

Interest Rate Setting and the Colombian Monetary Transmission Mechanism

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Abstract

This paper is concerned with interest rate setting by commercial banks and how the transmission of monetary policy is reflected in these rates. For this purpose we study the case of the Colombian banking industry for the period 1996-2004. Using microdata, the Certificate of Deposit(CD) market and the credit market are studied for a balanced panel of 21 and 16 banks, respectively. The paper motivates the discussion with a theoretical model that explains how banks set their interest rates and how these are affected by the policy rate. Overcoming some of the empirical difficulties presented in other studies, this paper deals with them by performing panel unit root tests and panel cointegration tests. The results suggest that the transmission of the policy rate to the CD rate and the credit rate is on average high and quick. Additionally, rates react strongly to inflation shocks, specially credit rates. Finally, the evidence presented shows the importance of banks' characteristics and inflation as long-run drivers of interest rates.

JEL: C33, E43, E52, E58

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1 Introduction

There is a general agreement that, at least in the short-run, the monetary authority may use its instruments to accomplish its objectives. Most central banks conduct their monetary policy by targeting a short-term interest rate¹. Movements on this rate are then transmitted in the same direction to all the other market rates forcing households and firms to revise their optimal consumption and investment decisions. Then, through several channels, monetary policy may affect the real economy².

The above mechanism hinges on the assumption that indeed, movements on the policy rate are transmitted to other market rates *immediately* and in a *complete* fashion. However, international literature has pointed out that this pass-through is not immediate and is incomplete in the short-run. This implies that the mechanism takes time and is therefore worthwhile to examine. The latter also implies that monetary policy actions transmit with a lag to the financial system and to the real economy. The study of how banks set interest rates and how these are affected by policy rates therefore lies on the heart of the monetary transmission mechanism. This paper deals with this issue studying the Colombian banking industry for the period 1996-2004. The paper therefore examines the first step of the monetary transmission mechanism, *i.e.*, how the monetary authority affects relative prices, but does not study the consequences over consumption and investment of these changes in prices.

Recently, concerns about the effectiveness of the Banco de la República policy instrument have emerged due to the apparent rigidity of the Colombian benchmark rate, the DTF³. Figure 1 shows how, in the recent past, the DTF has remained still, in spite of changes in the policy rate. Even though this rate is a deposit rate, its stickiness is important since roughly 66 percent of the credit stock is arranged in a floating scheme tied to the DTF. This paper tries to evaluate the effectiveness of the policy instrument by examining if the stance

¹Borio (1997) reviews the implementation of monetary policy in industrial countries and shows how these economies have emphasized the role of market oriented policies such as interest rate targets.

²An excellent survey of these channels can be found on the *Journal of Economic Perspectives* (1995) , Vol. 9, No. 4

³The DTF is the weekly average rate for Certificates of Deposits (CDs) maturing on a 90 day horizon.

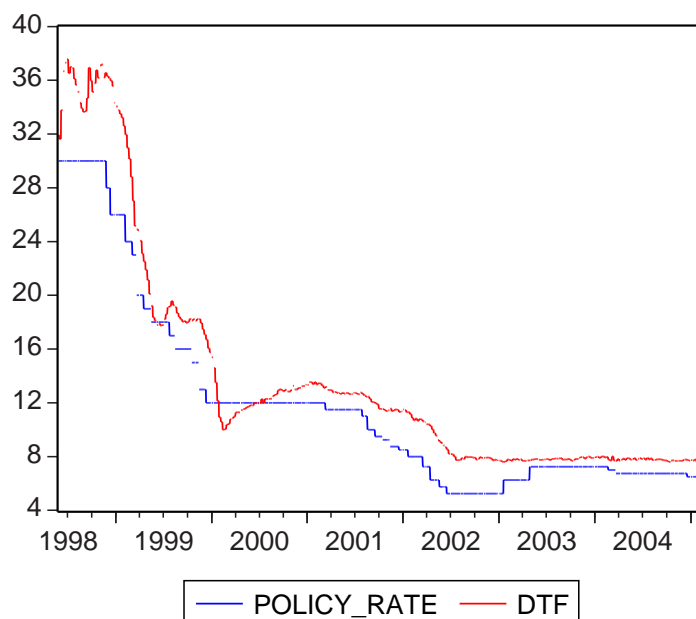


Figure 1: The DTF and the Policy Rate (Nov 1998- Feb 2005). Banco de la República

of policy is transmitted to bank's interest rates.

Although several papers like Clavijo (2004) and Gómez, Vásquez and Zea (2005) have examined different aspects of the monetary transmission mechanism for the Colombian economy, only Julio (2001) has examined the pass-through of the policy rate to market rates. However, this paper lacks microeconomic foundations, a common feature in international literature, as well as a discussion of the policy implications of its findings. The present paper contributes to the existing literature by providing microeconomic foundations, and by using microeconomic data. The use of bank level data is interesting since heterogeneity, a characteristic of Colombian banks, can be examined and also the use of these data is not common in international literature. The paper also has novel features in the econometric methodology such as panel unit root tests and panel cointegration tests. The use of these techniques allow a much better estimation of time series relations between variables, a desirable characteristic in light of the purpose of this paper.

Overall, the results show that the transmission of interest rates, from the policy rate,

proxied by the interbank rate, to the average Certificate of Deposit (CD) rate and to the average credit rate is high and quick. Rates seem to react vigorously to inflation shocks, specially credit rates. The evidence presented shows the importance of banks' characteristics and inflation as long-run drivers of interest rates.

The paper unfolds as follows. The next section reviews the relevant literature. Section three and four are the core sections of the paper. In the third section, a theoretical model is developed while section four tackles the problem empirically. Finally, the last section concludes with some policy implications.

2 Literature Review

Arbitrarily, this review classifies relevant literature in three basic groups. The first group discusses interest rate rigidity, the second deals with interest rate setting and the third one reviews the scarce Colombian literature on the subject. Rather than being comprehensive, representative papers are presented.

As mentioned before, international literature has found that interest rates exhibit rigidity. The first paper that examined this issue was Hannan and Berger (1991) in which rigidity was examined for deposit rates in the American banking industry. Rigidity emerges from menu costs in which banks weight the benefits of changing rates against the costs. Their empirical results show that smaller banks operating in more concentrated markets are less likely to change interest rates. Furthermore, they find that rigidity is exacerbated when the stimulus for a change is upward, suggesting asymmetric adjustment⁴.

Cottarelli and Kourelis (1994) were the first to provide a systematic measure of the degree of lending rate stickiness across a set of developed and developing countries. In a first step, they measure the speed of adjustment of bank lending rates to money market rates. In a second step, they regress this speed against several variables related to the structure of the financial system. In such a way, the paper first evaluates the stickiness and then tries to link it

⁴Evidence about asymmetry is not concluding between countries. While papers like Mojon (2000) find positive evidence for the Euro others as Espinosa-Vega and Rebucci (2003), for Chile, have failed to accept it .

to the countries' financial structure. On average, the paper finds that the degree of stickiness is high. While in the long-run full adjustment takes place, in the short-run, adjustment is only one third of the long-run multiplier. The degree of stickiness, particularly in the short-run, is very different across countries, suggesting that short-run differences may be a consequence of adjustment costs, rather than long-run differences in loan demand elasticities. Relating the stickiness to the financial structure, the authors find several conditions that increase lending rate flexibility: i) the existence of a market for negotiable short-term instruments; ii) relative volatility of money market rates; iii) the absence of barriers to entry in the banking industry; iv) absence of constraints on international capital movements and v) private ownership of the banking system. This paper as well as other in a similar spirit such as Mojon (2000) and Espinosa-Vega and Rebucci (2003), lack microeconomic foundations. However, they provide useful insights since they document stickiness and provide clues about why it happens.

The second group of studies builds its empirical estimations on the microeconomic foundations of price setting by banks. Gambacorta (2004) studies the cross-sectional differences in interest rates for a panel of Italian banks. The study is motivated by a model in which a risk neutral bank operates under monopolistic competition. Under the assumption that bank's interest rates and the money market rate are cointegrated, first order conditions are expressed as an error correction model and are estimated using the Arellano and Bond (1991) methodology. Basically, four conclusions emerge from the empirical analysis. In the first place, there is heterogeneity in the pass-through from money market rates to both deposit and loan rates only in the short-run. In the second place, short-term interest rate loans for illiquid and undercapitalized banks react less to shocks from the monetary authority. In the third place, banks with a high proportion of long-term lending change their prices less. Finally, Gambacorta (2004) finds that bank size is unimportant.

In this group, Berstein and Fuentes (2003a) study the lending rate's flexibility to changes in the policy instrument for the Chilean banking industry. Their work is an attempt to identify bank characteristics that can explain differences in average lending rates and the way they react to changes in the policy rate. In a first step, their work replicates exercises

as the ones documented in the first set of papers finding rigidities only in the short-run. The second part of their work is based on micro data. An asymmetric information model in which banks operate under monopolistic competition is derived as a theoretical base for their empirical estimations. Their dynamic panel data model finds evidence of important differences in the response of banks prices to the policy rate. The smaller the banks, the larger the share of household consumers and the lower the portion of past due loans the smaller the rigidity of interest rates to changes in the monetary authority instrument.

