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# ECB Monetary Policy Passthrough to Bank Interest Rates During Tightening

Republic of Kosovo

Ezgi Ozturk

SIP/2025/004

**IMF Selected Issues Papers are prepared by IMF staff as background documentation for periodic consultations with member countries.** It is based on the information available at the time it was completed on December 4, 2024. This paper is also published separately as IMF Country Report No 24/365.

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**ECB Monetary Policy Passthrough to Bank Interest Rates During Tightening, Republic of Kosovo**
**Prepared by Ezgi Ozturk**

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**ABSTRACT:** This paper analyzes the transmission of ECB policy rate changes to bank interest rates in Kosovo during the 2022-23 tightening cycle. While both lending and deposit rates increased, the passthrough was more limited compared to the euro area and regional peers. Three key factors explain this limited transmission: Kosovo's stage of financial development, high banking sector liquidity, and significant bank concentration.

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SELECTED ISSUES PAPERS

# ECB Monetary Policy Passthrough to Bank Interest Rates During Tightening

Republic of Kosovo

Prepared by Ezgi Ozturk[1]

[1] "The author would like to thank participants at the IMF Workshop in Pristina (November 8, 2024), and the IMF Kosovo team for helpful comments and suggestions.

INTERNATIONAL MONETARY FUND

# REPUBLIC OF KOSOVO

## SELECTED ISSUES

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Approved By
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Prepared By: Ezgi Ozturk

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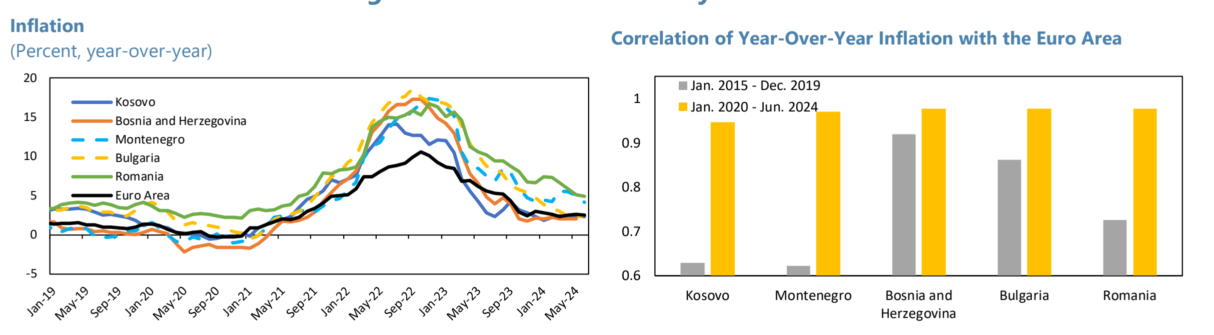
# ECB MONETARY POLICY PASSTHROUGH TO BANK INTEREST RATES DURING TIGHTENING[1]

*During the recent tightening cycle, transmission of the ECB policy rate to market rates in Kosovo—a unilaterally euroized economy—has been limited. This is true even when compared to regional peers with similar exchange rate regimes. This chapter analyzes the size of the transmission to bank interest rates and the underlying factors limiting the passthrough.*

## A. Inflation Episode of 2021–23

**1. Inflation surged in Europe, including in Kosovo, in 2021–22 following post-COVID-19 recovery and Russia's war in Ukraine.** Euro area inflation increased from around 1 percent in early 2021 to a peak of 10.6 percent in October 2022. In Kosovo, inflation spiked faster, peaking at 14 percent in July 2022, up from around 1 percent in early 2021. Inflation peaks for other countries with similar exchange rate regimes were even higher. For instance, in unilaterally-euroized Montenegro, inflation peaked at 17.5 percent in November 2022, and in Bulgaria, which has a currency board and peg to the euro, inflation peaked at 18.7 percent in September 2022. In the period following the pandemic, which included the inflation surge, the-year-over-year inflation correlation between the euro area and these economies increased compared to five years preceding the pandemic. This increase was more pronounced in Kosovo and Montenegro.

