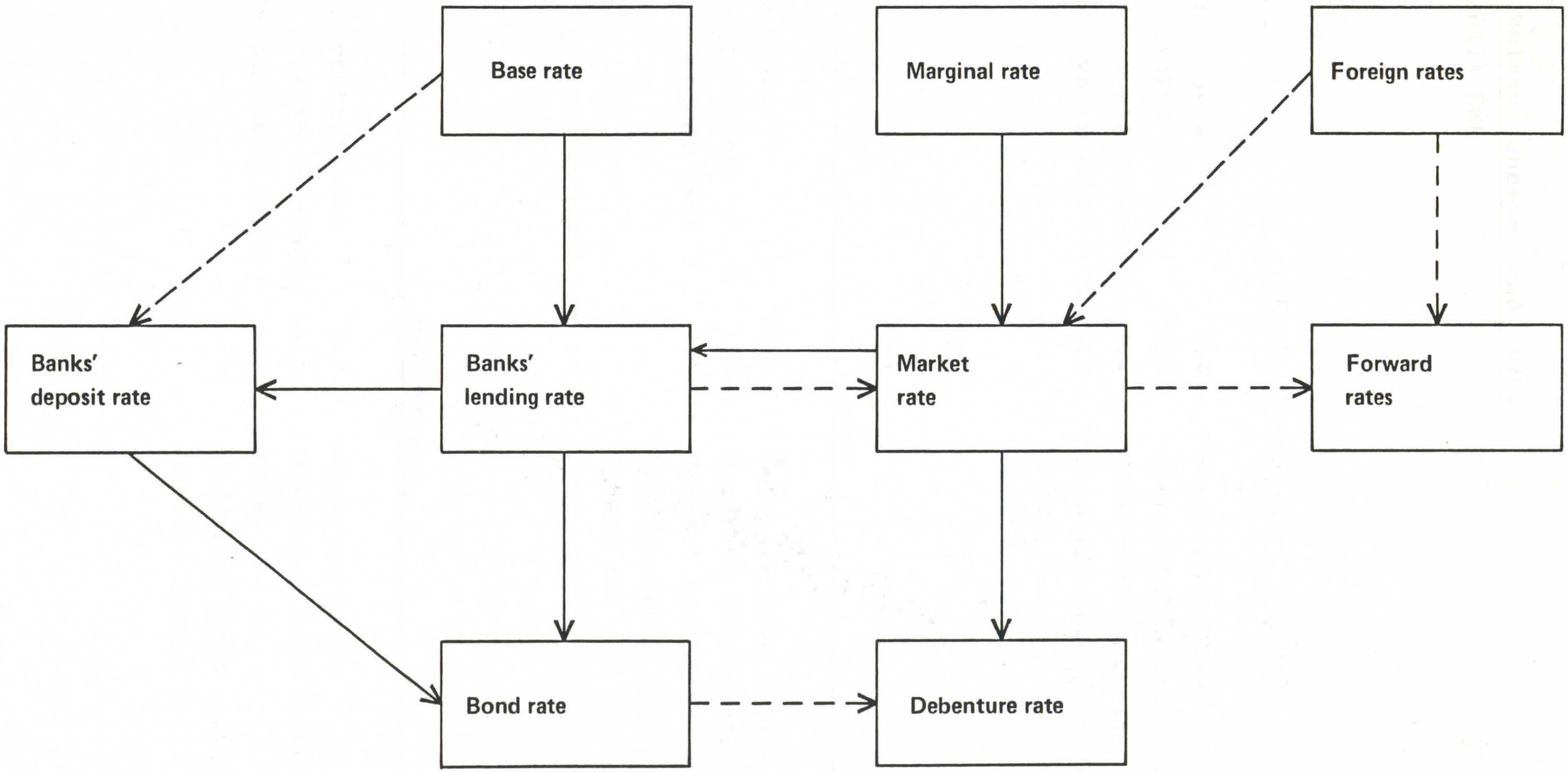

Table 1 Balance Sheets, End -1981

Bill Fmk

Bank of Finland

Net foreign assets	8.4	Notes and coins	5.6
Commercial banks' debt	3.3	Commercial banks' deposits	2.5
Lending to private non-banks	4.4	Government deposits	3.3
Lending to government	0.8	Deposits from private firms	1.6
		Other, net	3.9

