



Interest rate deregulation: Monetary policy efficacy and rate rigidity

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ABSTRACT

This paper examines the effects of interest rate regulation, and subsequent deregulation, on the efficacy of monetary policy and rigidity of retail bank deposit rates in Hong Kong. Using an error-correction model, we find that interest rate deregulation increases the efficacy of monetary policy by improving the correlation between retail bank deposit rates and market interest rates and increasing the degree of long-term pass-through for retail bank deposit rates. Our study also shows that the adjustments in retail bank deposit rates are asymmetric and rigid upwards during the regulated period, but tend to be rigid downwards during the deregulated period. The spreads between retail bank deposit rates and market rates have also tightened sharply after the removal of interest rate controls.

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1. Introduction

In this study, we examine the effects of interest rate regulation, and subsequent deregulation, on the efficacy of monetary policy and rigidity of retail deposit interest rates in Hong Kong. The topic of interest rate regulation (and deregulation) has been extensively studied in the banking literature. One area of research, for example, is on the economic rents that financial institutions extract from interest rate controls. Studies have shown that financial institutions earned substantial economic rents from deposit interest rate restrictions (Hutchison and Pennacchi, 1996; Chan and Khoo, 1998), while the removal of deposit rate ceilings affected the stock returns of financial institutions negatively (Dann and James, 1982; Kwan, 2003). Another area of research is on the regulatory dialectics theory (Kane, 1977, 1981), which is about the circumvention of interest rate regulation through non-price competition and innovations in money market instruments (Eisenbeis, 1985).

However, very little is known about the effects of interest rate regulation (and deregulation) on the efficacy of monetary policy and rigidity of retail interest rates, despite the large body of

literature on interest rate regulation. To study these issues, we examine the case of interest rate regulation, and subsequent deregulation, in Hong Kong. One reason for studying the Hong Kong experience is that interest rate controls in Hong Kong tend to be binding. Another reason is that deposit interest rates had been regulated in Hong Kong since 1964 and was only deregulated on a staggered-basis starting from 1994. The long historical sample period allows us to conduct robust statistical tests associated with the effects of interest rate regulation and subsequent deregulation.

To examine the efficacy of monetary policy during the regulated and deregulated periods, we look at the interest rate (pass-through) channel of monetary policy.¹ Previous studies on the credit channel of monetary policy (Bernanke and Gertler, 1995; Gertler and Gilchrist, 1994; Kashyap and Stein, 2000) tend to assume immediate and complete pass-through in the policy rates to retail bank deposit and loan rates. Recent studies on the interest rate channel of monetary policy, however, have shown that interest rate pass-through may not be complete and that interest rate adjustments are sluggish and may be asymmetric (Cottarelli and Kourelis,

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¹ Other recent studies that examine the efficacy of monetary policy from the interest-rate pass-through channel perspective include: Kleimeier and Sander (2006), Liu et al. (2008), Kobayashi (2009), and Agénor and El Aynaoui (2010).

1994; Bondt, 2002; Hofmann and Mizen, 2004; Chong et al., 2006; De Graeve et al., 2007). Interest rate rigidity has important implications because the effectiveness of monetary policy depends on how fast and to what extent banks pass through changes in policy rate to deposit and lending rates. If there is an asymmetric rigidity in interest rate adjustments, then expansionary and tightening monetary policy can impact the economy at different pace. Also, the transmission of monetary policy will not be uniform across all sectors of the economy if the speed and magnitude of interest rate adjustments differ across both financial institutions and financial products (Chong et al., 2006).

Interest rate regulation can affect the efficacy of monetary policy by impeding the adjustments of deposit and loan rates to changes in market interest rates and by introducing asymmetric rigidity to the rate adjustments process. Conversely, interest rate deregulation can have the opposite effects. In support of this argument, our study shows that interest rate deregulation in Hong Kong has improved the efficacy of monetary policy actions. First, in comparison to the regulated period, we find that the correlations between retail bank deposit rates and market rates are higher during the deregulated period. This result indicates that retail bank deposit rates are more responsive to movements in market interest rates and, hence, to monetary policy actions after the removal of interest rate controls. Second, we find a significant increase in the degree of long-term pass-through for retail bank deposit rates after the removal of interest rate controls. The implication of this result is that interest rate deregulation has increased the size of the interest rate response to monetary policy actions, which in turn means that the effect on the economy will be relatively larger for a given policy action.