Both of these works provide very useful and interesting insights and overcome the atheoretical treatment of previous papers. However, they lack an adequate econometric treatment. The authors do not deal explicitly with the time series properties of the variables. They assume stationarity or non-stationarity of the variables without performing formal tests. In the case of Berstein and Fuentes (2003a), they estimate the model in levels. In the case of Gambacorta (2004), he assumes interest rates are non-stationary and therefore estimates an *error correction model* assuming bank characteristics are $I(0)$. The strategy implies only one cointegration relation neglecting all other possible stationary combinations.

The third group comprises papers by Julio (2001) and Barajas, Steiner and Salazar (1999). Julio (2001) studies the relationship between the central bank policy rate and the interbank rate, the deposit rate and lending rates for ordinary and preferential customers comparing the exchange rate band period and the free floating period. The study covers the period 1988-2001. Using a vector error correction model, he finds evidence of a long-run relation in which none of the variables is excluded and in which interest rate volatility is less after the central bank adopted the free floating scheme. With the exception of the lending rates, during the free floating period, the variance of the rates is explained in greater proportion by changes in the policy rate. The finding by Julio (2001) therefore provides evidence in favor of the effectiveness of the policy instrument. The paper lacks microeconomic foundations as well as a discussion about the policy implications of the findings.

Despite the absence of Colombian literature on interest rate setting, the work by Barajas, Steiner and Salazar (1999) provides a useful insight in the sense that it studies interest

rate margins for the banking industry. Using both aggregate and microeconomic data the paper tries to explain the determinants of the interest rate margin for the pre-liberalization (1974-1988) and post-liberalization periods (1991-1996). Prior to the liberalization period, margins were driven to a great extent by competition while during the post-liberalization period loan quality became the most important determinant. The panel data analysis for the liberalization period suggests that operational costs are relatively more important than loan quality as determinants of the interest rate margin.

Overall, four main conclusions emerge from this review: i) pass-through is incomplete in the short-run and is therefore worthwhile to study; ii) banks' specific characteristics matter and for the Colombian case loan quality and operational costs seem particularly relevant as determinants of interest rates; iii) a long-run relationship between policy rates and market rates has existed in Colombia, at least in the period 1988-2001; iv) works focusing on microeconomic data have failed to deal properly with the econometric traits of the series.

3 How do banks set interest rates?

A theoretical model

In this section a model in the Monti-Klein spirit ⁵ is developed in order to understand how banks set interest rates and how these are related to the policy rate. Banking activities consist of the production of loans, deposits and CDs. The analysis is based on a partial equilibrium in the sense that demand for deposits, CDs and credit are given to the bank, and with these, the bank maximizes profits ⁶.

The setup is as follows: we describe the demands the bank faces, followed by the costs it

⁵This model assumes a monopolist bank. Certainly, assuming this environment is not a reasonable description of the Colombian banking industry. Probably the best assumption is one of monopolistic competition. However, this model can be generalized to the monopolistic competition case by assuming the existence of N banks and adding product differentiation. Since the main issue of the paper is the setting of interest rates, adding these features to the model does not add in this sense.

⁶Deriving them (*i.e. general equilibrium*) should not add any insight to the main issue of this paper. What could be interesting in a general equilibrium framework, but beyond the scope of the paper, could be how interest rates affect demands for loans and deposits.

assumes, the profit maximization problem and finally first order conditions are presented.

The bank faces demand for credit, deposits and certificates of deposits (CDs)⁷. Demand for credit is a negative function of the loan rate i_l , as with any normal good, and a positive function of income y and prices p . As prices increases, more credit is needed, everything else constant, as a result of lower purchasing power. Positive shocks to income, the scale variable, increase the demand for credit, as in a money demand equation.

$$L^d = c_0 i_l + c_1 y + c_2 p \quad (3.1)$$

$$c_0 < 0; \quad c_1 > 0; \quad c_2 > 0;$$

Demand for deposits and CDs are similar and depend positively on the yield of the asset, i_d and i_{CD} respectively, income and prices⁸. Formally, the demand for deposits and CDs take this form:

$$D^d = d_0 i_d + d_1 y + d_2 p \quad (3.2)$$

$$d_0 > 0; \quad d_1 > 0; \quad d_2 > 0;$$

$$CD^d = n_0 i_{CD} + n_1 y + n_2 p \quad (3.3)$$

$$n_0 > 0; \quad n_1 > 0; \quad n_2 > 0;$$

The bank's balance sheet can be represented as follows:

⁷The specification for these demands follow Gambacorta (2004). Demand for CDs was added.

⁸The cost of other funding activities as well as the return on other assets can be included in the specification.

$$L + R = D + CD + K \quad (3.4)$$

where L stands for loans, R for reserve, D for deposits, CD for certificates of deposits and K is capital, which is exogenous and above requirements. When the reserve R is positive it yields an exogenous rate i . However, after loans are handed, banks face a liquidity risk. This risk can be materialized if withdrawals X are larger than R . This liquidity problem can be solved by going to the *interbank market*⁹ and borrowing funds at the rate i_m that each bank faces¹⁰. Following the reserve management modelling literature, and more specifically Freixas and Rochet (1997), each bank makes an estimate of the expected value of funds it has to obtain in the interbank market. Assuming X is a gaussian random variable, the liquidity shortage can be written as follows:

$$C^{IL}(X, R) = E [Max(0, X - R)] = \int_R^\infty (x - R)f(x)d(x) \quad (3.5)$$

We assume the interbank rate that each bank faces is a function of the policy rate set by the monetary authority and the bank's particular characteristics. For example, it is reasonable to assume that a poorly capitalized small institution is charged a higher rate than a healthier big institution. i_m can be written as:

$$i_m = a_0 i_{CB} + \vec{a} \vec{x} \quad (3.6)$$

where i_{CB} is the policy rate, \vec{x} is a vector of bank specific variables and $a_0 > 0$.

The bank faces the cost C^L from producing loans and the cost C^D from producing deposits and CDs. These costs can be interpreted as screening and monitoring costs as well as branching costs. Costs increase with the size of the operations as well as with wages.

⁹Since there is just one bank, this market cannot be labelled an interbank market. However we can think of it as a money market where different non-bank financial institutions meet.

¹⁰One can argue two reasons why the illiquid bank has to go this market instead of going directly to the Central Bank window. The first is that the commercial bank can only borrow a limited amount of funds at an attractive rate at the Central Bank. Hence, the remaining, has to be raised in the interbank market. The second reason is that going directly to the Central Bank has important reputational costs

$$C^L = C^L(L, w) \quad (3.7)$$

$$\frac{\partial C^L(L, w)}{\partial L} > 0; \quad \frac{\partial C^L(L, w)}{\partial w} > 0;$$

$$C^D = C^D(D, CD, w) \quad (3.8)$$

$$\frac{\partial C^D(D, CD, w)}{\partial D} > 0; \quad \frac{\partial C^D(D, CD, w)}{\partial CD} > 0; \quad \frac{\partial C^D(D, CD, w)}{\partial w} > 0;$$

The bank maximizes profits choosing optimal interest rates, taking into account that a percentage j of the loans are not repaid.

$$Max \pi(i_l, i_d, i_{CD}) = i_l(1 - j)L + iR - i_dD - i_{CD}CD - i_m C^{IL}(X, R) - C^L - C^D \quad (3.9)$$

Substituting the balance sheet identity, *i.e.* equation (3.4), the problem can be rewritten as follows:

$$Max \pi(i_l, i_d, i_{CD}) = (i_l - i - i_l j)L + (i - i_d)D - (i - i_{CD})CD - i_m C^{IL}(X, D + CD + K - L) - C^L - C^D \quad (3.10)$$

First order conditions can be derived from this equation for i_l, i_d and i_{CD} ¹¹. For practical purposes we are only interested in first order conditions for i_l and i_{CD} . Equations (3.12) and (3.13) show the first order conditions for both rates. As expected, both rates move in the same direction than the policy rate. Equation (3.6) implies that a higher policy rate increases the liquidity cost. In the case of the CDs market, the increase in this cost forces the

¹¹It is worth noting the following:

$$\frac{\partial}{\partial R} E[C^{IL}(x, R)] = - \int_R^\infty f(x) d(x) = -[1 - \Phi(R)] \quad (3.11)$$

where Φ is the c.d.f of the distribution.

bank to offer a higher rate i_{CD} so he can attract more CDs, a stable source of funding not subject to withdrawals, and in this way reduce the cost. For the credit market, the higher liquidity cost is transferred to consumers in the form of higher rates.

$$i_{CD} = -\left\{ \frac{n_1 y + n_2 p}{2n_0} + \frac{1}{2} \frac{\partial C^D(D, CD, w)}{\partial CD} - \frac{a_0 i_{CB} + \vec{a} \vec{x}_t}{2} [1 - \Phi(R)] \right\} \quad (3.12)$$

$$\frac{\partial i_{CD}}{\partial y} < 0; \quad \frac{\partial i_{CD}}{\partial p} < 0; \quad \frac{\partial i_{CD}}{\partial w} < 0; \quad \frac{\partial i_{CD}}{\partial i_{CB}} > 0;$$

$$i_l = -\frac{c_1 y + c_2 p}{2c_0} + \frac{1}{2(1-j)} \frac{\partial C^L(L, w)}{\partial L} + \frac{a_0 i_{CB} + \vec{a} \vec{x}_t}{2(1-j)} [1 - \Phi(R)] \quad (3.13)$$

$$\frac{\partial i_l}{\partial y} > 0; \quad \frac{\partial i_l}{\partial p} > 0; \quad \frac{\partial i_l}{\partial w} > 0; \quad \frac{\partial i_l}{\partial i_{CB}} > 0; \quad \frac{\partial i_l}{\partial j} > 0;$$

On the one hand, the optimal i_{CD} depends positively on the policy rate and negatively on income, prices and wages (equation 3.12). Higher income and prices increase the supply of funds consumers take to the bank, and therefore a lower interest rate is needed to clear the market. Higher wages imply lower yields i_{CD} to consumers.

