Other financial corporations: Cinderella or ugly sister of empirical monetary economics?

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UK monetary data are typically analysed at the sectoral level, as it has been found easier to identify stable money demand functions for households and for 'private non-financial corporations' (PNFCs) than for the private sector as a whole. This is, at least in part, because the behaviour of 'other financial corporations' (OFCs) has been hard to explain and fairly volatile. As a result there are few studies of OFCs, even though they hold a significant component of the broad money stock. There is also a question of relevance for monetary policy makers here. OFCs' money holdings and borrowing have grown rapidly in recent years and it is important to understand whether this has any consequences for aggregate demand and ultimately for inflation.

This paper offers an empirical analysis of the determinants of OFCs' money holding. It does so in a framework in which OFCs' sterling borrowing from the banking system is modelled simultaneously. Both OFCs' money holdings and bank borrowings are shown to be cointegrated with a common set of driving variables. These cointegrating equations could be interpreted as evidence of stable long-run OFCs' money demand and credit demand relationships.

The long-run relationships identified perhaps add to the literature on the links between financial activity and economic growth. But the main point of this analysis that is of potential relevance for monetary policy, is to test whether links can be identified between OFCs' money and borrowing and UK aggregate demand. We use models of household and PNFC behaviour (developed by us elsewhere) to test for linkages from OFC money and borrowing to consumption and investment.

The main results are that there is no detectable relationship between OFCs' money and borrowing and consumption, but there does appear to be a long-run relationship between OFCs' borrowing and aggregate investment. This could be because some OFCs borrow in order to buy capital equipment, which is then leased to PNFCs. Or it could be that OFCs provide financial services to PNFCs which make them better able to invest (for example, by lowering the cost of capital as suggested in the finance and growth literature). This implies that there may be a link from OFCs' financial behaviour to aggregate demand and inflation via investment and so it would be dangerous to ignore OFCs entirely. However, only a study of OFCs' behaviour at a disaggregated level will be able to distinguish whether this link is via leasing companies or whether there is a more general influence of financial firms on the investment behaviour of PNFCs. This remains for future work.