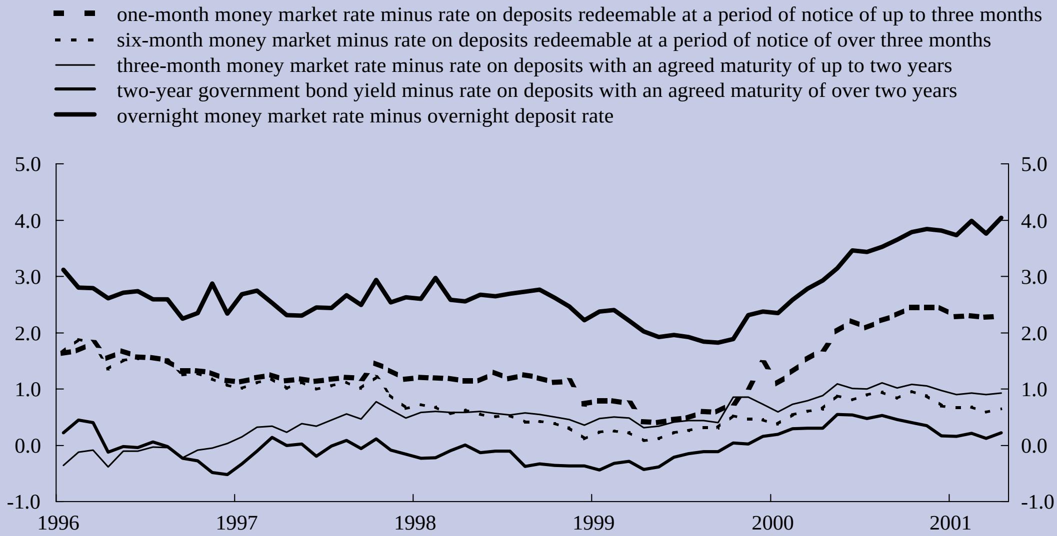
Box 4

The relationship between retail bank interest rates and market interest rates

This box deals with the relationship between retail bank interest rates and market interest rates in the euro area, which is an important link in the monetary transmission process. A wide range of factors ultimately influence the adjustment of interest rates in retail bank markets: competition in the financial services industry in different segments of the deposit and credit markets, bank-customer relations, (expected) bank exposure to interest rate risk, credit and other risk premia, the administrative cost of effectively changing bank interest rates, the degree of passive behaviour on the part of deposit holders and borrowers, etc.

Chart A1: Spread between comparable market interest rate and bank deposit rate

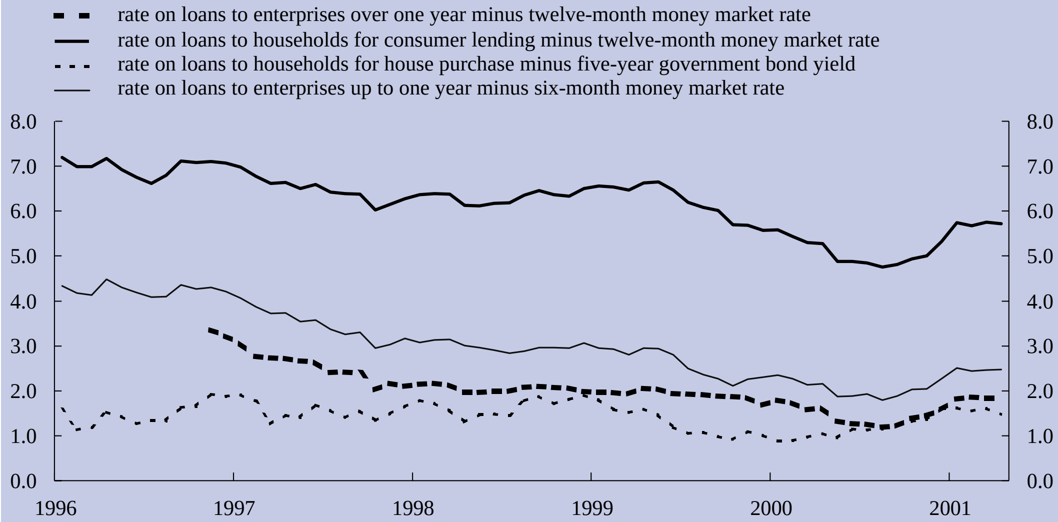
(percentage points; monthly data)



Sources: ECB aggregation of individual country data and Reuters.
Note: From 1 January 2001 onwards Greek data are also included.

Chart A2: Spread between bank lending rate and comparable market interest rate

(percentage points; monthly data)



Sources: ECB aggregation of individual country data and Reuters.
Note: From 1 January 2001 onwards Greek data are also included.

The charts below plot the spread between retail bank interest rates and market interest rates with a comparable maturity between January 1996 and April 2001. The charts show that the levels of retail bank interest rate spreads differ across instruments and that retail bank interest rate movements differ from market interest rate changes. The latter fact suggests that retail bank rates do not adjust immediately to market interest rates on a one-to-one basis. A second set of charts illustrates this by plotting for some selected instruments the retail bank interest rate together with a comparable market interest rate.