On the other hand, the optimal loan rate depends positively on income, prices, wages, and the policy rate (equation 3.13). Higher income and prices increase the demand for credit forcing the interest rate to go up in order to clear the market. Loan rates move in the same direction than wages and loan quality as costs are transferred to consumers.

4 Empirical Evidence

4.1 The data

The data set used, is comprised by two subsets: one for the CDs market and another for the credit market. For the CDs market, information about interest rates is available from

January 1996 with monthly periodicity for instruments maturing in 30, 45, 60, 90, 120, 180 and 360 days. Weighting by the amount of CDs maturing in each horizon, i_{CD} was constructed. In the case of the credit market, information begins on May 1997 and includes information on consumer credit and commercial ordinary, preferential and treasury credit. Mortgage credit was excluded since by Sentence 955 of 2000, the Colombian Constitutional Court established interest rate ceilings for these operations. i_l was constructed by weighting the amount of loans in each type of credit operation. For both cases, interest rates are marginal, *i.e.*, they are a monthly average of the interest rates charged on operations during that month and are not based on the stock of credit or deposits. Both data sets end on September 2004. The use of these data is rather novel since it has been rarely used. Only Estrada (2005) has used this information for the CDs market.

This information was complemented by balance sheet data supplied by the Superintendencia Bancaria. Additionally, information for the capital adequacy ratio (CAR) and number of employees was included¹². The panels were balanced¹³ and resulted in 21 financial institutions for the CDs market and 16 institutions for the credit market¹⁴. Trying to implement the model presented previously, the following indicators, in addition to the CAR, were constructed: non-performing loans to total loans (j), average monthly wages (w) for the banking industry, the share of bank i assets to total assets as a proxy for size and the ratio total loans to deposits. The latter proxies for liquidity risk since a bank that lends a higher proportion of its deposits is prone to face liquidity problems. The capital adequacy ratio and the size proxy are included as variables that may affect the cost of interbank funding

¹²The monthly number of employees was estimated with yearly observations as in Estrada and Osorio (2004) regressing the number of employees against fixed assets and a time trend. Specification tests, suggested the following fixed effects model:

$$\ln(\text{employees}) = 4.893 + 0.141 * \ln(\text{fixed assets}) - 0.0525 * t$$

(1.086) (0.06) (0.008)

with $R^2 = 0.676$. Standard Error in parenthesis.

¹³Balancing the panel could result in an bias even though banks selected are representative. What this implies is that results should be interpreted as exclusive for these banks. However, balancing the panel has important benefits in terms of an adequate econometric treatment.

¹⁴Only the sample for the CDs market includes former savings and loans institutions (*CAVs*).

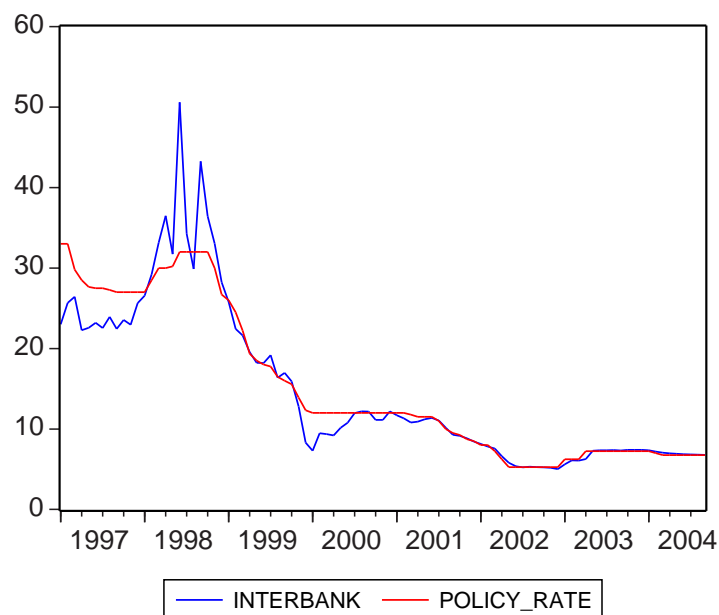


Figure 2: The Interbank Rate and the Policy Rate (Jan 1997- Sept 2004). Banco de la República

(\vec{x}) .

Microeconomic data were complemented with the seasonally adjusted industrial production index and the twelve month variation of the consumer price index. As for the policy rate variable, the interbank rate was chosen. The main reason for not using the policy rate is the step function behavior it exhibits since changes are not frequent. This creates econometric problems since little variation is not a desirable characteristic when thinking in parametric approaches. However, as can be seen from Figure 2, the interbank rate follows very closely the Central Bank policy rate¹⁵.

4.2 Empirical strategy

As a first step, unit root tests were conducted to all variables. Traditional augmented Dickey Fuller tests were performed on the industrial production index, the inflation rate and the

¹⁵Indeed, this is a common assumption for the Colombian case. See for example Bernal (2002).

interbank rate since these series are common for all individuals in the panel ¹⁶. In all cases variables were non-stationary. Unlike previous work by Berstein and Fuentes (2003a) and Gambacorta (2004) in which they assume bank interest rates are either stationary or non-stationary and where they assume bank characteristics are stationary, this paper deals with this issue performing panel unit root test. The Im, Pesaran and Shin(1997) (IPS) test and Maddala and Wu(1999) Fisher test were used. Both tests are discussed in the appendix ¹⁷. The use of panel unit root tests helps us deal with the structure of the data as well as to overcome the low power of traditional tests ¹⁸. As can be seen from Table 1, all variables follow unit root processes.

Table No. 1: Panel Unit Root Tests*

		IPS	Fisher
CD rate	c	0.658	0.99
	c y t	0.472	1.00
Credit rate	c	0.586	0.99
	c y t	0.511	0.99
Size	c	0.3434	0.2896
	c y t	0.8385	0.5015
CAR	c	0.4555	0.2718
	c y t	0.6349	0.6811
Non-performing loans	c	0.2617	0.2468
	c y t	0.7107	0.4523
Wages	c	0.826	0.5077
	c y t	0.7964	0.4853
loans/deposits	c	0.7383	0.4715
	c y t	0.9334	0.5363

*p-values reported. Ho= unit root. 3 lags

¹⁶Results for these tests are not presented but are available upon request.

¹⁷Is worth pointing out two points: i) for both tests the null hypothesis is the existence of a unit root, and ii) the empirical evaluation of these tests by Maddala and Wu(1999) favor the use of the Fisher test.

¹⁸See Chapter 4 of Maddala and Kim (1998) on this issue.

Given that all variables are $I(1)$, it is natural to think in a cointegration framework. The fact that we have an important number of variables leads us to think of cointegration in the spirit of Johansen (1988) and Johansen and Juselius (1990). Since the dataset has a panel structure, a panel VEC estimation seems logical. Following Larsson, Lyhagen and Lothgren (2001), let us consider a panel data set that has N cross-sections (banks) and T time periods. The error correction model for the $VAR(k_i)$ can be written as follows:

$$\Delta Y_{it} = \Pi_i Y_{i,t-1} + \sum_{k=1}^{k_i-1} \Gamma_{ik} \Delta Y_{i,t-k} + \varepsilon_{it} \quad (4.1)$$

Larsson, Lyhagen and Lothgren (2001) propose a likelihood-based cointegration rank test that allows us to test the existence of cointegration which implies a model as (4.1). If that is the case, then Π_i is of reduced rank, and it is possible to let $\Pi_i = \alpha_i \times \beta_i$. This allows us to estimate the long-run relationship between the variables. The test proposed is similar in spirit to the IPS test and is based on conventional trace tests. The test is discussed in the appendix. The test statistics, Z_t trace, are presented in Tables 2a and 2b for the CDs market and the credit market respectively. This test statistic should be compared to a $N(0, 1)$. As can be seen from the tables, a common cointegration rank does exist. For the CDs market, the panel test suggests that there are at least 4 cointegration relations while for the credit market there are at least 8 cointegration relations¹⁹.

¹⁹For the CDs market, the following variables were used: CD rate, industrial production index, inflation rate, interbank rate, CAR , wages, loans to deposits and the size proxy. For the credit market the same variables were used with the exception of the CD rate which was replaced by the credit rate and the ratio of non-performing loans to total loans which was included.