In this study, we also provide empirical evidence on two different ways that banks can extract rents from interest rate regulation. First, banks can extract rents by paying a lower deposit rate than the prevailing competitive market interest rate. In support of this argument, we find that the mean (and median) spreads between retail deposit rates and market interbank rates contracted by as much as 69–117 basis points (29–94 basis points) following the removal of deposit rate controls in Hong Kong. Second, banks can extract rents from interest rate regulation by raising deposit rates at a much slower pace when market interest rates are rising and lowering deposit rates at a quicker pace when market interest rates are falling. Using a standard error-correction model (ECM) that allows for asymmetry in rate adjustments, we find that retail bank deposit rate adjustments tend to be asymmetric and rigid upwards when the rates were regulated, but tend to be rigid downwards during the deregulated period.

Thus, the above findings also add to the literature on interest rate rigidity. Previous studies have attributed the rigidity in the interest rate adjustment process to a number of factors that include fixed menu cost, high switching cost, imperfect competition, and asymmetric information (Hannan and Berger, 1991; Scholnick, 1996; Heffernan, 1997; Dutta et al., 1999; Chong et al., 2006). Our study indicates that a key determinant of asymmetric interest rates rigidity is interest rate regulation (and deregulation). Deposit interest rate controls enable banks to extract economic rents by adopting an upward rigidity in the deposit rate adjustment process. In contrast, deposit rate deregulation results in more intensive rate competition and, hence, downward rigidity in the deposit rate adjustment process.

The remainder of the paper is organized as follows: Section 2 provides some institutional background on the interest rate regulation, and subsequent deregulation, in Hong Kong. Section 3 outlines our methodology. Section 4 discusses the data and results and Section 5 concludes the paper.

2. Institutional background

2.1. Interest rate rules and deregulation

In Hong Kong, bank deposit rates had been regulated by a cartel of banks since 1964. Originally designed to prevent “destructive” interest rate competition, an interest rate agreement for a uniform interest rate structure among banks was concluded under the auspices of the Exchange Banks Association (the precursor to the Hong Kong Association of Banks) in July 1964. The agreement was applicable to all banks operating in the colony and any violation of the agreement would result in a bank being denied access to the clearing house facilities (Wong and Wong, 2005).

Statutory backing for the interest rate controls was provided following the establishment of the Hong Kong Association of Banks (HKAB) as a statutory body in 1981. The government’s statutory backing for the interest rate agreement was based two reasons (KPMG and Barents Group, 1998). First, the agreement was deemed to protect the smaller locally-owned and incorporated banks from competition that they may not be prepared to face. Second, for monetary policy purposes, the agreement allowed the authorities to influence a spectrum of interest rates in Hong Kong.

The HKAB governed the maximum deposit rates that all licensed banks could pay for Hong Kong dollar deposits through a set of interest rate rules. The interest rate rules were applicable to Hong Kong dollar deposits of less than HK\$500,000 and with a maturity of up to 15 months. Under the interest rate rules, no interest payment was allowed on current account deposits. In addition, the interest rates on savings account deposits, 24-hour demand deposits, seven-day demand deposits, and time deposits with a maturity up to 15 months were determined and reviewed from time to time by the HKAB, after consultation with the Hong Kong Monetary Authority (HKMA), the de facto central bank in Hong Kong. All licensed banks in Hong Kong are members of the HKAB and, hence, were subjected to the interest rate rules. The HKAB has the authority to discipline its member banks, up to the point of expulsion, for any violations of the association’s rules and ordinances.

The HKAB’s interest rate rules remained in full operation until 1994. The Consumer Council in Hong Kong published a report in February 1994 that called for greater competition in the retail deposits market and the gradual abolishment of all interest rate rules. The HKAB naturally disagreed with the Consumer Council’s recommendation. Eventually, the HKMA issued an official response to the Consumer Council’s report in July 1994. The HKMA endorsed the need for more competition in retail interest rates, but emphasized that it must be balanced with the need to maintain stability in the banking system (KPMG and Barents Group, 1998). A gradual and cautious approach in deregulation was thus adopted in order to avoid instability in the banking system. A summary of the various phases of the interest rate deregulation, which was staggered over a time span of about seven years from October 1994 to July 2001, is as follows:

- October 1, 1994 Removal of interest rate cap on time deposits with maturity greater than one month
- January 3, 1995 Removal of interest rate cap on time deposits with maturity greater than seven days
- November 2, 1995 Removal of interest rate cap on time deposits with maturity greater than 24 hours
- July 3, 2001 Removal of interest rate cap on demand and saving deposits

The initial phase of the deregulation focused on the removals of interest rate ceilings on time deposits of various maturities over

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