**Figure 1. Kosovo: Inflation Synchronization**



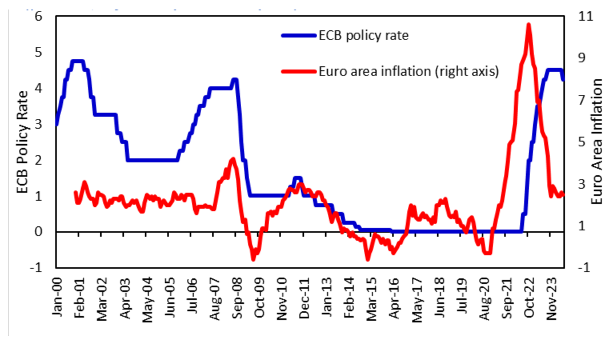

Sources: National statistics office of respective countries, and Haver Analytics.

**1. Following the surge of inflation, the ECB implemented the most aggressive monetary policy tightening since the ECB came into existence, effectively leading to a rise in bank interest rates both in and out of the euro area.** Between June 2022 and September 2023, the ECB policy rate increased significantly, from 0 percent to 4.5 percent. This represented a faster and stronger tightening compared to the previous most substantial tightening episode,

[1] Prepared by Ezgi Ozturk (EUR). For a more detailed analysis, please see a recent IMF study by Beyer et al (2024) on monetary policy passthrough to interest rates in 30 European economies, which includes euro area and non-euro area countries with independent monetary policy. This chapter complements facts presented in the Beyer et al study by documenting facts on the passthrough to bank rates in Kosovo, Montenegro, Bulgaria, Bosnia and Herzegovina, and Romania, which were not included in the study.

which recorded an escalation from 2 percent in December 2005 to 4.25 percent in September 2008. Passthrough of changes in the policy rate to economic agents' financial decisions is key to the effectiveness of the monetary policy transmission mechanism.[2] In this context, the literature suggests that the ECB's policy rate changes have been effective not only in euro area but also in non-euro area economies.[3] This paper complements earlier studies by documenting the ECB policy rate passthrough to bank rates in unilaterally euroized economies as well as economies with managed floating exchange rates or a currency board.

**Euro Area Monetary Policy Rate and Inflation**




Source: European Central Bank.

## B. Response of Bank Rates in Kosovo to ECB Policy Tightening

**2. Bank interest rates in Kosovo increased following the ECB policy tightening, however the passthrough has been limited, particularly for lending rates.** Both lending and deposit rates in Kosovo inched up since the beginning of the ECB tightening cycle. However, this increase has been much smaller than in the euro area. For instance, from the start of the ECB tightening cycle in July 2022 to August 2023, non-financial corporations (NFC) loan rates increased by 3 percentage points (pp) in the euro area but by only 0.9 pp in Kosovo.[4] The increase in Kosovo was similar to that observed in Montenegro, the other euroized western Balkan economy, 1.1pp, and lower than that observed in Bosnia and Herzegovina or Bulgaria, which have currency boards and pegs to the euro, and Romania, which has a managed floating regime. Similarly, the increase in deposit interest rates in Kosovo has been smaller than the euro area. But, in contrast to NFC loan rates, NFC deposit rates in Kosovo increased by 1.1 percentage points, which is close to what was observed in Bosnia and Herzegovina, and Bulgaria.