Table 2a: Larsson et. al (2001) Cointegration Test: CDs market

$H_0: r$	Avg. Trace	Z_t trace
0	239.68	27.09*
1	165.73	16.29*
2	111.87	8.73*
3	71.42	2.91*
4	42.03	-1.28
5	21.07	-4.54
6	7.89	-6.51
7	1.13	-7.00

* H_0 rejected

Table 2b: Larsson et. al (2001) Panel Cointegration Test: Credit market

$H_0: r$	Avg. Trace	Z_t trace
0	358.99	54.9*
1	263.23	42.96*
2	186.59	32.9*
3	128.27	24.9*
4	82.74	18.17*
5	50.15	13.33*
6	26.47	9.26*
7	10.64	5.62*
8	1.30	0.45

* H_0 rejected

Having established the existence of cointegration relationships between the variables, estimation issues have to be addressed. The panel VEC estimation was done estimating equation (4.1) for each of the banks for each market using the Johansen (1988) procedure. The major limitation of this strategy is that inference is limited because a covariance matrix between individuals cannot be estimated²⁰. This limits the analysis since interesting hypothesis, such as $\beta_i = \beta$, cannot be tested. However, the strategy followed allows for the estimation

²⁰The only available joint likelihood estimator for equation (4.1) is proposed by Groen and Kleibergen (2002). Unfortunately, this estimation procedure could not be implemented since computationally it is very demanding.

of each Π_i ,²¹ which is a much better assumption than $\Pi_i = \Pi$ as in the Engle and Granger panel VEC literature.

Although results varied bank by bank, weak exogeneity tests and exclusion tests suggested the variables used were appropriate. It is interesting to note that variables such as loan risk, *CAR* and size were also important in the work by Berstein and Fuentes (2003b). The signs, given by the theoretical model, and sizes of the coefficients associated with the long-run vector determined which cointegration vector was used. For one bank in the credit market no plausible vectors were found. This bank was excluded from the analysis.

4.3 Results

As a result of our estimation, we obtained the long-run coefficients (β) for the interbank rate, the policy rate proxy, for both markets. A coefficient near one means that interest rates set by banks move in line with the policy rate, *i.e.*, the instrument works in the long-run. Arbitrarily, Table 3 classifies banks according to the degree of transmission. A bank was classified as a low transmission bank if the coefficient was below 0.5, a medium transmission bank if the coefficient was somewhere between 0.5 and 0.75 and was classified as a high transmission bank if the coefficient was above that range. For the CDs market, 11 out of 21 banks were classified as high transmission banks, 8 were classified as medium and only 2 as low. The average coefficient for all the sample was 0.75. For the credit market, the average coefficient was 0.76. 7 banks classified as high transmission, 7 as medium and 1 as low. The difference between this β s widens when we consider only the banks that appear in both data sets. For these *common* banks, the average coefficient is 0.73 for the CDs market and 0.79 for the credit market.

²¹Since what we estimate is the following:

$$\begin{pmatrix} \alpha_1 \beta'_1 & & \dots & 0 \\ 0 & \ddots & & 0 \\ 0 & & & 0 \\ 0 & \dots & 0 & \alpha_N \beta'_N \end{pmatrix} \quad (4.2)$$

Table 3: Distribution of banks according to their degree of transmission

	CDs market	Credit market
Low	2	1
Medium	8	7
High	11	7
Total banks	21	15
Average β	0.75	0.76

Lutkepohl(1993) emphasizes the fact that properly speaking, long-run coefficients cannot be interpreted as elasticities since this would imply ignoring the endogenous nature of the variables. However, they do show us the long-run relationship between the variables. This endogeneity issue was tackled using impulse response functions that are presented in Figures 3 to 8. Impulse response functions are plotted for the corresponding interest rate, CD rate or credit rate, the inflation rate and the industrial production index. For the policy rate shock and the inflation rate the shock amounted to 100 basis points increase. In the case of the industrial production index, a one standard deviation positive shock was applied.

For the CDs market, it is possible to see that all banks react to the policy shock by increasing interest rates although the intensity is different among banks. It is worth noticing that only one of the banks seems to overreact to the policy rate shock, defining overreaction as a response in a much higher proportion than the shock. It is possible to measure, approximately, how many months a bank takes to respond with the maximum interest rate. On average, after 6.1 months the maximum response is observed. As for the credit market, all banks react to the shock and in a different way. However, it is possible to classify 5 out of 15 banks as *over-shooters*. These banks increase their credit rate in much more than the 100 basis point shock in the policy rate. On average, after 4.4 months the maximum response is observed suggesting that credit rates react faster than deposit rates to interbank movements. Additionally, one can compare the maximum response of banks that are in both data sets. For the majority of the banks, the maximum response is higher in the credit market than in the CDs market. Big banks react strongly in the CDs market when compared to the rest,

while in the credit market, reaction of these seems to be milder.

As expected both rates react to inflation shocks. What is very interesting is that interest rates overreact to unexpected inflation shocks. Rates are increased in a much higher proportion than changes in the inflation rate. While for the CDs market, 14 out of 21 banks turned out to be *over-shooters* with respect to the inflation rate, in the credit market all of the banks but one can be classified as *over-shooters* in this sense. Comparing the maximum response of common banks, the reaction is stronger in the credit market.

As for the income shock, the response of the CDs rate and the credit rate is different. On the CDs market, for the majority of the banks, interest rates take some time to react but they do so in a positive humped shaped fashion. For the credit market, the most common reaction is a quick and positive one followed by a downward response.

These facts suggest that deposit rates are stickier than credit rates. This behavior lacks a straight forward explanation if we keep in mind that the period of study is characterized by interest rates going down²² and that impulse response analysis is symmetrical. The last implies that an explanation to this finding has to work adequately to upward and downward stimuli. For example, explaining this result as the consequence of an oligopolic behavior could fail to work since if this was the case, it would be strange for banks to lower their lending rate faster and stronger than its deposit rate when faced with a downward stimulus²³.

Variance decomposition exercises, presented on Tables 3 and 4, turned out to be extremely suggestive. In a 24 month horizon it was possible to observe the following behavior for 11 out of 15 banks included in the credit market. In the first periods, an important part of the credit rate variance was explained by the rate itself and by the interbank rate. Inflation and variables reflecting the cost of financial intermediation, such as loan quality or wages, explained a minor share of the interest rate variance. On the last periods, the percentage

²²Out of the 104 monthly observation, 67 periods presented a downward move in the interbank rate.

²³One can think of other reasons as for example the balance sheet structure of Colombian banks, where one third of the assets are denominated in fixed rates while on the liability side most instruments are on a variable basis. Taking this into account, it would be reasonable to think that when faced with a positive inflation shock, banks have to increase more than proportionally the rates charged in order to compensate for the stock of loans that is set at a fixed rate. However when thinking of negative inflation shocks this might not make sense because it would not be reasonable to say that banks would forgo the profits already made by lowering interest rates down.

explained by the same rate and the interbank rate dropped importantly. However, the fraction explained by the inflation rate and the proxies for financial intermediation costs increased dramatically. What the latter suggests is that in the short-run credit rates are driven by the interbank rate and the rate itself. In the long-run, the credit rate depends upon financial intermediation costs and inflation. For the remaining 4 banks what could be observed was that the importance of the interbank rate increased as well as financial intermediation costs and inflation. For these banks, the same rate explained a very important percentage of the variance of the rate. For the CDs market, 12 out of 21 banks followed the behavior described above. In the short-run, variance of the CD rate was driven by the same rate and by the interbank rate, while inflation and financial intermediation costs are the main determinants in the long-run. For 6 banks, the importance of intermediation costs increased with time but inflation did not play an important role. For the remaining three banks, the percentage explained by intermediation costs increased with time but the importance of inflation decreased, which is strange when thinking of nominal interest rates.

Rounding up, the exercises presented highlighted the following facts: i) transmission seems to be high and quick; ii) all banks react in the same direction than the change in stance of policy but some react more than others; iii) the maximum interest rate response is faster in the credit market than in the deposit market when faced with a policy stimulus; iv) interest rates overreact to inflation shocks specially in the credit market; v) variance of interest rates is determined in the short-run mainly by the same rate and the interbank rate while in the long run, inflation and financial intermediation costs seem to be the driving factors.

5 Conclusions and policy implications

The present paper studied the Colombian monetary transmission mechanism, for the period 1996 to 2004, trying to examine how banks' interest rates are affected by the monetary authority. This is a relevant issue since central banks conduct their monetary policy by targeting a short-term interest rate that affects all other market rates. In addition, the

rigidity exhibited lately by the Colombian benchmark interest rate, the DTF, has raised questions about the effectiveness of the policy instrument. The paper tackled the pass-through issue empirically by using microeconomic data for the credit market and the CDs market. Overall the results show that pass-through to both credit rates and CDs rates is high and quick, that rates react strongly to inflation shocks and that the policy rate seems to drive interest rates in the short-run while in the long-run, inflation and financial intermediation costs are the main drivers. The response of credit rates to a policy shock is quicker than for the CDs rate and is stronger when faced by an inflation shock.

