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Box B: QB 1 – March 2023

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Transmission of monetary policy: the Bank Lending Channel

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To tackle high inflation, the ECB has increased its policy rate by 300 basis points (bps) since July 2022 to reach 2.5%. At its most recent monetary policy meeting in February, the ECB Governing Council[3] increased interest rates by 50bps and signalled its intention to increase rates by a further 50 bps in March.

Monetary policy is the primary policy tool for controlling inflation. It does so by influencing financing conditions across the economy and, through that, steering aggregate demand. By adjusting its interest rates, the ECB influences the cost of market borrowing for banks and other financial institutions. This in turn influences the lending rates consumers and business face, as well as the interest received on deposits, influencing their spending and investment decisions. This affects overall demand and inflation. Estimates for the euro area suggest that it can take between one and three years for the full effects of monetary policy to be transmitted to the real economy (Havarnek and Rusnak 2013, Lane 2022).

One of the first and most direct ways to assess transmission of monetary policy to the economy is by examining interest rates on bank lending and the associated volumes.

Euro Area

Evidence to date shows that pass through of monetary policy to new lending rates in the euro area has, so far, been broadly similar to the last hiking cycle (November 2005 and March 2008), albeit the pace of tightening has been much faster (see Figure 1).

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[3] The Governing Council is the main decision-making body of the ECB. It consists of the six members of the Executive Board, plus the governors of the national central banks of the euro area countries.

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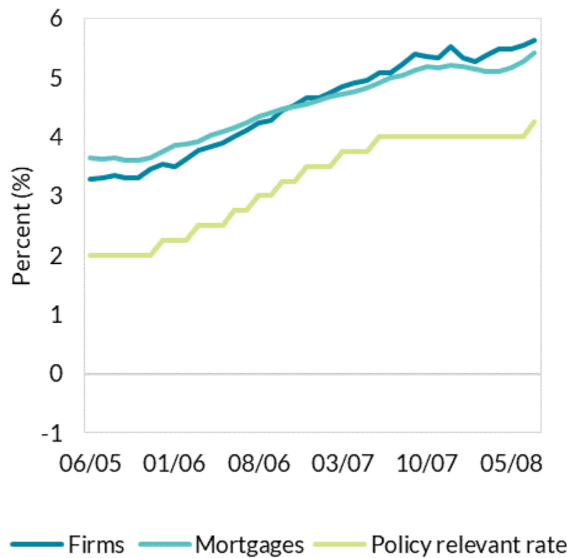
Figure 1: Evolution of policy relevant and new lending rates: current hiking cycle versus 2005-2008 hiking cycle, euro area.

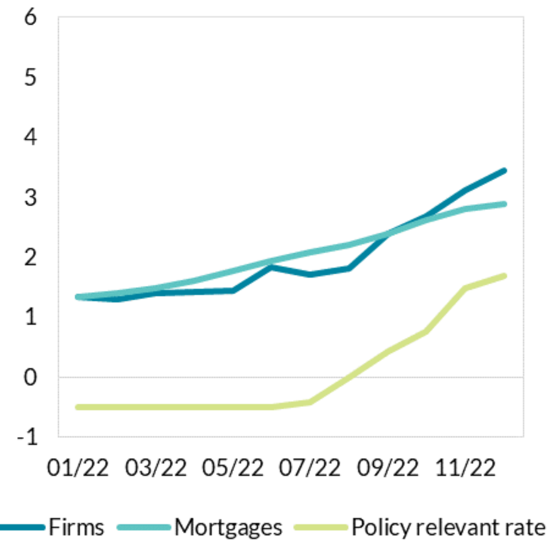
Figure 1a: Hiking cycle 2005-2008



Source: MIR SDW.

Note: Policy relevant rate is the MRO.

Figure 1b: Current hiking cycle



Source: MIR SDW.

Note: Policy relevant rate is the DFR.

While interest rates have, on average, moved closely with the changes in the policy rate, there has been some variation in pass through across countries, particularly for mortgage rates (Figure 2). A key feature which drives these differences is the product mix across countries. For example in Germany, fixed rate mortgages of greater than 10 years are common, while in Finland variable rate mortgages are standard. This leads to differences in pass through. In countries with more variable rate mortgages, increases in ECB rates are shared across existing and new mortgages. In countries with a large share of fixed mortgages, changes in the monetary policy rate affect the interest rate on new mortgages only.

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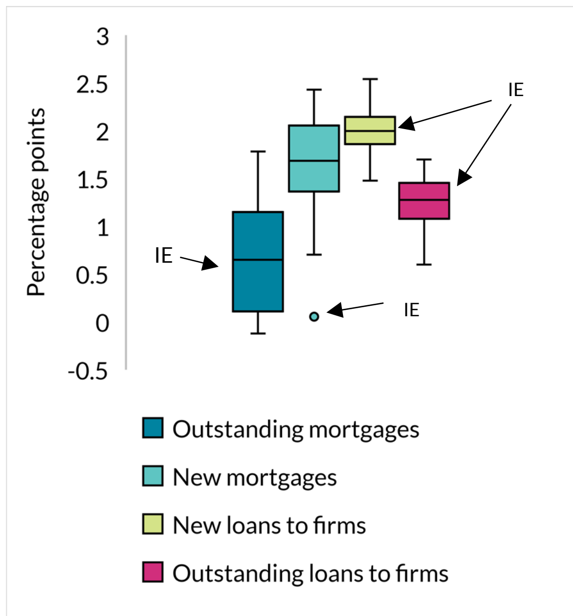
Figure 2: LHS: Change in lending rates across products since January 2022, euro area countries. RHS: Level of interest rates since January 2015, euro area and Ireland.