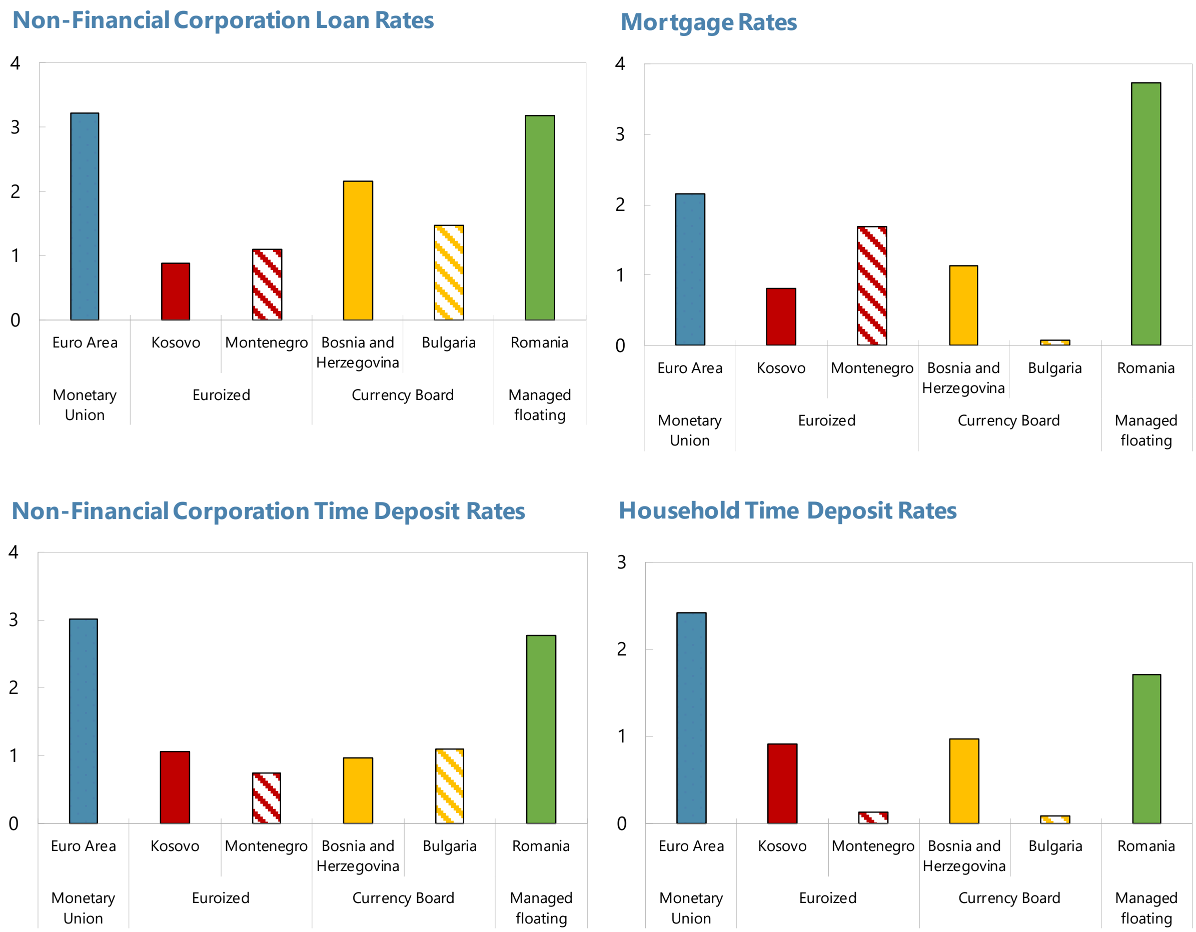
[2] Changes in the policy rate affect short-term interbank interest rates, and in turn, affect bank lending and deposit rates, which are affecting investment and consumption-savings behaviors, debt service costs, and financial constraints of households and firms, and profits and lending capacity of banks (Beyer et al, 2024).

[3] For instance, Moder (2021) analyzes the long-run co-movement between the ECB policy rate and the deposit and lending rates in countries outside the euro area, excluding those with unilateral euroization, and shows that more than one third of all euro retail rates in these countries are closely linked to the ECB monetary policy rate; domestic monetary policy rates have less impact on retail rates for loans denominated in euros, suggesting that domestic central banks can only partially influence the euro part of the interest rate channel.