These results have at least four important policy implications. In first place, the policy instrument is effective in a first step, since it moves both the CDs rate and credit rates. However, these results do not provide evidence of the effectiveness of the monetary transmission mechanism as a whole, since the paper does not evaluate the effect of monetary actions on consumption and investment decisions. In second place, the fact that interest rates react more to inflation shocks than to policy shocks is an argument in favor of monetary intervention. If high interest rates are seen as pervasive, society is better off with central bank intervention (assuming the intervention is effective in taming inflation) than without it, since in the first scenario interest rates increase less than in the second. In third place, as shown empirically, in the long-run, interest rates reflect inflation and intermediation costs. Politicians worried with the inconvenience of high interest rates should pursue real policies to reduce financial intermediation costs such as eliminating the financial transaction tax and *mandatory low yield government investments* as well as improving the legal framework for reducing the time and costs of recuperating delinquent loans. Finally, policy makers interested in improving the effectiveness of the monetary authority should keep in mind that the literature studying interest rate rigidity has identified market concentration as a main source of low pass-through.²⁴ Reforms aimed at increasing banking competition should make the instrument more effective.

In spite of the positive evidence presented here, further research should assess the ef-

²⁴Evidence in this regards is presented in Hannan and Berger (1991) for the American industry and Berstein and Fuentes (2003b) for the Chilean industry.

fectiveness of the monetary mechanism as a whole and should study the consequences of interest rate rigidity in terms of optimal monetary policy. A novel paper in this last area is Kobayashi (2005). As the results suggest banks' asymmetric response could be an issue worthwhile to study as well.

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Econometric appendix

Panel unit root tests

In this paper, two different panel unit root test are performed, namely, Im, Pesaran and Shin(1997) (IPS) test and Maddala and Wu (1999) Fisher test. In what follows, both tests are briefly discussed following quite closely Maddala and Wu(1999).

The basic idea of the parametric IPS test is to test the following model:

$$\Delta y_{i,t} = \rho_i y_{i,t-1} + \alpha_i + \varepsilon_{i,t}$$

where under the null, $\rho_i = 0$ and α_i for all i . In this way, IPS overcome the major limitation of earlier work by Levin and Lin(1992) in which $\rho_i = \rho$. IPS perform individual unit root test for the N cross-section units instead of pooling the data. Letting $t_{i,T}(i = 1, 2, \dots, N)$ denote the t-statistics for testing unit roots, $E(t_{i,T}) = \mu$ and $V(t_{i,T}) = \sigma^2$, then:

$$\sqrt{N} \frac{\bar{t}_{N,T} - \mu}{\sigma} \implies N(0, 1)$$

where $\bar{t}_{N,T} = \frac{1}{N} \sum_{i=1}^N t_{i,T}$. μ and σ are computed using Monte Carlo methods. In essence, IPS tests the joint significance of N independent unit root tests.

The non-parametric Fisher test, proposed by Maddala and Wu (1999), is based on the sum of log- p -values derived from individual unit root test. If test statistics are continuous, the significance levels $\pi_i(i = 1, 2, \dots, N)$ are independent uniform (0,1) variables, and $-2\log_e \pi_i$ has χ^2 distribution with two degrees of freedom. Using the additive property of χ^2 variables, $\lambda = -2 \sum_{i=1}^N \log_e \pi_i$ has a χ^2 distribution with $2N$ degrees of freedom. With this statistic, the null of a unit root can be tested.

Based on Monte Carlo experiments Maddala and Wu(1999) favor the use of the Fisher test. Smaller size distortion and higher power, even in the presence of stationary and non-stationary series, support this test.

Panel cointegration test

Larsson, Lyhagen and Lothgren (2001) propose a panel test for the existence of a common cointegration rank based on likelihood inference for vector autoregressive models as in the spirit of Johansen. They propose an LR-bar test statistic similar to the test statistics proposed by Im, Pesaran and Shin(1997).

Formally, the following rank hypothesis is tested for all $i = 1, \dots, N$:

$$H_0 : \text{rank}(\Pi_i) = r_i \leq r$$

$$H_1 : \text{rank}(\Pi_i) = p$$

That is, we are testing the hypothesis that all of the N banks in the panel have at most r cointegrating relationships among p variables.

Denoting the trace statistic for group i as $LR_{iT}\{H(r) \mid H(p)\}$, the LB-bar statistic is defined as the average of the N individual trace statistics:

$$\overline{LR}_{NT}\{H(r) \mid H(p)\} = \frac{1}{N} \sum_{i=1}^N LR_{iT}\{H(r) \mid H(p)\}$$

The standardized LB-bar statistic for a common panel cointegration test they propose takes the following form:

$$\Upsilon_{\overline{LR}} = \frac{\sqrt{N}\overline{LR}_{NT}\{H(r) \mid H(p)\} - E(Z_k)}{\sqrt{Var(Z_k)}}$$

The moments of Z_k can be obtained from Table 1 of the Larsson, Lyhagen and Lothgren (2001) paper. The authors also prove that, under certain assumptions, $\Upsilon_{\overline{LR}} \implies N(0, 1)$ as N and $T \longrightarrow \infty$.

Figure 3: Banks' CD rate response to 100 basis points increase in the interbank rate(21 banks).

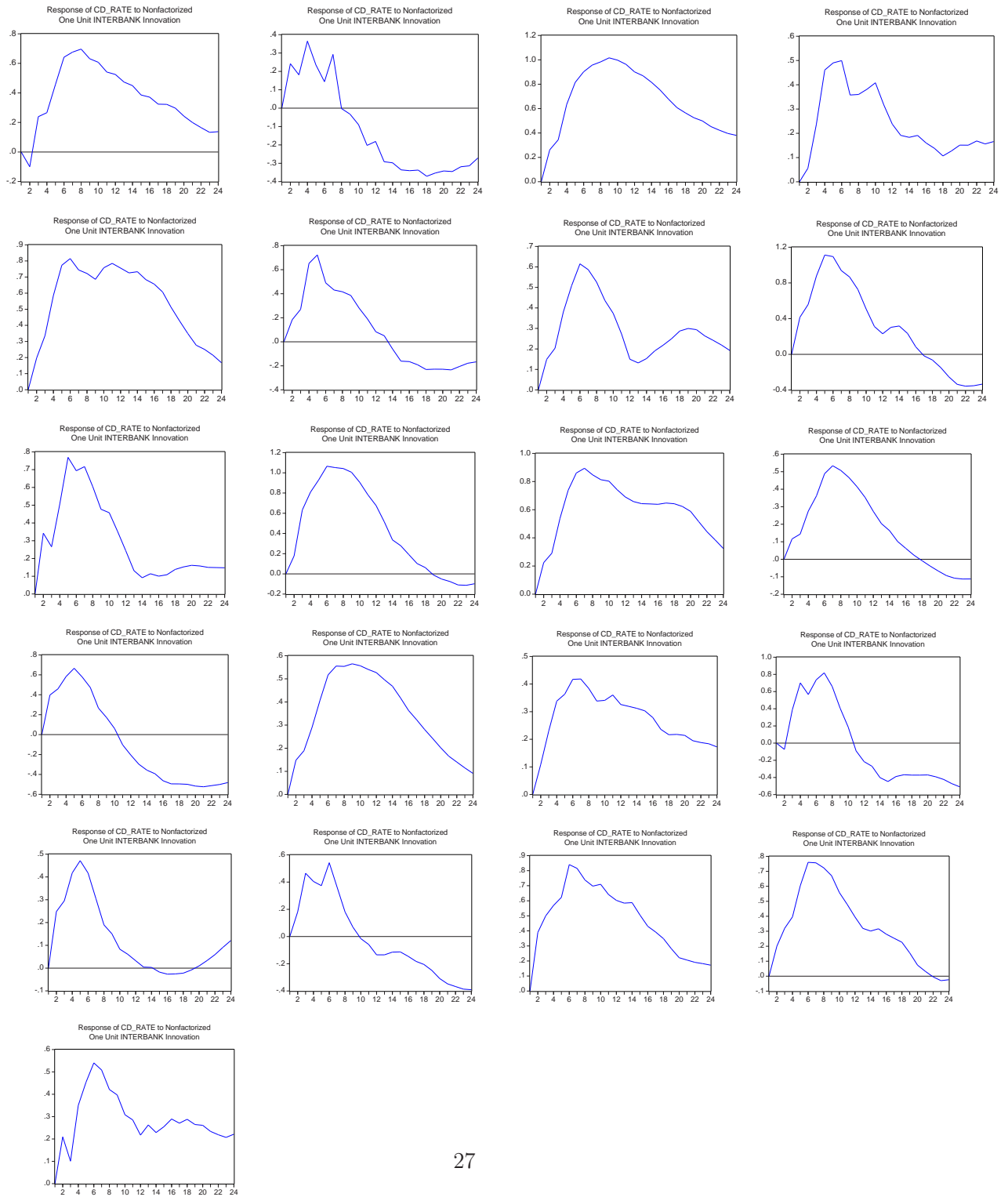


Figure 4: Banks' credit rate response to 100 basis points increase in the interbank rate (15 banks).