As regards bank deposit rates, significant differences exist in their relationships with market interest rates across individual deposit instruments. The spread between two-year government bond yields and deposits with an agreed maturity of over two years was always close to zero between January 1996 and April 2001, as shown in Chart A1. This suggests that competitive forces are very strong in this segment of the deposit market and that it leads banks to set this interest rate close to market interest rates. A similar conclusion can be drawn for deposits with an agreed maturity of up to two years. As can be seen in Chart B1, the interest rate on these deposits follows a similar movement to the three-month market interest rate, indicating a relatively speedy pass-through of market interest rate changes to this bank deposit rate. A similarly fast adjustment to market interest rate changes can be found for the interest rate on deposits redeemable at a period of notice of over three months.

By contrast, the spreads on overnight deposits and deposits redeemable at a period of notice of up to three months were substantially wider in the period under review than the other bank deposit rate spreads. Furthermore, these spreads have widened considerably since the autumn of 1999, suggesting that these two deposit rates reacted sluggishly to the rise in money market rates that took place between the last quarter of 1999 and the end of 2000. This can be explained to some extent by the fact that these euro area deposit rates are still regulated or administered in some euro area countries. Moreover, these instruments are often targeted at the general public, who use them for reasons of convenience. The sticky behaviour of the retail bank rate on deposits redeemable at a period of notice of up to three months is also illustrated in Chart B2.

Chart B1: Interest rate on deposits with an agreed maturity of up to two years and three-month money market rate

(percentages per annum; monthly averages)

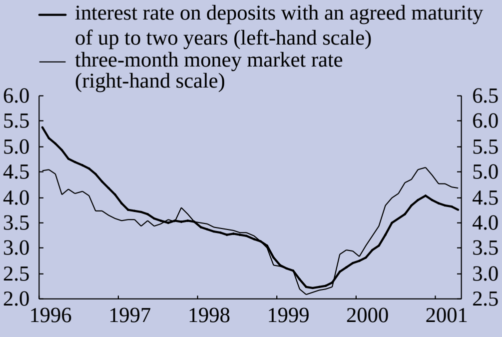
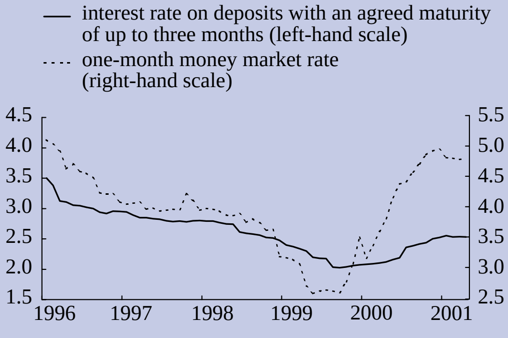


Chart B2: Interest rate on deposits redeemable at a period of notice of up to three months and one-month money market rate

(percentages per annum; monthly averages)



Sources: ECB aggregation of individual country data and Reuters.
Note: From 1 January 2001 onwards Greek data are also included.

Turning to bank lending rates, credit risk also plays a role. For instance, loans for house purchase have a relatively low credit risk, since they are collateralised and therefore show the smallest bank lending rate spread, as can be seen from Chart A2. However, credit risk plays a more important role for lending to enterprises and, in particular, for consumer lending. After a tendency for bank lending rate spreads to narrow, especially for loans to enterprises, spreads have widened since mid-2000. This general widening in bank lending rate spreads might be a reflection of an increase in credit risk, as suggested by trends in corporate bond spreads in the euro area after the summer months of 2000, which saw some widening, particularly for low-rated firms.

The adjustment of bank lending rates to market interest rate changes also differs across instruments, as illustrated in Charts B3 and B4 for loans to households. The interest rate on loans to households for consumer lending responds sluggishly to market interest rate changes compared with the interest rate on loans to households for house purchase. This is probably due to the strong competition that banks face, also from non-banks, in the mortgage market. In a similar way, the interest rate on loans to enterprises reacts quickly to market interest rate changes, suggesting that banks have to compete strongly with other external finance sources of corporations. In particular, the growing importance of corporate debt securities markets in the euro area, among other factors, may have increased the strength of prevailing competitive forces in the credit market for enterprises.

Chart B3: Interest rate on loans to households for consumer lending and twelve-month money market rate

(percentages per annum; monthly averages)

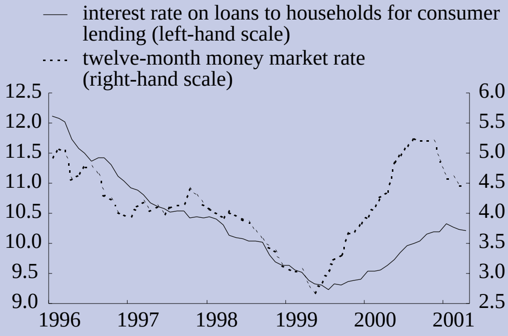


Chart B4: Interest rate on loans to households for house purchase and five-year government bond yield

(percentages per annum; monthly averages)