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Heterogeneous monetary transmission process in the Eurozone: Does banking competition matter?

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A B S T R A C T

This paper examines the implications of banking competition for the interest rate channel in the Eurozone over the period 2003–2010. We use an Error Correction Model (ECM) approach to measure the long-run and short-run relationships between money market rates, bank interest rates, and our competition proxy, namely, the Lerner index. We find that competition (i) reduces the bank lending interest rates, (ii) increases the long-term interest pass-through and (iii) speeds up the adjustment towards the long-run equilibrium in the short-run. Therefore, increased competition would improve the effectiveness of monetary policy transmission through the interest rate channel, and from this point of view should be fostered in the Eurozone. Finally even if we observe that other factors related to the recent crisis matter for monetary policy transmission, bank competition remains a key determinant of the pass-through.

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1. Introduction

While the European Monetary Union (hereafter, EMU) celebrated its 15th anniversary in 2014, its heterogeneity remains a great concern. The recent crisis has exacerbated the fragmentation of

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financial markets and increased the heterogeneity of monetary policy transmission in the euro area countries (see, e.g., Bernhofer and van Treeck, 2013; Blot and Labondance, 2013; Ciccarelli et al., 2013). This now constitutes a major challenge for the effectiveness of the single monetary policy (ECB, 2012).

However, the financial crisis only tells part of the story. In other words, the existence of heterogeneous financial conditions in EMU is not new (see, e.g., Marotta, 2009; Bernhofer and van Treeck, 2013), even if the decline in the nominal interest rates in all euro area countries over the two decades preceding the financial crisis has tended to mask this heterogeneity in some financial market segments. Since the start of the EMU, some degree of national differentiation in the financial conditions has existed despite policy initiatives to foster financial integration, such as the Financial Services Action Plan (FSAP) launched in 1999.

Furthermore, this persistence of cross-country differentials in terms of the financial conditions suggests that other factors than the country-specific imbalances revealed by the crisis have driven the financial heterogeneity within the EMU. Among these driving factors, the literature has highlighted the central role of the financial and banking structures (see, e.g., Cecchetti, 1999), and particularly the role of the banking sector competition. Indeed, we can expect that because of a fear of losing market share, commercial banks operating in a competitive market will supply loans with lower rates and will adjust their retail rates more quickly in response to changes in monetary policy interest rates than banks operating in concentrated markets. Given the predominantly bank-based nature of financing to households and firms in the Eurozone, heterogeneous degrees of banking competition may constitute a major impediment to a smooth transmission of the ECB's monetary policy. Naturally, the level of competition and concentration in the banking sector is also expected to influence the pass-through from the monetary policy to the deposit rates, which may have adverse effects from a macroeconomic perspective. As theoretically shown by Güntner (2011), by amplifying the changes in private households' liquidity premiums, a sluggish adjustment of the deposit rates amplifies the magnitudes and frequencies of fluctuations in output, consumption and employment in business cycles.

Starting from the seminal theoretical paper of Klein (1971), a strand of the empirical literature has studied whether the degree of bank competition affects monetary transmission. This literature has both focused on individual countries and been conducted at a cross-country level. In this second category of studies, we find in particular the pioneering papers of Cottarelli and Kourelis (1994) and of Borio and Fritz (1995), whose empirical results support the fact that lending rates adjust more sluggishly to changes in money market rates in a less competitive environment, proxied by the existence of barriers to entry. Thereafter, using different measures of banking competition, a number of studies have tried to test the effect of competition on the interest rate pass-through in the euro area (see, e.g., Mojon, 2001; Sander and Kleimeier, 2004; De Bondt, 2005; Kok Sørensen and Werner, 2006; Gropp et al., 2007). Overall, the results of these studies support the previous empirical findings by highlighting a tight relationship between the level of banking competition and the degree and speed of bank rates' adjustment to changes in market interest rates. In a recent study, van Leuvensteijn et al. (2013) reassessed this question by using a further measure of banking competition: the Boone (2008) indicator. In line with previous papers, van Leuvensteijn et al. (2013) found for eight euro area countries over the period 1994–2004 that the degree of banking competition is a major determinant of the interest rate pass-through, and furthermore, stronger competition implies a stronger responsiveness of loan rates to market rate changes.

Against this background, the aim of our study is to extend the existing empirical evidence on euro area countries by reassessing the effect of banking competition on the interest rate pass-through in the context of the recent financial crisis. In other words, our aim is to evaluate whether the degree of banking competition still matters in the transmission of monetary policy, as there is increasing evidence that country-specific imbalances have become more important in driving financial conditions in the aftermath of the financial crisis. More precisely, our paper extends the study of van Leuvensteijn et al. (2013) in at least three major dimensions: first, to take into account the potential effect of the crisis on the interest rate pass-through, we extend the study period considered by van Leuvensteijn et al. (2013). In fact, our study covers the period from January 2003 to December 2010 for a large sample of 11 euro area countries. Second, unlike van Leuvensteijn et al. (2013), we use the traditional Lerner (1934) index as a competition measure, which is popular in the empirical literature. Indeed, although the Boone index has a better theoretical foundation (see, e.g., Boone,

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