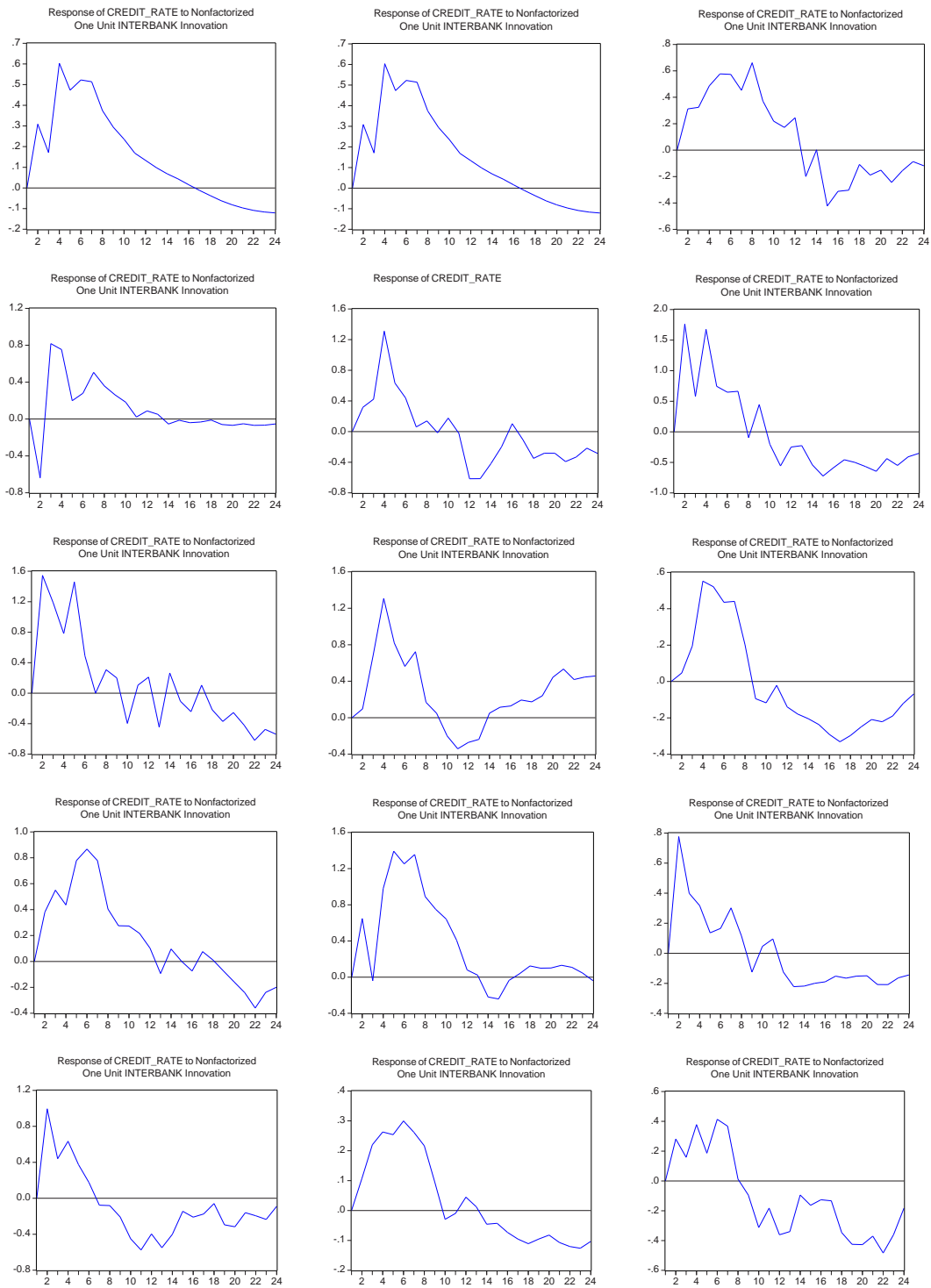


Figure 5: Banks' CD rate response to 100 basis points increase in the inflation rate (21 banks).

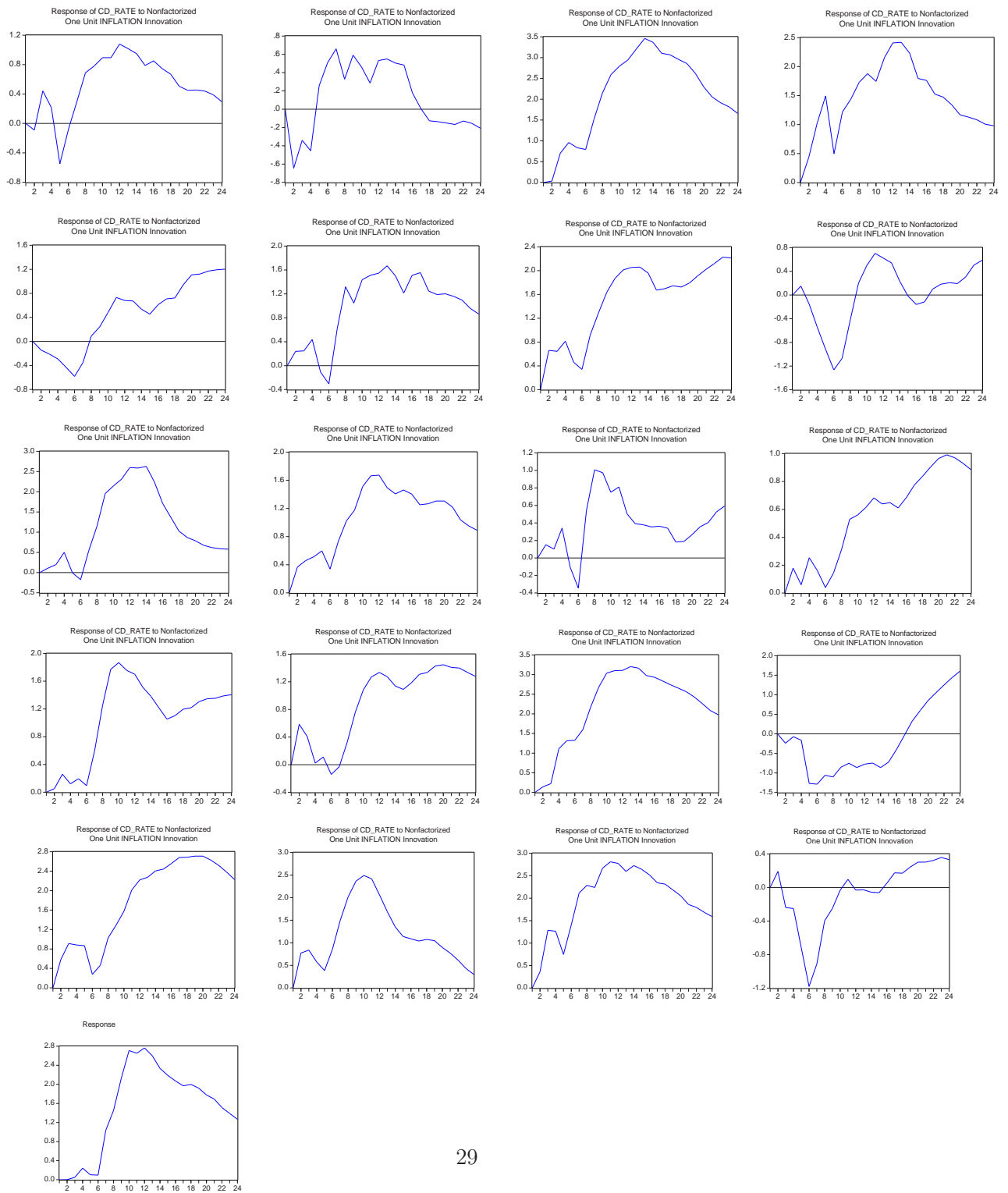


Figure 6: Banks' credit rate response to 100 basis points increase in the inflation rate (15 banks).