[4] The passthrough from policy rates during the recent tightening cycle has been weaker for most of the bank rates than the previous tightening cycles in the euro area. For instance, per one percentage point increase in ECB policy rate, on average, NFC loan rates increased by 0.7 pp during the recent tightening episode and 0.9 pp during earlier tightening episodes.

**Figure 2. Kosovo: Cumulative Changes in Bank Rates**

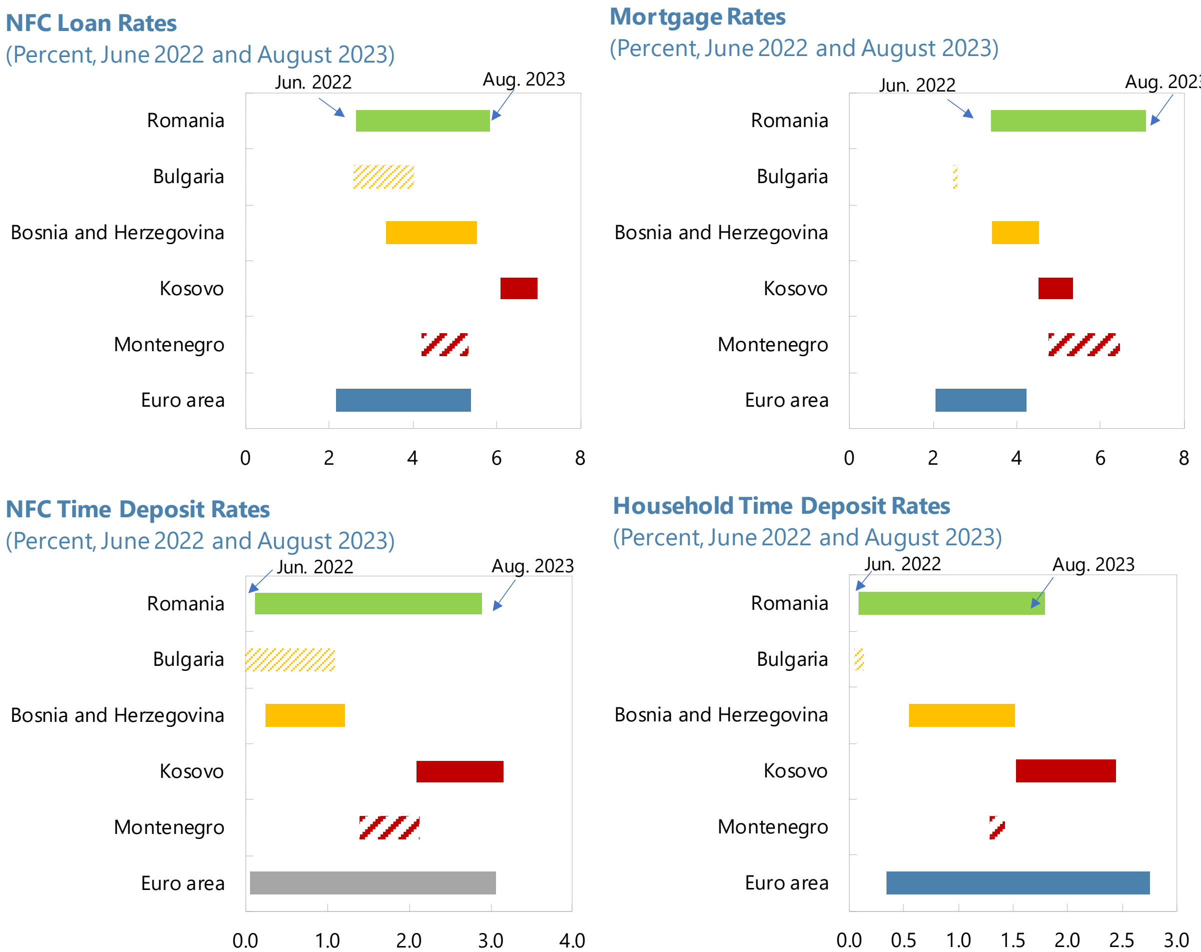
(Percentage points, 2022M6–2023M8)




