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Impact of bank competition on the interest rate pass-through in the euro area

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Abstract

This article examines the impact of bank competition on the interest rate pass-through in the euro area. We use a panel of euro area countries from 2000 to 2010. Our findings show that the interest rate pass-through is higher in countries with a higher degree of bank competition. This result is robust to various specifications and is not driven by changes in the interest rate pass-through over time. Our findings suggest that the introduction of new entrants in the banking sector are likely to increase the interest rate pass-through in the euro area.

Notes

¹ Except Kok Sørensen and Werner ([2006](#)), who used a nearly identical data set. This is the first time the data set has been published in a journal article.

² For other euro area countries we have insufficient data to estimate the Boone indicator.

³ Enterprises comprise the entire population of nonfinancial corporations.

⁴ Of course, competition is not the only factor determining the level of bank interest rates. Factors such as credit and interest rate risk, banks' degree of risk aversion, operating costs and efficiency are also likely to impact on bank margins. See, for example, Maudos and Fernández de Guevara ([2004](#)).

⁵ See, for example, Neuberger and Schwaiblmair (1992) and Merton and Sundaresan (1995) for empirical evidence on the pass-through of interest rate changes to US banks.

⁶ In addition to the adjustment costs, banks may face a situation where they are limited in their ability to limit the costs of a rate increase. They may also choose to pass on the costs of a rate increase to their customers. This may also limit the ability of banks to pass on the costs of a rate increase to their customers. This may also limit the ability of banks to pass on the costs of a rate increase to their customers.

⁷ Sander Gilman's (1981) model also model the severe impact of a rate increase on banks. This approach aims to pass on the costs of a rate increase to the customers. This approach aims to pass on the costs of a rate increase to the customers.



⁸ The few existing empirical studies based on the Boone indicator have all used a log-linear relationship. See, for example, Bikker and van Leuvensteijn ([2008](#)).

⁹ For other arguments against the HHI, see [Section I](#).

¹⁰ See also van Leuvensteijn et al. (2011) who use a similar approach.

¹¹ GMM is used to correct for endogeneity between market shares and marginal costs using different moment conditions.

¹² Most likely, the favourable result for Germany hinges in part on the special structure of its banking system, being built on three pillars, i.e. commercial banks, publicly-owned savings banks and cooperative banks (see Hackethal, [2004](#)).

¹³ In order to avoid spurious results, see Granger and Newbold (1974).

¹⁴ An ECM is a dynamical system in which the deviation of the current state from its long-run relationship will be fed into its short-run dynamics. This provides a coherent framework for the analysis of interest rate dynamics.

¹⁵ See, for example, Mojon ([2001](#)), De Bondt ([2002](#), [2005](#)), Sander and Kleimeier ([2004](#)), and Kok Sørensen and Werner ([2006](#)).

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²⁰ In the panel versions of the tests the alternative hypothesis assumes a root which is less than one, but is identical across the countries. Hence, the group mean versions allow for stronger heterogeneity. As a result, we focus on the test's group mean version.

²¹ For some bank products in some countries, it is not possible (due to insufficient data availability) to extend interest rates series all the way back to 1994. Therefore, unbalanced samples were used for some bank products.

²² The two series have been linked in January 2003 with a parallel level shift of the series prior to this date. The level shift was based on the average monthly difference between the NRIR and MIR series for the period from January 2003 to September 2003 for which observations for both definitions were available. In contrast to Kok Sørensen and Werner ([2006](#)), we use new business weights (applying monthly averages observed in the January 2003–June 2004 period to smoothen out undue volatility) to aggregate the MIR categories to the NRIR. We believe this captures the differences across countries more precisely in terms of initial rate-fixation periods and also corresponds better to the new business rate nature of the NRIR statistics.

²³ The market rates have been chosen to best match bank interest rates on the basis of information from the Methodological Notes for the NRIR statistics and from the volume weights of the MIR statistics.

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²⁸ A re-estimation of Equation [6](#) with the distance to default for, respectively, mortgage, consumer loans and loans to firms using ECB data suggests no substantial change in the parameter of the Boone indicator. This lack of change appears for each of the four types of loans. Unfortunately, the level of default tends to decrease the lending rates instead of increasing it (as one would expect). Apparently, this indicates an underpricing of default risk in the period 1999–2002, see for instance Pavlov and Wachter ([2006](#)). Inclusion of Gross Domestic Product (GDP) to capture the business cycle did not change this result. Hence, inclusion of risk does not improve (nor significantly changes) our relationship between competition and the interest rate pass through.

²⁹ We use Newey–West's kernel-based HAC variance estimations to correct for heteroscedasticity and autocorrelation, with the bandwidth set on two periods.

³⁰ See also Mojon ([2001](#)), De Bondt ([2005](#)) and Kok Sørensen and Werner ([2006](#)).

³¹ Re-estimation with a risk measure, did not affect the estimation results of the ECM, see also footnote 28.

³² As mentioned in [Section V](#), the estimated long-run relationship between, on the one hand, interest rates on consumer loans and current account deposits and, on the other hand, the Boone indicator is statistically significant.

³³ The null hypothesis of no cointegration between the variables is rejected at the 1% level. The residuals are stationary in favour of the long-run relationship. The results are reported in separate tables.

³⁴ The relationship between the variables is formulated in terms of the Boone indicator.

³⁵ See



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