Banks

Lending to public	95.3	Deposits from public	86.7
Lending to government	1.0	Deposits from government	1.9
Deposits in central bank	2.5	Central bank debt	3.3
		Foreign debt	8.5
		Other, net	- 1.6

Government

Deposits in central bank	3.3	Domestic bonds	8.8
Lending to private non-banks	25.4	Borrowing from domestic banks	1.0
Deposits in domestic banks	1.9	Borrowing from central bank	0.8
		Foreign loans	13.0

Gavin Bingham

MONEY AND BANKING IN FINLAND: A REPRESENTATIVE SURVEY OF THE LITERATURE IN ENGLISH

In what follows the literature on banking and money in Finland accessible to the non-Finnish speaking reader is reviewed. No attempt is made to be exhaustive, but rather to provide a few representative references in five main categories: institutions, monetary policy planning, channels of monetary policy transmission, the conduct of monetary policy and financial innovation. A more exhaustive survey from a different perspective can be found in an article by Bingham, et al. (1981).

Institutions

The principal description of monetary institutions is a collection of articles published in the Bank of Finland Monthly Bulletin entitled Financial Markets in Finland. The Finnish Bankers Association also puts out an annual publication describing the Finnish financial system. One particular feature of the financial system relevant to monetary policy is the dominance of the variable interest rate contract. It is discussed in an article by Hurme (1981).

Policy Planning

Monetary policy planning takes place within an overall framework which exploits the relationships between the financial and national income accounts. This policy planning framework is described in articles by Airikkala and Bingham (1977), Kostiainen and Korhonen (1977) and Airikkala and Pauli (1979).

Avenues of Policy Transmission

The transmission of monetary policy has received much attention in the Finnish literature. The bulk of the work falls into two classes: credit rationing and the balance of payments. Work on credit rationing is relevant for understanding non-market clearing equilibria, which are potentially of great relevance outside the financial sphere. One noteworthy contribution in this area is by Koskela (1976), who exploits the concepts of homogeneous and heteregeneous credit markets. Koskela also discusses the allocative impact of credit rationing as well as its implications in a demand management context. Willman (1981) has perceptive account of the influence of credit rationing for fiscal and monetary policy. Unlike many other macroeconomic models, the Bank of Finland quarterly model explicitly attempts to take credit rationing into account. An account of the monetary realtionships in this model will be found in Kukkonen (1974). Mellin and Viren (1982) consider how credit rationing affects consumption, while the latter author and Koskela have a number of papers on the determinants of savings in the University of Helsinki, Bank of Finland and ETLA discusison paper series. Although not dealing with credit rationing directly, Oksanen (1977) discusses bank behaviour in a concentrated financial system where interest rates are regulated. A survey of the Finnish demand for money literature is found in Suvanto (1980).

The literature on the balance of payments is partly in the "monetary approach" tradition. Notable examples are the writings of Korkman (1980), Halttunen (1980) and Halttunen and Korkman (1981). Aurikko (1976) is among those writing on capital movements. Nyberg (1982) provides in interpretation of the Finnish business cycle and unlike Korkman (1978) takes into account financial factors to some extent.

The Conduct of Monetary Policy

An account of the conduct of monetary policy over the span of a decades will be found in an article by Koivisto in the Weltwirtschaftliches Archiv in the late 1970s, while articles in the Bank of Finland Monthly Bulletin provide a picture of more recent developments. Oksanen (1974) discusses the role of the discount window and Puntila (1976) describes the call money market which, however, has evolved since that date.

Financial Innovation

Like the markets in so many other countries, Finnish financial markets have recently tended to evolve. The changes in these markets and their implications are discussed in articles by Puntila (1982), Bingham and Åkerholm (1982) and Bingham and Pauli (1983). Finance companies, the rapid growth of which is a token of innovation, are discussed in Pauli and Bingham (1983). For an account of the impact over the longer term, see Bingham (1980).

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