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Competition in banks' lending business and its interference with ECB monetary policy

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ABSTRACT

Our paper calls attention to the heterogeneous levels of competition in EMU banking systems. Employing a modified Lerner Index, our methodically unique data set enables us to calculate banks' pricing power in the national lending business alone, instead of measuring market power for banks' total business. We document that market power in the exclusive segment of lending is greater than market power in total banking business. In an OLS regression model for the period 2003–2009, we find that changes in competition considerably affect funding conditions in the individual countries and therefore interfere with a homogeneous transmission of ECB monetary policy.

1. Introduction

Adjustments of the refinancing rate are the central bank's essential tool to meet the (primary and ancillary) targets of monetary policy, i.e. to maintain a stable price level, to promote economic growth and to safeguard financial stability. In doing so, the European Central Bank (ECB)

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implicitly relies on an effective transmission of changes in the official rate to bank interest rates for loans, as well as for deposits. However, the European Monetary Union (EMU) is characterised by a large degree of heterogeneity, e.g. in terms of economic activity, productivity, and above all regarding banking market structures and banks' business models. Not least, diverse national inflation rates are therefore a persistent feature of the currency union. This heterogeneous framework implies that ECB policy measures affect macroeconomic developments unequally across euro area countries. Even in case of identical macroeconomic constellations the conduct of monetary policy is hampered by national banking system characteristics. First and foremost Cottarelli and Kourelis (1994) and Cecchetti (1999), currently Adams and Amel (2011), identified market concentration as a vital indicator for banks' market power, which represents a major source of interference with monetary policy transmission. In a novel framework, this paper attempts to analyse whether changes in national banking competition impede a homogeneous transmission of monetary policy actions in the EMU.

Research on banking market competition typically uses banks' total business to calculate market power with conclusions drawn about the effect on real economic activity, such as corporate funding conditions. As the latter are clearly reflected in the specific lending business of banks, we feel the need to better define the relevant market for competition measures in the banking sector. Therefore, our article develops an approach to calculate the degree of competition in the lending business alone, which must be regarded as the most crucial link to the real economy and, consequently, as a vital indicator for central bank actions.

Compared to the existing literature, this article offers five major improvements. Firstly, we focus on the EMU banking sector and develop a modification of the common Lerner Index in order to generate results for specific segments of the national lending business. In contrast to the majority of previous studies, we utilise corporate lending rates instead of total revenue across all business segments as a proxy for prices. One of the major advantages is that we are able to draw more precise conclusions on the corporate funding conditions in EMU member countries.

Secondly, our data set employs the ECB monetary financial institutions (MFI) interest rate statistics. Hence, we make use of completely harmonised retail interest rate series. This is a clear advantage compared to previous empirical studies, which had to be based on national retail interest rate datasets not being harmonised pertaining to loan categories, maturities and fixed interest rate periods, and which often exhibited incomplete and unbalanced samples. Our analysis features no data break or biased results caused by dissimilarities of national definitions.

Thirdly, we enhance the ECB MFI interest rate statistics by calculating an interest rate average weighted by loan volumes. To the best of our knowledge, this paper documents the first approach that tackled the laborious way through every national central bank statistic to calculate an accurate lending rate for 'total new business' comparable across all member countries. By this, the explanatory power of conclusions regarding the national lending business rises significantly.

Fourthly, the analysis comprises all founding member countries of the EMU and Greece. In doing so, we can detect cross-country differences whereas most other studies estimate euro area wide parameters only.

In a final step, we utilise our novel results and investigate the effectiveness of central bank actions against the background of diverse national degrees of competition in the EMU lending business. In a regression model, our paper displays the impact of changes in the national degree of competition on national loan rates and their interference with monetary policy.

Our paper is organised as follows. The next section gives an overview of the existing literature on the interdependence between monetary policy and competition in the banking market. Section 3 illustrates the heterogeneous structural characteristics of European banking systems first and develops a measure of banking competition in the national lending business thereafter. Section 4 introduces the econometric methodology to test for potential interference of competition with central bank actions. Our empirical results are discussed in Section 5. The paper closes by drawing first conclusions from our findings and providing policy recommendations.