**3. Just before the ECB's tightening measures, loan and deposit rates in Kosovo were higher than in the euro area and comparable economies.** For instance, mortgage rates in the euro area in August 2023 were still lower than the level of mortgage rates in Kosovo at the beginning of the tightening cycle in June 2022. This contrast reflects different levels of financial market development and risk perception. Deposit rates being high initially can be explained by bank dependence on local deposits more than on wholesale funding (and consequently paying a higher price to attract deposits). Although banks with the largest customer shares in Kosovo are subsidiaries of foreign banks, the system is still affected by Kosovo-specific risks, while Kosovo is still developing the financial sector's legal and regulatory framework.

## Figure 3. Kosovo: Bank Rates During the ECB Monetary Policy Tightening

(Percent, 2022M6–2023M8)



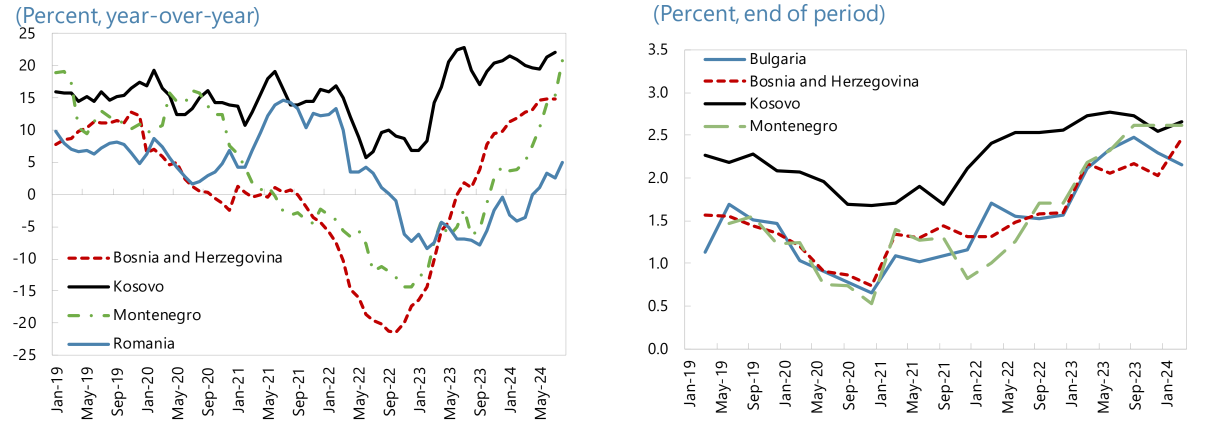

4. **During the recent ECB monetary policy tightening, private sector credit growth has been larger, and banks have been more profitable in Kosovo than in comparator economies.** Profitability of banks in Kosovo has always been stronger than the banks in comparator economies, with larger credit growth despite high lending rates. Although keeping the leading position in profitability, the gap on profitability with banks in comparator economies has narrowed.[5] This could be partially explained by stronger ECB policy rate pass-through to loan rates in these economies than Kosovo.

[5] The IMF 2024 Article IV report on Montenegro confirms that net interest margins have widened in Montenegro, leading to record levels of bank profitability.

**Figure 4. Kosovo: Private Sector Credit Growth and Bank Profitability**

**Real Private Credit Growth**
(Percent, year-over-year)

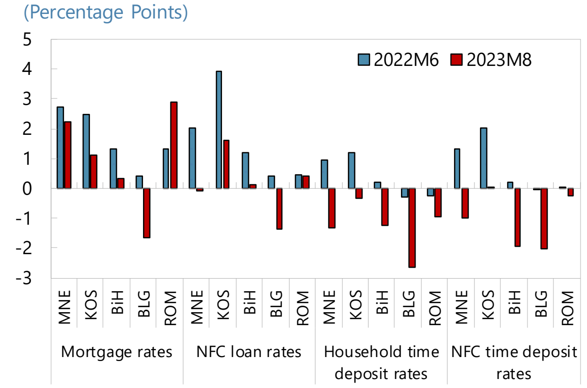
**Bank Profitability**
(Percent, end of period)




Sources: Central banks of respective countries and Haver Analytics.