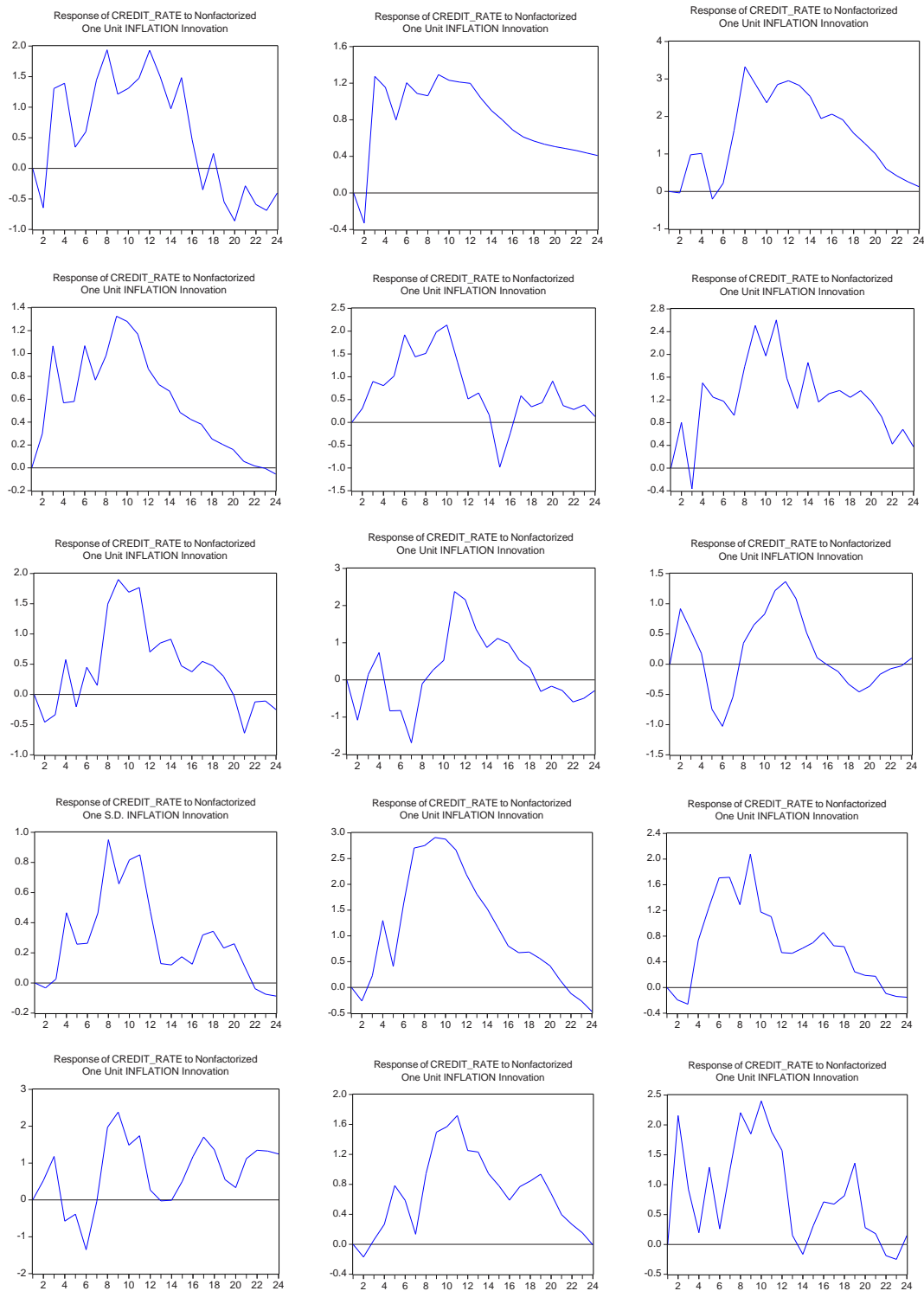


Figure 7: Banks' CD rate response to one standard deviation increase in the industrial production index (21 banks).

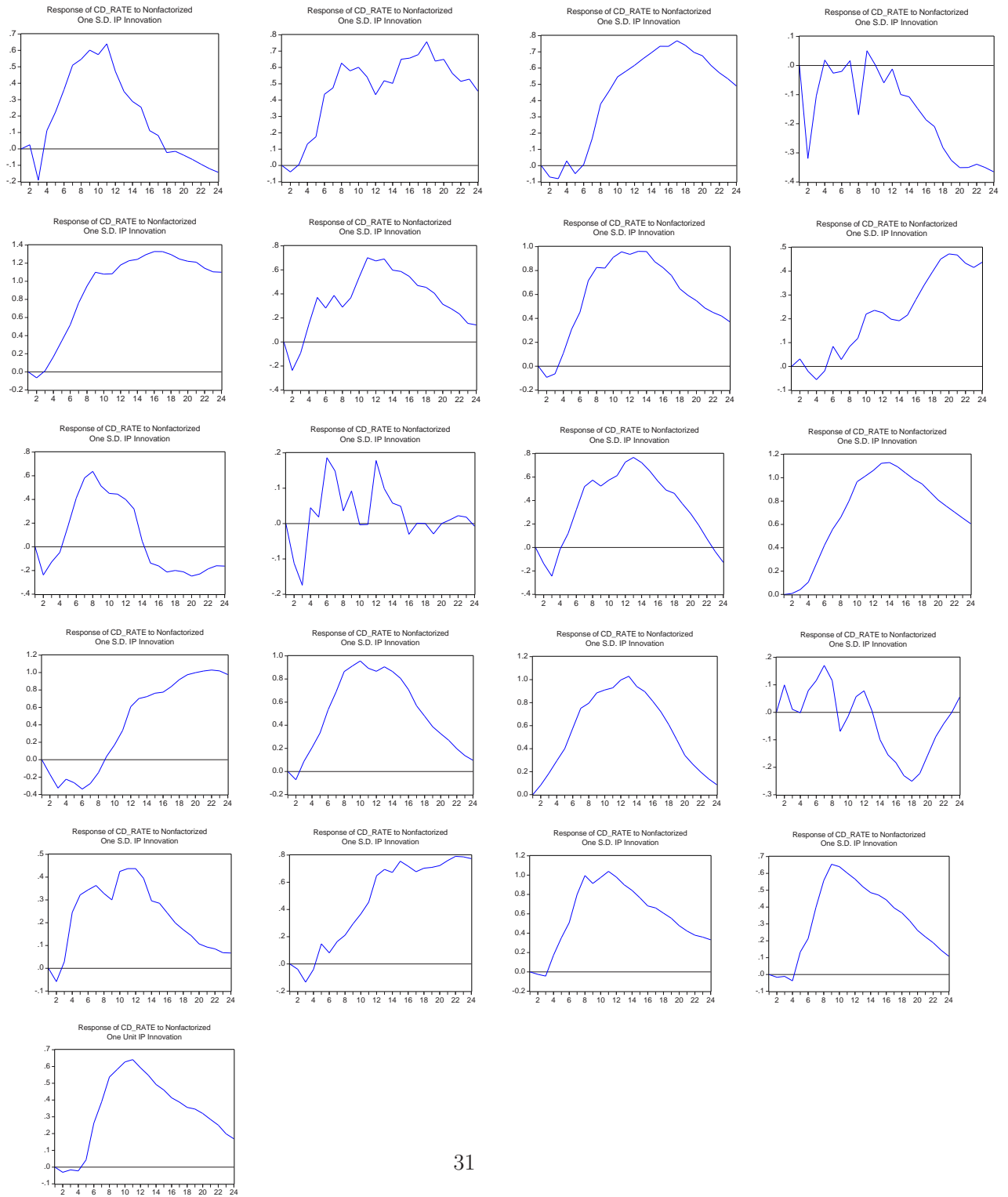


Figure 8: Banks' credit rate response to one standard deviation increase in the industrial production index (15 banks).

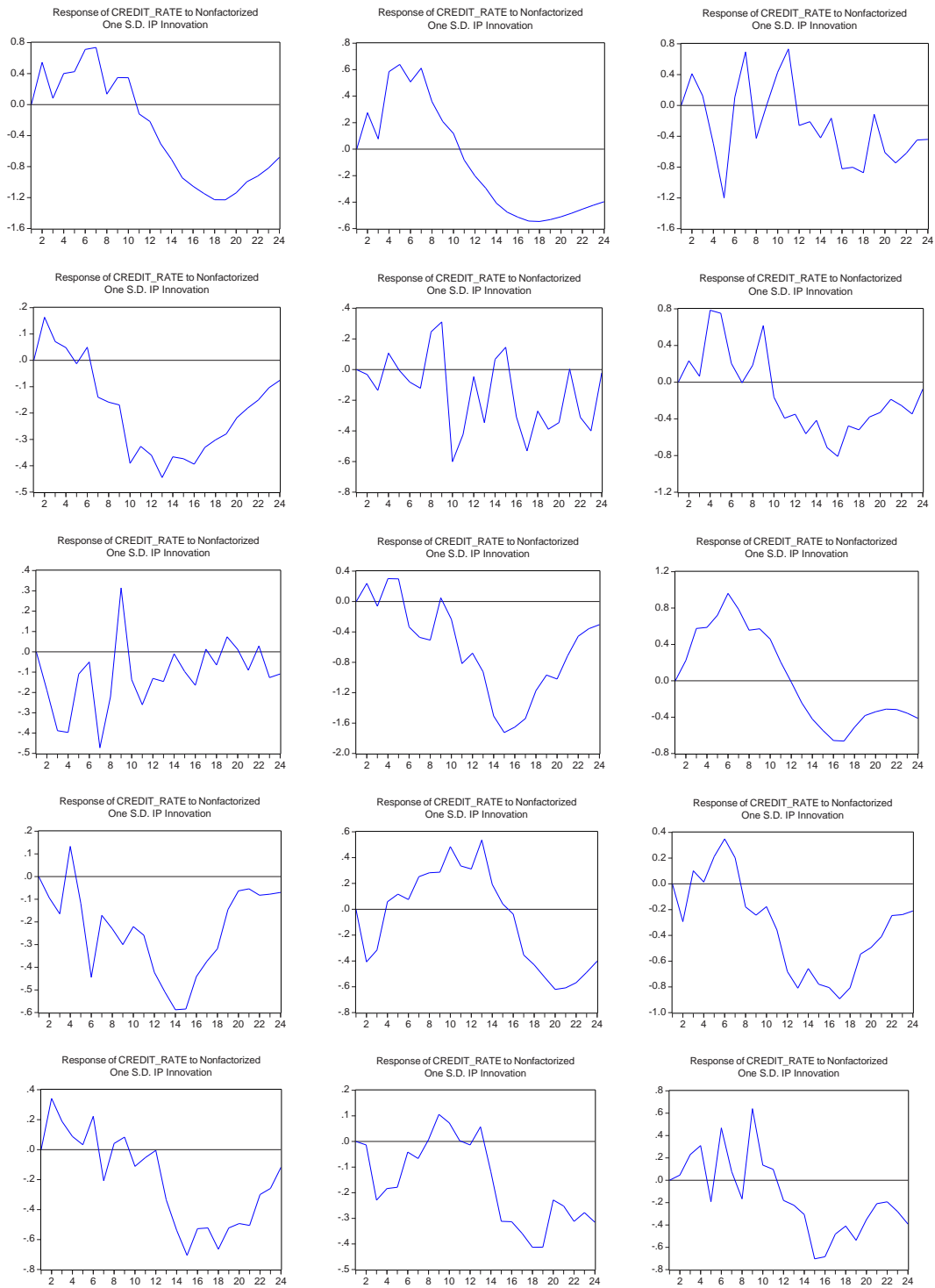


Table 3: Variance Decomposition exercise for CD rate (21 banks)

