



# Convergence in euro-zone retail banking? What interest rate pass-through tells us about monetary policy transmission, competition and integration

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## Abstract

This study aims at unifying the empirical research on interest-rate pass-through in the euro zone. After endogenously determining structural breaks we select optimal pass-through models, which allow for thresholds and asymmetric adjustment. By applying these models to monetary policy shocks as well as cost-of-funds changes, we show that in post-break periods monetary policy transmission has become faster, that heterogeneity across the euro zone has decreased in some banking markets, and that more competition improves the pass-through predominantly in deposit markets. As national characteristics are still important pass-through determinants, convergence remains incomplete and monetary policy will continue to operate in a heterogeneous euro zone.

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## 1. Introduction

How uniform is the monetary transmission process in the euro zone? Given the dominant role of bank finance in the euro zone, banks are important conveyers of monetary policy impulses.<sup>1</sup> However, banking markets are often considered to be more resistant to convergence than other parts of the monetary transmission mechanism. As such, divergences in national banking market structures and competition as well as a lack of euro-zone banking market integration can be expected to lead to heterogeneous effects of monetary policy across the euro-zone economies.

Recent literature has therefore focused on empirical analyses of the pass-through of monetary policy impulses to retail banking interest rates in the euro zone.<sup>2</sup> Overall, these studies agree that there is a substantial degree of short-run bank interest rate stickiness. Furthermore, all studies find considerable differences in the pass-through not only across different bank lending and deposit rates but also across countries. These differences are typically attributed to the divergent structures of national financial systems. However, the single currency is often perceived to be a unifying force by making the pass-through faster, more complete and more homogeneous over the recent years. Nevertheless, the differences in the results of pass-through studies remain large and can be attributed mainly to four factors: (1) the choice of the exogenous market interest rate, (2) the length and timing of the sample periods, particularly with respect to the treatment of possible structural breaks, (3) the chosen methodology for the pass-through analysis, and (4) the design of the analysis of pass-through determinants.

In this study we provide a unifying analysis of the euro-zone pass-through mechanism by addressing these four issues: First, the pass-through is investigated by using both proxies for monetary policy rates as well as proxies for the bank's cost of funds. The first approach focuses on the transmission of monetary policy impulses into the financial sector while the second approach highlights the role of competition and market structures. Both approaches can be found in the literature and should therefore be viewed as complementary. Our unifying analysis allows for a direct comparison. Second, we investigate if and when the pass-through has changed between 1993 and 2002 by not postulating, but endogenously searching for structural breaks. Third, we estimate a large variety of pass-through models, including threshold and asymmetric adjustment models. The model finally used for each retail rate in each country is automatically selected according to statistical criteria set a priori. Finally, we investigate the determinants of the size, speed and convergence of the pass-through process.

The results of our study can be summarized as follows: First, the euro-zone pass-through mechanisms have undergone considerable structural changes in the past

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<sup>1</sup> See [Bernanke and Gertler \(1995\)](#) and [Kashyap and Stein \(1993\)](#) for a discussion of the different transmission channels of monetary policy.

<sup>2</sup> This literature includes [BIS \(1994\)](#), [Cottarelli et al. \(1995\)](#), [Borio and Fritz \(1995\)](#), [Mojon \(2000\)](#), [de Bondt \(2002\)](#), [de Bondt et al. \(2002\)](#); [Kleimeier and Sander \(2002, 2003\)](#), [Sander and Kleimeier \(2002\)](#), and [Toolema, Sturm and de Haan \(2002\)](#), [Heinemann and Schüler \(2003\)](#).

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