

Interest rate pass-through in Europe and the US: Monetary policy after the financial crisis

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Abstract

We examine the interest rate transmission mechanism for the Eurozone and the USA and discuss this issue in the light of the recent financial market tensions. For an efficient monetary policy, any change in the central bank policy rate is meant to be transmitted to retail interest rates, ultimately influencing consumer and business lending rates and therefore aggregate domestic demand and output. The disaggregated GETS methodology is employed, which allows us to reveal the relative importance of the central bank and money market rates as policy vehicle variables in the two banking systems. Our empirical results for the two banking systems are rather mixed as far as it concerns the pass-through transmission and completeness. We also refer to the lessons learned prior to and after the collapse of the monetary and financial system on both sides of the Atlantic. We believe that this study has interesting policy insights and provides certain policy suggestions, which might be useful for the regulatory authorities in their attempt to monitor and reinforce monetary policy effectiveness.

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1. Introduction

Standard economic theory includes monetary policy as one of the two main tools that governments can use to influence output, investment, prices and employment in any economy. Monetary

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policy can affect key macroeconomic variables through the functioning of three distinct channels, namely the interest rate channel, the bank lending channel and the broad credit channel.¹ Angeloni, Mojon, Kashyap, and Terlizzese (2002) find that the interest rate channel is the most important for monetary policy transmission in the Euro area. The adjustment of retail bank interest rates (deposit and lending rates) in response to changes in wholesale rates (central bank and interbank money market rates)² is a fundamental element of the interest rate transmission mechanism. For an efficient monetary policy, any change in the central bank policy rate is meant to be transmitted to retail interest rates, ultimately influencing consumer and business lending rates and therefore aggregate domestic demand and output. In effect, if the interest rate transmission is not efficient, then the required policy reaction by the monetary authorities will have to be stronger in order to achieve the same end result. The efficiency of the interest rate transmission channel has become particularly important in the context of the recent financial crisis which was erupted in August 2007 and intensified in the second half of 2008. Moreover, as money and other credit markets has been getting further intertwined over the past two decades, disruptions to the money and funding markets can have adverse macroeconomic consequences (Čihák, Harjes, and Stavrev, 2009). For all these reasons, the regular monitoring and assessment of the interest rate pass-through (PT hereafter) is critical for policymaking.

The main aim of this paper is to provide empirical evidence on the interest rate pass-through process in the Euro area and USA (the locomotives of the world economy) and to discuss this issue in the light of the recent financial market tensions. We address the question of how the monetary transmission process works in these two economies and whether their responses to interest rate dynamics are symmetric or asymmetric. We also show how rapidly and extensively changes in policy rates and market interest rates are passed on to retail bank interest rates. To the best of our knowledge it is the first attempt to make a comparative study of the efficiency of the monetary policy between the Eurozone and the USA regarding the symmetric or asymmetric responses of retail rates to wholesale rates changes. In an attempt to unveil the existence and importance of a pass-through behaviour, the disaggregated general-to-specific model (hereafter GETS) is employed. This model, which has not been used before in the relevant literature, allows us to estimate and make inferences not only about the short and long run interest rate elasticities but, as well as, for the upward/downward stickiness of the interest rate transmission mechanism. Any upward or downward change in the central bank policy rate is meant to be transmitted to retail interest rates for the monetary authorities to be able to affect consumer and business lending rates and therefore aggregate domestic demand and output. Moreover, it is important for both central bankers and Treasury Secretaries to have a precise understanding of the upward and downward degree of the interest rate pass-through in order to be able to design the appropriate monetary policy along the different phases of the business cycle.

The empirical results for the two banking systems are rather mixed as far as it concerns the wholesale rates PT transmission and completeness. In the Eurozone it is mainly the money market rate that is transmitted more effectively to the retail rates (and in particular the lending rates). Also, the interest rate PT is complete in the long run, only when the wholesale rate is the money market rate and the retail rate is the deposit rate. For the US case, it is the central bank rate rather than the money market rate that works more effectively as a policy vehicle variable. Also the interest rate PT is nearly complete in the long run only between the central bank rate and the

¹ See Mishkin (1995) and Bean, Larsen, and Nikolov (2002) for a detailed discussion of the transmission channels.

² The money market rate can be considered as a policy controlled variable since central bank can influence it through short-term interest rate policy.

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