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Imperfect Competition in Bank Retail Markets, Deposit and Loan Rate Dynamics, and Incomplete Pass Through

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Abstract

This paper examines determinants of pass through from the market interest rate to bank retail deposit and loan rates. A dynamic adjustment cost model with imperfect competition implies that these rates depend on own lagged values and on lagged, current, and expected future values of the security rate. Greater competition in retail markets reduces the impact of lagged and expected rates on current retail rates while raising the effect of the current security rate, yielding greater pass through. These results have important implications for both the specifications used in empirical work and biases introduced into estimates of pass-through effects.

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