Period	S.E.	CD rate	interbank	p	IP	size	CAR	loans/deposits	w
1	1.0	37.7	49.3	1.9	0.2	7.4	2.9	0.2	0.4
12	5.5	7.9	62.0	3.7	9.1	1.3	5.6	10.1	0.2
24	7.4	6.6	56.2	6.6	6.1	2.5	12.3	9.2	0.4
1	0.9	83.5	6.5	2.2	1.2	1.3	0.2	5.0	0.0
12	3.9	10.9	13.0	10.3	29.2	1.4	6.8	27.3	1.0
24	8.6	7.4	7.7	5.7	26.4	3.2	3.9	37.9	7.8
1	1.0	33.0	58.3	0.3	0.3	7.7	0.2	0.2	0.0
12	6.4	29.6	38.6	12.9	9.4	3.8	0.7	1.0	4.0
24	9.5	25.5	21.3	20.3	15.8	9.5	0.6	3.1	4.0
1	1.2	31.3	55.9	0.4	2.9	0.0	0.3	7.1	2.2
12	4.9	9.6	19.7	23.0	0.6	16.2	2.1	22.8	6.0
24	6.8	7.1	11.7	25.6	1.4	25.2	3.1	19.2	6.6
1	0.5	41.6	24.1	6.5	7.1	3.3	0.6	0.0	16.7
12	4.6	7.5	28.6	2.6	49.1	4.6	2.8	2.2	2.4
24	8.1	5.1	14.2	2.5	43.7	21.9	8.0	1.9	2.7
1	1.24	56.65	42.07	0.07	0.00	0.02	0.15	0.99	0.04
12	4.5	21.1	35.2	7.0	9.1	1.1	18.1	4.3	4.2
24	5.9	14.0	23.9	17.5	10.4	7.9	16.5	4.9	4.9
1	0.8	40.0	55.5	0.0	2.0	1.5	0.3	0.0	0.7
12	4.8	14.9	25.3	5.6	36.9	1.0	6.9	3.3	6.0
24	7.8	14.7	9.6	10.9	30.0	2.6	6.6	6.2	19.3
1	0.5	66.2	10.9	2.9	2.9	1.1	4.4	0.9	10.7
12	3.0	11.1	38.1	5.7	5.3	5.3	0.8	4.8	29.0
24	6.6	11.7	14.2	1.3	14.5	6.7	1.1	1.2	49.4
1	0.8	60.1	30.5	5.2	1.3	1.7	0.9	0.2	0.1
12	6.2	5.7	26.9	7.8	23.3	4.9	1.0	19.4	10.9
24	8.6	3.0	20.8	11.3	16.7	8.0	0.8	31.4	7.8
1	1.0	37.6	41.7	0.2	0.5	5.1	9.5	5.1	0.3
12	5.5	28.1	47.1	6.7	1.0	0.8	13.7	1.1	1.6
24	6.6	22.1	35.3	14.1	0.7	3.7	14.0	8.2	1.8
1	0.5	64.0	24.9	5.3	4.3	0.0	0.3	1.0	0.2
12	4.7	23.1	24.5	9.1	21.9	8.9	3.0	5.5	4.0
24	7.4	14.6	14.7	4.1	19.7	26.5	15.2	3.2	2.0
1	0.7	42.2	54.0	0.3	2.0	0.0	0.6	0.6	0.3
12	6.5	3.3	37.0	1.9	9.0	6.5	0.4	13.8	28.1
24	9.3	3.3	25.5	2.5	9.7	14.7	0.4	18.0	25.8
1	0.6	43.2	33.1	10.2	1.7	0.0	3.7	8.0	0.1
12	4.9	9.3	23.3	2.2	41.6	20.0	1.8	0.3	1.4
24	8.7	4.3	8.2	1.2	42.3	33.3	7.7	1.1	1.9
1	1.0	69.0	22.8	0.0	1.3	0.9	1.0	5.1	0.0
12	7.0	2.3	42.1	10.7	36.2	3.9	1.1	1.7	2.0
24	9.7	1.3	39.1	13.7	35.9	2.6	3.1	1.1	3.1
1	1.0	45.0	45.6	4.8	0.1	2.6	0.9	0.7	0.3
12	4.4	3.9	56.7	13.2	6.5	2.9	4.4	8.3	4.0
24	7.1	2.9	40.5	5.5	26.7	13.9	2.6	4.8	3.2
1	0.6	63.5	15.7	6.2	1.5	7.9	3.0	1.7	0.5
12	5.4	2.7	61.9	2.8	18.5	0.8	9.7	2.4	1.3
24	7.6	1.7	47.9	7.9	18.3	6.7	15.5	1.3	0.8
1	0.8	58.8	30.1	5.6	1.8	0.2	1.3	2.0	0.2

Table 3: Variance Decomposition exercise for CD rate (21 banks)

Period	S.E.	CD rate	interbank	p	IP	size	CAR	loans/deposits	w
12	6.7	9.5	30.8	8.2	28.3	3.9	0.2	11.1	7.9
24	9.9	7.9	27.5	12.3	26.8	6.3	0.7	11.7	6.8
1	1.2	18.0	76.8	1.0	0.2	2.8	0.1	1.0	0.0
12	4.3	8.8	38.9	15.2	1.9	7.3	3.2	14.6	10.1
24	6.9	4.7	20.7	9.8	2.4	5.7	4.3	8.5	43.9
1	0.9	65.5	14.5	12.7	0.1	3.3	0.0	0.6	3.3
12	5.3	7.3	49.9	13.5	5.6	1.4	2.4	6.0	13.9
24	7.3	4.1	30.3	21.8	5.7	10.0	3.5	12.4	12.2
1	1.3	27.2	62.8	3.5	0.9	2.6	0.0	0.3	2.8
12	4.9	3.2	42.7	7.6	8.9	3.9	2.1	10.6	21.0
24	7.2	2.0	36.7	9.1	16.4	8.0	7.3	7.0	13.5
1	1.5	29.2	61.2	6.5	2.4	0.0	0.0	0.0	0.5
12	6.8	14.0	23.4	2.6	21.6	6.1	20.5	11.0	0.6
24	9.7	10.4	13.4	5.2	22.4	3.1	14.4	26.1	4.9

Table 4: Variance Decomposition exercise for Credit Rate (15 banks)

Period	S.E.	interbank	credit rate	size	CAR	IP	p	w	j	loans/deposits
1	3	55	34	0	0	0	0	0	1	10
12	5	48	12	1	1	2	8	10	6	12
24	6	40	11	1	1	10	10	12	5	11
1	3	55	34	0	0	0	0	0	1	10
12	5	48	12	1	1	2	8	10	6	12
24	6	40	11	1	1	10	10	12	5	11
1	3	5	80	2	0	2	0	1	10	1
12	5	41	28	6	6	5	3	5	4	2
24	6	36	24	6	7	13	3	5	4	2
1	2	81	17	0	1	0	0	1	0	1
12	4	43	14	13	3	3	15	3	1	5
24	5	35	12	12	6	3	15	11	2	5
1	2	56	40	0	0	0	0	0	1	2
12	5	27	19	4	4	1	18	16	7	4
24	6	21	15	14	4	12	13	12	4	5
1	3	87	11	0	0	0	0	0	1	0
12	5	34	10	2	4	3	27	2	10	9
24	6	32	10	2	5	4	27	1	9	11
1	2	87	11	0	0	0	0	0	2	0
12	5	46	17	2	12	1	11	1	4	6
24	6	40	14	10	8	1	10	2	3	12
1	2	55	38	0	1	0	2	0	1	3
12	5	31	24	2	6	2	18	3	7	7
24	6	32	13	5	6	3	12	3	18	10
1	3	23	68	6	1	1	0	0	0	0
12	5	45	19	4	0	11	4	14	3	0
24	6	42	15	3	3	16	4	12	3	2
1	3	24	76	0	0	0	0	0	0	0
12	5	28	42	1	1	3	18	2	5	1
24	6	25	38	2	1	6	19	2	4	2
1	3	85	12	0	1	0	0	0	0	0
12	6	38	27	1	1	0	20	2	9	2
24	6	32	23	1	1	7	22	2	9	2
1	3	30	62	2	0	3	2	0	1	0
12	5	60	5	2	1	13	11	2	1	5
24	6	52	4	3	1	16	11	3	2	8
1	2	54	39	0	2	2	0	1	0	3
12	4	35	24	2	4	3	11	9	9	2
24	6	30	13	3	6	5	22	10	6	3
1	3	3	70	0	0	1	1	7	13	4
12	6	29	9	1	8	7	15	12	18	2
24	6	27	10	3	7	6	18	11	18	2
1	2	53	42	0	0	0	2	0	1	1
12	5	26	18	15	9	2	24	2	2	1
24	6	17	9	26	6	11	18	2	7	3