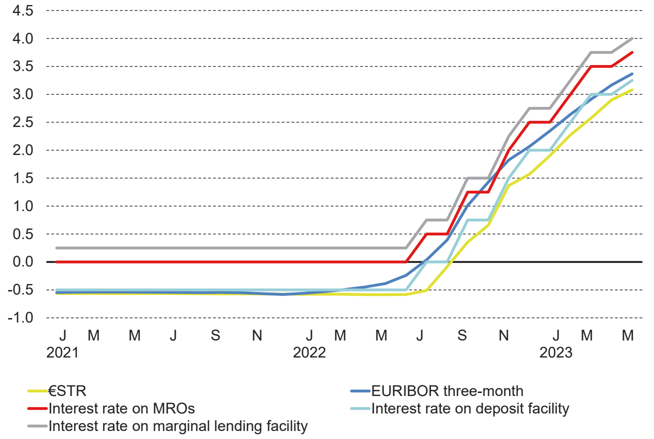
BOX 1: THE RECENT INTEREST-RATE PASS-THROUGH FROM MONETARY POLICY RATES TO MALTA'S RETAIL LENDING RATES, AND THE IMPACT ON GDP GROWTH AND INFLATION[1]

Introduction

Chart 1
KEY MONEY MARKET INTEREST RATES
(percentages per annum; market rates – monthly averages; ECB rates – end of month)



Source: ECB.

During the last decade, inflationary pressures in the euro area were low despite the very accommodative monetary policy stance. Indeed, the Deposit Facility Rate (DFR) was negative, from June 2014, until mid-2022, when the ECB began to raise its policy rates. In addition, several non-standard monetary policy measures were implemented to inject liquidity in the economy and safeguard the monetary transmission mechanism. However, inflationary pressures in the euro area and across the world have recently increased sharply, which has prompted central banks to embark on an unprecedented pace of monetary tightening. In this context, the ECB's Governing Council increased the DFR from -0.5% to 0.0% in July 2022. A rapid succession of policy rate increases since then brought the DFR to 3.25% in May 2023 (see Chart 1). Meanwhile, non-standard monetary measures also started to be gradually withdrawn. As a result, the Euro Short-term Rate (€STR) rose from -0.56% in December 2021 to 3.06% in May 2023, while the three-month EURIBOR rate increased from -0.58% to 3.37%.

In view of the substantial increase in monetary policy rates, this box presents a partial and preliminary assessment of the degree to which Maltese commercial banks have passed on these increases to mortgage rates and lending rates for non-financial corporations, compared to the other euro area countries. Moreover, the pass-through rate from the change in monetary policy rate to retail lending rates for the period December 2021 and March 2023 is estimated for Malta and the other euro area countries. These estimates are then utilised to estimate the impact of the bank lending channel on GDP growth and inflation in the projection horizon.

[1] Prepared by Ian Borg and Martina Cassar, Manager and Economist, respectively, within the Economic Projections and Conjunctural Analysis office.

The box relies on harmonised MFI interest rate statistics (MIR) on new business volumes with residents of the euro area published by the ECB.[2] Croatia is excluded from the analysis due to data limitations.

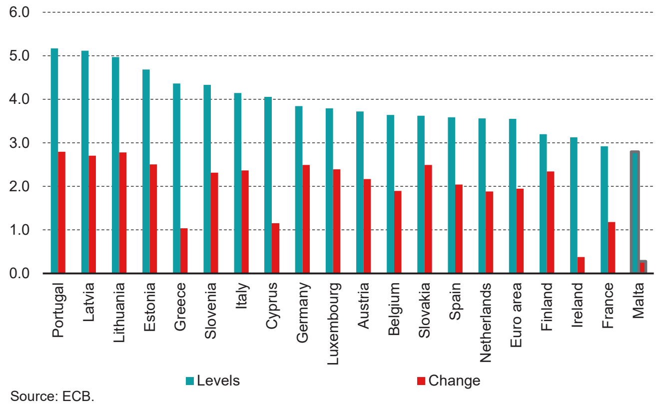
Interest-rate pass-through since December 2021 to March 2023

Chart 2 depicts the three-month moving average of the mortgage lending rate in March 2023, as well as the change in the lending rate since December 2021 to March 2023. The mortgage lending rate in Malta stood at 2.8% in March 2023, which was the lowest when compared to other euro area countries. Since December 2021, the three-month average mortgage lending rate rose by just 28 basis points, while the euro area average rose by 195 basis points. Both the level of the lending rate and its rise since December 2021 were the lowest in Malta when compared to other euro area countries.

