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Convergence of interest rate pass-through in a wider euro zone?

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Abstract

This study investigates interest rate pass-through convergence for the eight Central and Eastern European countries (CEECs) that joined the European Union. Based on a unifying empirical pass-through model that allows for thresholds, asymmetric adjustment, and structural changes, we find that the pass-through in many CEECs has become faster over time and is generally more complete than in the euro zone. We find evidence for convergence across CEECs with market concentration, bank health, foreign bank participation and monetary policy regime as conditioning factors. No convergence of the CEEC pass-through is found vis-à-vis the heterogeneous euro zone.

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1. Introduction

The eastern enlargement of the European Union (EU) in 2004 will soon be followed by an eastern enlargement of the euro zone. While the so-called Maastricht criteria focus on nominal convergence of inflation rates, market interest rates and government deficits and debt, the issue of

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convergence of financial structures has recently become a focal point of the debate on the European integration project for at least two reasons: With respect to the genuine objective of EU integration policy to create a single European financial market it is now widely recognized that retail banking markets are still the least integrated financial markets within the EU (for a recent review see, e.g., Baele et al., 2004). With respect to the emergence of a (more) homogenous euro-zone monetary transmission, it has been argued that ‘‘differences in financial structure are the proximate cause for [these] national asymmetries in the monetary transmission mechanism’’ (Cecchetti, 1999). Pass-through (PT) studies which investigate how retail banking interest rates react to changes in market interest rates can provide evidence on both issues: First, banking markets are said to be integrating when different national bank rates react similarly to market interest rate ‘‘news’’.[1] Secondly, if monetary transmission heterogeneities are mainly driven by financial structure differences, then PT convergence may be at the heart of monetary transmission convergence. Building on previous work for the incumbent euro zone (Sander and Kleimeier, 2004) we here explore both the potential for interest rate PT convergence across the eight central and eastern European countries (CEECs) that joint the EU in 2004 and the potential for convergence of this group vis-à-vis the incumbent euro zone and some of its members.

Financial structure heterogeneity within the current European Monetary Union (EMU) is now well documented by various strands of research.[2] Heterogeneity is also confirmed in most euro-zone PT studies that are based on a variant of the pioneering work by Cottarelli and Kourelis (1994). Important contributions include BIS (1994), Cottarelli et al. (1995), Borio and Fritz (1995), Mojon (2001), de Bondt et al. (2002), Sander and Kleimeier (2002, 2004), Toolsema et al. (2002), Heinemann and Schüler (2003), de Bondt (2004), and De Graeve et al. (2004). Typically, these studies find considerable differences in the pass-through across the countries of the euro zone. Moreover, a substantial degree of short-run bank interest rate stickiness and very limited evidence for a full pass-through in the long run is found. Asymmetric adjustment of retail interest rates is also regularly documented. Finally, it is often argued that the single currency could act as a unifying force that has the potential to make the PT faster, more complete and more homogeneous. However, as argued by Sander and Kleimeier (2004), legal and cultural differences may continue to preclude full convergence in the incumbent euro zone. So can convergence towards a heterogeneous aggregate euro zone be meaningful? To address this issue comprehensively, we investigate three different concepts of convergence: convergence across CEECs, convergence of CEECs towards an aggregate euro zone and towards a few selected incumbent euro-zone countries chosen as representatives for different legal families.

Given the diverse macro-economic developments and financial structures in the new EU member countries, one might hypothesize that a wider euro zone will lead to an even more heterogeneous monetary policy transmission process. Until now, there exist only very few PT studies for CEECs. These are often limited to individual countries such as the studies by Opiela (1999), Wróbel and Pawłowska (2002), and Chmielewski (2004) for Poland, and Horváth et al. (2004) for Hungary, or they relate to selected countries only, such as Crespo-Cuaresma et al. (2004) and Kot (2004), who compare the Czech Republic, Hungary and Poland. In all studies,

[1] Baele et al. (2004) classify cross-country PT-studies as a ‘‘news-based measure’’ of financial market integration.

[2] Recent overviews on financial integration in the euro zone are given by Freixas (2003) and Baele et al. (2004). While the latter study predominantly uses so-called beta- and sigma-convergence measures, Kleimeier and Sander (2000, 2003), and Schüler and Heinemann (2002) investigate retail banking market integration using cointegration methodology. For an application of the cointegration approach to CEECs see Brada et al. (2005).