

Box 5

THE PASS-THROUGH OF MARKET INTEREST RATES TO MFI LENDING RATES SINCE THE START OF STAGE THREE OF EMU

Bank lending rates tend to be driven by developments in money and capital markets, after some adjustment delays.¹ Changes in bank lending rates, in turn, are an important aspect of the monetary policy transmission process because they affect financing conditions and, hence, spending decisions with respect to housing and non-housing investment as well as consumption, which will eventually spill-over to prices and output. This box examines how the conditions in money and capital markets have affected bank lending rates between January 1999 and December 2004.

The analysis is based, for the past two years, on the new harmonised statistics on MFI interest rates on new business (available since January 2003). For the period from 1999 to 2002, the

¹ For more details, see, for example, Box 3 entitled “The determination of bank lending rates in the euro area” in the ECB’s Annual Report of 2002.

previous non-harmonised retail interest rates have been used. In addition, the period between January 1999 and December 2000 is considered separately in order to take account of the fact that market interest rates had reached a peak towards the end of 2000. This last sub-division is somewhat artificial because most market interest rates declined in the first few months of 1999.

Looking at the period starting in January 2003, for which a more precise analysis can be conducted, all MFI interest rates on new loans declined. The most pronounced downturn, which exceeded the decline in market interest rates, occurred in interest rates on *loans to households for house purchase*. This may, in part, have been driven by strong competition in this market segment, and by increases in the value of mortgage collateral as a result of the strong housing market dynamics in several countries (see also the results of the latest Bank Lending Survey).² In the preceding periods, for which a comparison can only be tentative since the underlying retail interest rates referred to loans of all maturities, changes in interest rates on loans for house purchase tended to respond significantly to those in market interest rates, irrespective of whether market interest rates were rising or falling.

Since early 2003, the decrease in short-term MFI interest rates on *loans to non-financial corporations* has also tended to exceed the decrease in the three-month EURIBOR, while long-term MFI interest rates fell by broadly the same order of magnitude as the five-year and ten-year government bond yields. The decline in MFI interest rates on loans to non-financial corporations since the beginning of 2003, in particular in those on short-term loans, may reflect

² See Box 1 entitled "The results of the January 2005 bank lending survey for the euro area" in the February 2005 issue of the Monthly Bulletin.

MFI interest rates on new loans

	Change in basis points		
	Jan. 1999 to Dec. 2000	Dec. 2000 to Dec. 2002	Jan. 2003 to Dec. 2004
Loans to non-financial corporations			
(a) original maturity of up to one year	112	-120	-
bank overdrafts	-	-	-93
floating rate and an initial rate fixation of up to one year	-	-	-74
(b) original maturity of over one year	141	-111	-
initial rate fixation of over one and up to five years	-	-	-43
initial rate fixation of over five years	-	-	-55
Loans to households			
(a) for consumption	56	-61	-
bank overdrafts	-	-	-36
floating rate and an initial rate fixation of up to one year	-	-	-47
initial rate fixation of over one year	-	-	-74
(b) for house purchase	133	-133	-
floating rate and an initial rate fixation of up to one year	-	-	-92
initial rate fixation of over five years	-	-	-84
Memo items			
Three-month Euribor	179	-199	-66
Two-year government bond yield	176	-190	-28
Five-year government bond yield	152	-119	-47
Ten-year government bond yield	125	-66	-58

Source: ECB.

Note: From 1999 to 2002, data refer to retail interest rates; as from 2003, data refer to MFI interest rates. The latter are weight-adjusted. For further information, see the box entitled "Analysing MFI interest rates at the euro area level" in the August 2004 issue of the Monthly Bulletin.

the fact that MFIs have recently reduced their credit risk premia against the background of the improved profitability of, and balance sheet restructuring efforts by, non-financial corporations (see also Section 2.6). In addition, some lagged adjustments to previous decreases in market interest rates, related to the normal delays in the pass-through to lending rates,³ may also have contributed to the more marked decline in MFI interest rates since January 2003. This view is supported by the observation that, in the past, retail interest rates on loans to non-financial corporations have tended to move less than market interest rates, signalling that, for a variety of reasons such as customer-bank relations, banks adjust their interest rates on these loans only gradually in phases of rising or falling interest rates.

Short-term MFI interest rates on *loans to households for consumption* have generally also fallen since January 2003, but by significantly lower orders of magnitude than, for example, the three-month EURIBOR. The results of the latest Bank Lending Survey suggest that credit standards, although easing progressively, may still reflect banks' negative perceptions regarding the creditworthiness of consumers. At the same time, it should be noted that consumer credit rates have displayed significant sluggishness also in the past. For example, in both sub-periods starting in January 1999 and in December 2000, retail interest rates on loans for consumption moved by only a fraction of the changes that occurred in market interest rates at short to medium-term maturities. Long-term MFI interest rates on loans to households for consumption, by contrast, have declined more than market interest rates (e.g. the ten-year government bond yield) since January 2003. This may reflect that, at least in some countries, longer-term consumer credit is collateralised to a greater degree, thereby reducing credit risk considerations.

Overall, considering the period from 1999 to 2004, the rates on loans to non-financial corporations tended, to a significant extent, to reflect changes in market interest rates, but with some lag. The rates on loans to households for house purchase more closely followed market interest rates in the first few years of the single monetary policy and tended, more recently, to fall more sharply than market interest rates, in an environment of increasing house prices and enhanced competition. Most rates on loans to households for consumption, at least the short-term rates, continued to display, until recently, significant sluggishness in their response to movements to market interest rates.

³ For available empirical evidence, see, for example, G. de Bondt, "Retail bank interest rate pass-through: new evidence at the euro area level", ECB Working Paper No 136, April 2002.