With regard to loans to non-financial corporations (NFCs), Malta's lending rate stood at 4.4% in March 2023, above that in the euro area, which stood at 3.7% (see Chart 3).[3] The level of the lending rate was 8th highest in the euro area. The change in the three-month average NFC lending rate in Malta stood at 66 basis points, and hence these have been more responsive than mortgage lending rates. However, this change was much lower than the 251 basis points rise in the euro area, and was the lowest across all euro area countries, where increases of at least 200 basis points were recorded.

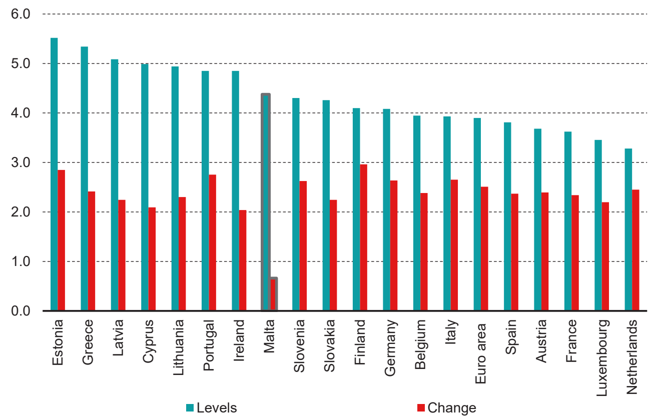
This suggests that, although we observe

Chart 2
LENDING RATES FOR MORTGAGES
(percentages per annum – three-month moving average of new business – APRC)*



Source: ECB.
Last observation: March 2023.
*APRC covers the total cost of a loan, comprising the interest rate component and other (related) charges.

Chart 3
LENDING RATES FOR NFCs
(percentages per annum – three-month moving average of new business)



Source: ECB.
Last observation: March 2023.

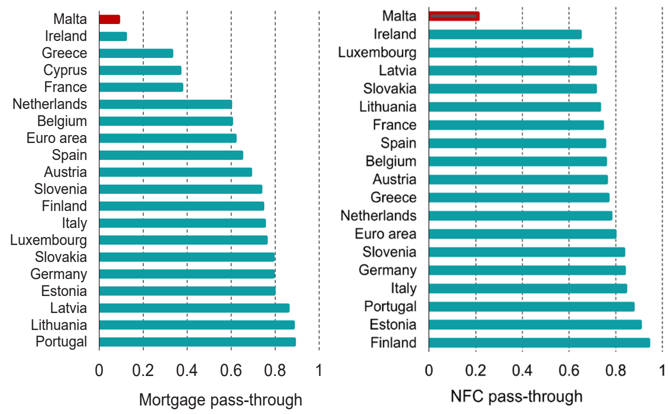
[2] These data may thus differ from MIR data covering transactions with residents of Malta cited in other Bank publications.
[3] The three-month moving average of lending rates to NFCs for residents of Malta only stood at 4.9% in March 2023, around 98 basis points higher than those prevailing in December 2021. Such change would still be the lowest across all euro area countries.

some increase in lending rates in Malta in response to the increase in monetary policy rates, the pass-through to retail rates has been low. To estimate the pass-through rate over the period December 2021 to March 2023, we calculate the following simple equation:

$$PT = \frac{\Delta rr_i}{\Delta pr}$$

where Δrr_i is the change in the retail lending rate of country i between December 2021 and March 2023, while Δpr is the change in the €STR during the same period.

Chart 4
PASS-THROUGH RATES
(ratio of change in lending rate to the change in €STR)



Sources: ECB; own workings.

