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*Monetary Policy and Financial Liberalization: The Case of United Kingdom Consumption**

This paper outlines work done recently to investigate the impact of financial liberalization on monetary policy effectiveness. We look at the case of United Kingdom consumption behavior, in particular the savings ratio. Over the 1990s this sector has been heavily influenced by comprehensive deregulation of the U.K. financial services industry which has caused stable long-run relationships for the U.K. consumption function to shift significantly. We analyze the relationship between financial liberalization and consumption by evaluating and extending a forward-looking model in which the degree of financial deregulation influences the behavior of two groups of consumers: those constrained to consume from current income only and those able to borrow on the basis of expected future income flows. We show that specifications incorporating such features capture recent U.K. behavior reasonably well and pick up the main shifts in the savings ratio. We also show that changes in the extent of financial regulation cause the transmission of monetary policy to alter in important ways which have implications for the way in which monetary policy should be implemented.

Introduction

One of the principal ways in which monetary policy can affect the macroeconomy is through its influence on personal consumption. Over the last two decades, personal consumption in most industrial countries has been subject to considerable change. For example, in the United States, the savings ratio has shown a pronounced downward trend, and in the United Kingdom the savings ratio has shown a distinct cycle. As a result, most recent attempts to model consumption behavior in the U.K. have hit two major

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hurdles: they have failed to pick up the fall in the savings ratio during the consumption boom of the late 1980s, and they have failed to pick up the recovery in saving during the early 1990s. Relationships which appeared to be stable began to shift, and there was a tendency for "long-run, equilibrium" models to underpredict during the 1980s boom and overpredict in subsequent periods. This phenomenon has inspired a number of studies, such as Attanasio (1997), Attanasio and Weber (1994), Caporale, Sentance and Williams (1997) and Miles (1997), which highlight the role of the comprehensive deregulation of U.K. financial services during the 1980s and 1990s and the impact this had on housing and financial wealth as major factors in the behavior of the U.K. savings ratio.

An alternative view suggests that in many respects the failure of many consumption specifications arises because they have relied upon backward-looking error correction models (*ECMs*) as representations of the consumption process. For the U.K. case, Church, Smith and Wallis (1994a, 1994b) show that within this framework cointegrating relationships representing long-run equilibria can be established quite straightforwardly, but stable short-run dynamic structures are more elusive. The most successful formulations have included additional terms in the dynamic structure such as the unemployment rate or housing market turnover to pick up changes in financial or real activity. However, even in these cases there still tend to be problems in the lag response of the models, and it is clear that no single additional term has been able to provide an unambiguous solution.

The limitations of *ECM* specifications can also be explained in terms of the exposure of the underlying structural forms to the Lucas (1976) critique. Blake and Westaway (1993), for example, show that in a framework where an *ECM* is solved out from its microeconomic foundations there is evidence that instability may arise both from the exogenous income process and from institutional shifts in the model's "deep" structural parameters. They argue that this type of insight can only be gained when the final estimated equations are based on a clear theoretical framework. This is rarely the case in *ECM* specifications, which tend to use the statistical fit of the model as the main *desiderata*.

Using consumer theory in the design of aggregate functions is one of the ways in which a solution to statistical drawbacks might be found. Muellbauer (1994), Muellbauer and Lattimore (1994) and Attanasio (1997) provide surveys of some of the current thinking in this area, which has highlighted *inter alia* the role of forward-looking income expectations and financial (credit) constraints in agent consumption allocations. With this in mind, this paper outlines a model with an explicit role for financial variables, such as asset portfolios, to investigate whether these play a role in accounting for consumer behavior and whether they affect the impact of interest rate