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Journal of Banking & Finance 30 (2006) 1839–1870
Journal of BANKING & FINANCE
www.elsevier.com/locate/jbf

Expected versus unexpected monetary policy impulses and interest rate pass-through in euro-zone retail banking markets

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Available online 13 September 2005

Abstract

This paper investigates the interest rate pass-through in the euro-zone's retail banking markets by differentiating between expected and unexpected monetary policy impulses. The paper introduces interest futures as measures of expected interest rates into pass-through studies. By allowing various specifications of the pass-through process, including asymmetric adjustment, we find a faster pass-through in loan markets when interest rate changes are correctly anticipated. In contrast, deposit markets are found to be more rigid. Overall, our results suggest that a well-communicated monetary policy is important for a speedier and a more homogenous pass-through but may also be complemented by competition policies.
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JEL classification: E43; E52; E58; F36

Keywords: Interest rate expectations; Monetary policy; European banking; Competition in banking; Interest rate pass-through

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doi:10.1016/j.jbankfin.2005.07.006

1. Introduction

Investigating the pass-through of monetary policy impulses onto retail banking interest rates has become an important part of the research on the financial part of the monetary transmission process in the euro zone. The results of such analyses have direct implications for assessing the efficiency of the monetary policy, the heterogeneity (or a possible trend towards homogeneity) of the euro-zone financial system, and the competitive situation in different segments of the banking markets. While this research area is fairly well developed, the complete absence of interest rate expectations and monetary policy anticipation from the literature is striking. In the presence of forward looking financial markets, and in particular with the existence of interest rate futures, which may reflect expected future interest rates, pricing behaviour in retail banking is likely to be forward looking too. This study explores this issue by disentangling the impact of expected and unexpected monetary policy impulses.

Following the pioneering pass-through study by Cottarelli and Kourelis (1994) who apply a dynamic lending-rate model in an international context, this approach had soon been adopted within the European context (Cottarelli et al., 1995; BIS, 1994; Borio and Fritz, 1995). Additionally, since Sander and Kleimeier (2000) pass-through studies are now regularly based on an error-correction specification (e.g. Mojon, 2000; Heinemann and Schüler, 2003; Toolsema et al., 2001). Most recently, asymmetric adjustment of retail bank interest rates to monetary impulses has also been considered. This still relatively small literature (see e.g. Sander and Kleimeier, 2000, 2002; de Bondt, 2002; de Bondt et al., 2002) builds on Tong (1983), Scholnick (1996, 1999), Balke and Fomby (1997), Enders and Granger (1998), Baum and Karasulu (1998) and Enders and Siklos (2001). Euro-zone pass-through studies commonly find the following pattern: First, bank interest rates are sticky. Thus, monetary policy rate changes typically lead to a less than one-to-one change of retail rates, i.e. the short- and medium-run multipliers are taking values often far below unity. Second, there are considerable differences in the pass-through across different bank lending and deposit rates. Third, studies that allow for asymmetric adjustment typically find ample evidence for asymmetries but without any consistent pattern. Fourth, while there is no consensus yet regarding a possible full pass-through in the long run, most authors agree that the pass-through is most complete for short-term lending to enterprises. Fifth, most studies find significant differences in the pass-through mechanism across the euro-zone countries. Finally, there is increasing though still weak evidence that the pass-through mechanism has become faster and more homogeneous in the recent years, eventually pointing to a homogenising role of the Euro and the single euro-zone monetary policy. Nevertheless, the remaining differences in existing literature are still substantial. Sander and Kleimeier (2004) have tried to unify this research by arguing as follows: First, these differences are caused predominantly by differences in (1) the choice of exogenous market interest rate, (2) the length and timing of the investigated periods, (3) the treatment of possible structural breaks, and (4) the chosen methodology for the pass-through study. Second, these differences could be reconciled by focussing on a unifying approach that uses an appropriate measure of the monetary policy stance such as short-run money market rates, incorporates endoge-

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