Chart 4 shows that there has been very high heterogeneity in the pass-through of monetary policy to lending rates across euro area countries. The pass-through has been incomplete in all countries, i.e., retail lending rates rose by less than the short-term rate. Both with regard to mortgages and NFCs, Malta has experienced the lowest pass-through. Indeed, the pass-through to the mortgage lending rate stood at just 0.09, while that for rates on lending to NFCs stood at 0.2.

The low interest rate pass-through in Malta is not a new phenomenon. Previous estimates have put the short-term pass-through of mortgage lending rates in Malta at 0.26 and that for NFCs at 0.21.[4] However, the pass-through rates in Malta during the current tightening phase are even smaller than these estimates, especially for mortgages.

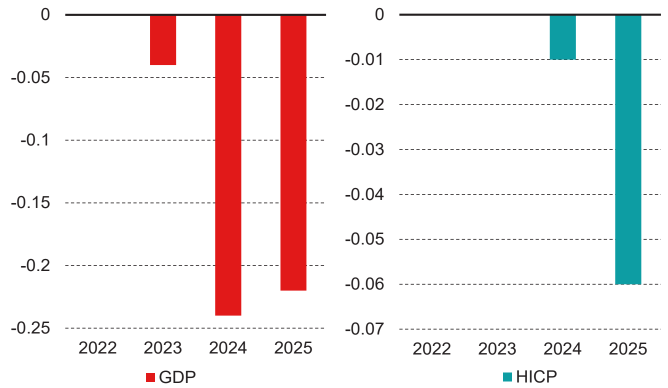
The impact of the bank lending channel on GDP growth and inflation in the projection horizon

In order to estimate the impact of the rise in interest rates on economic activity and inflation in the projection horizon, we proceed in two steps. As a first step, we utilise the estimated impact of monetary policy on the short-term lending rate published by the ECB in its May 2023 economic bulletin.[5] In the latter exercise, the ECB estimated the upward impact of monetary policy tightening on short-term lending rates to be 91bps, 373bps, 336bps, and 277bps between 2022 and 2025, respectively. We then impose these estimated impacts as interest rate shocks in the Bank's main macro econometric model – STREAM – to assess the impact on GDP growth and inflation. For the purposes of this exercise, we calibrate down the short-term pass-through from the policy rate to lending rates in view of the lower pass-through reported in the previous section.

[4] See Micallef and Gauci (2014), "Interest-rate pass-through in Malta", Article published in the Quarterly Review 2014:1.
[5] See A model-based assessment of the macroeconomic impact of the ECB's monetary policy tightening since December 2021.

Monetary policy tightening is expected to raise lending rates for NFCs and mortgages in Malta by around 150bps and 140bps, respectively, over the full projection horizon.[6] This exerts some downward pressure on Maltese real activity and inflation. In particular, the rise in interest rates is estimated to reduce GDP growth by 0.04% in 2023, 0.24% in 2024, and 0.22% in 2025 (see Chart 5). Meanwhile, the impact on HICP is even more muted, with an estimated peak decline of 0.06% in 2025. The estimated downward pressure on real activity and inflation is primarily driven by lower private consumption and investment.

Chart 5
IMPACT OF HIGHER LENDING RATES ON GDP GROWTH AND INFLATION PROJECTIONS
(% deviation from baseline growth)



Source: Central Bank of Malta.

These estimated impacts account only for the interest rate channel of monetary policy, i.e., the extent to which higher lending rates lead to lower credit to households and firms, and as a result lower consumption and investment. There are other channels that are not accounted for in the above simulation, such as tighter credit standards, the exchange rate channel, spill overs from downward pressure in euro area real activity, and inflation, as well as higher long-term rates. Hence, monetary policy tightening is likely to have a more marked impact on Maltese real activity and inflation than shown above. In view of Malta's trade openness, indirect impact which stems from trade spill overs and the exchange rate channel could make the impact of monetary policy substantial despite the low domestic pass-through of retail lending rates.

[6] Although the short-term pass-through rate is calibrated down in view of the observed low pass-through, the long-term pass-through is estimated at a longer horizon, and stands at around 50%.