Figure 2: Change in lending rates since January 2022 across the euro area. Median and interquartile range across products



Source: MIR SDW

Figure 2b: Level of rates over time in Ireland (solid line) and euro area weighted average (dotted line).

Source: MIR SDW

There are some tentative signs that increases in lending rates has started to transmit to volumes of new lending in the euro area. For firms, new lending plateaued in December 2022, while new mortgages have been declining steadily, particularly in countries where house prices rose sharply post-pandemic, such as Germany.

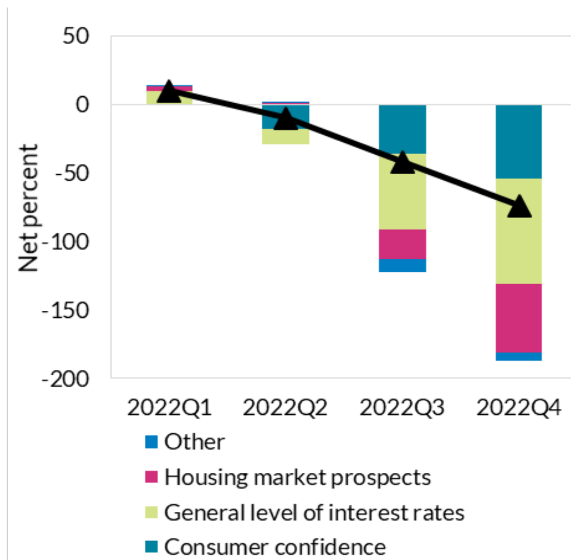
Results from the Bank Lending Survey[4] indicated that in Q4 2022 credit standards on loans to firms and households in the euro area tightened while demand fell. The Survey also indicates that these trends are likely to continue in Q1 2023.[5] The results of the Q4 2022 BLS also highlight the reasons for declining demand. For firms, these were the level of interest rates and lower fixed investment

[4] The Bank Lending Survey is a quarterly survey which asks banks about the supply of (via questions on credit standards) and demand for loans in the last quarter and their expectations for the next quarter.
[5] Previous research has shown that the BLS has forward looking indicator properties for firms' loan growth, particularly pointing to further declines in lending volumes going forward (Hunnekes and Kohler-Ulbrich, 2022).

needs, while households cited consumer confidence, housing market prospects as well as the level of interest rates (see Figure 3).

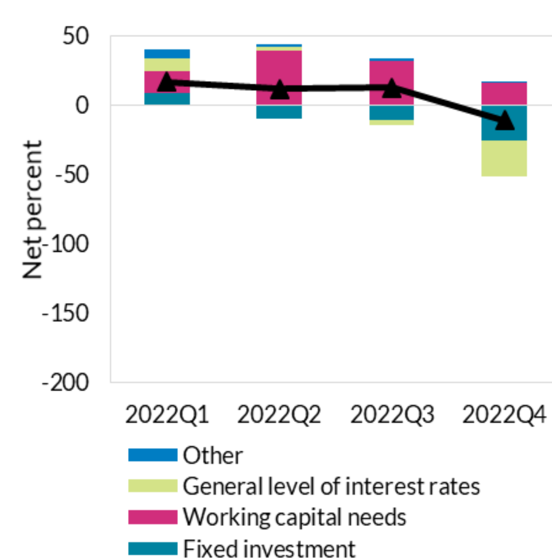
Figure 3: Demand for loans to firms and households and contributing factors.

Figure 3a: Household demand for loans for house purchase and contributing factors



Source: MIR SDW

Figure 3b: Firm demand for loans and contributing factors



Source: MIR SDW

Ireland

In Ireland, interest rates on loans to firms have increased in line with other euro area countries, while interest rates on new mortgages have been slower to react (Figure 2). Advertised mortgage rates are beginning to rise, but this is taking time to feed through the system due to time lags between approval and draw down. At a first glance, it appears that monetary policy is, for now at least, passing through more slowly relative to other euro area countries in terms of new mortgage lending rates.

Simulations from the Central Bank's structural macroeconometric model indicate that the short-run pass-through of policy rate changes to lending rates tends to be higher for interest rates on corporate loans than for mortgage rates. In particular, the estimates suggest that a one percentage point increase in policy rates raises corporate lending rates by close to 80 basis points within one year, while mortgage rates rise by around 60 basis points over the same period. These results are, directionally if not in terms of magnitude, broadly consistent with the differential rates of pass-through that have been observed thus far in this tightening cycle. The model simulations also suggest, however, that rates of pass-through tend to be similar across both types of lending in the long run.

The results of the Irish Bank Lending survey are also suggestive of slower pass through. In Q4 2022, credit standards for firms tightened, but were reported to be unchanged for mortgages. Meanwhile, demand for loans amongst firms was largely unchanged in Q4, but increased for mortgages. Ireland was the only country where such an increase was observed.

This should be viewed in the context of many years of higher interest rates on new mortgages relative to the euro area (Figure 2). In addition, the structure of the market, which has a high share of tracker and variable rate mortgages (61%), means that interest rates on outstanding mortgages in Ireland have risen by more than the euro area weighted mean. Finally, the exit of two banks from the market means that remaining banks may be competing to increase market share. [6]

Overall, it is clear that monetary policy is starting to work its way through the financial system, but it will take time to assess the impact it will have on economic activity and inflation. In Ireland, monetary policy is passing through to firm lending rates, but has been slower to affect new mortgage rates.

[6] Non-banks also play a role in Ireland, but these have been more affected by rising interest rates due to their use of wholesale funding which is more sensitive to changes in the monetary policy rate. We would therefore, expect their lending rates to rise faster than comparable lending rates in the banking sector.