5. **The more subdued passthrough of the ECB monetary policy rates to bank interest rates in Kosovo contributes to the convergence towards the euro area interest rate anchor.** A euroized country's interest rates are expected to converge to the anchor euro area average interest rate over time as the financial sector develops. Gaps between interest rates in Kosovo and the average rates in the euro area were larger at the beginning of the tightening cycle than those in comparator countries. Following the tightening, the gaps have narrowed with the help of the weaker passthrough in Kosovo. For instance, the gap with euro area time deposit rates is smaller in Kosovo than other comparator economies, where the size of the passthrough has been similar or even larger than Kosovo, but the initial rates were much lower.

**Gap Between Bank Rates in Euroized Economies vs. Rates in the Euro Area**
(Percentage Points)




Sources: European Central Bank, other national central banks of respective countries, and Haver Analytics.

## C. Factors Behind Low Interest Rate Passthrough

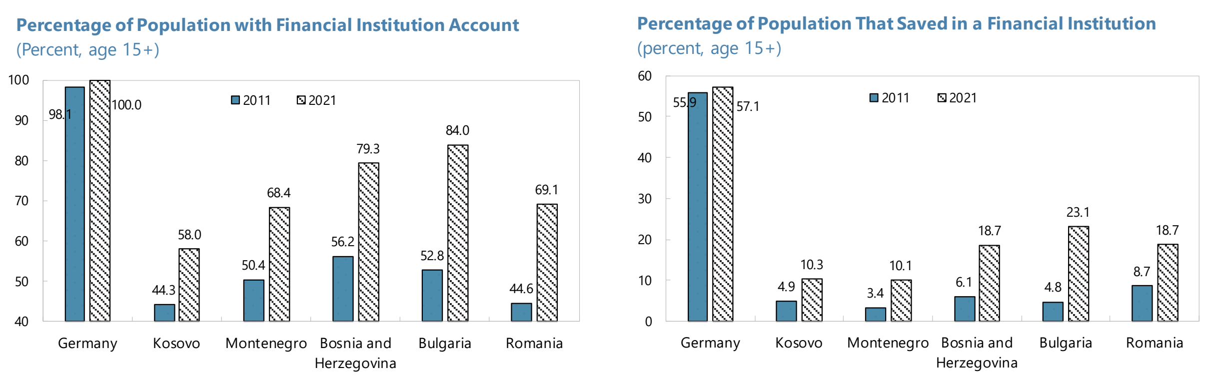
6. **Several factors could explain lower passthrough of ECB rates to bank rates in Kosovo.** Based on literature (Saborowski and Weber, 2013; De Bondt, 2005; Messer and Niepmann, 2023), we identify three of most relevant factors contributing to a more limited passthrough.[6]

[6] Saborowski and Weber (2013) identified country characteristics that have important effects on the effectiveness of interest rate transmission, including indicators of regulatory quality, inflation, financial development and dollarization, exchange rate flexibility, as well as banking sector competition, asset quality and liquidity. De Bondt (2005) showed that credit risk considerations can largely explain the adjustment speed of deposit and lending rates in response to changes in policy rates. Messer and Niepmann (2023) showed that high levels of liquidity is likely to explain the weak passthrough to deposit rates as banks do not have strong incentives to attract deposits when liquidity is abundant.

- **Financial development.** The level of bank rates is closely related to the degree of financial development, which has three key dimensions: financial deepness, inclusion, and efficiency (IMF, 2015). Financial deepening fosters competition; liquidity-enhanced financial inclusion broadens participation in the financial system and expands the deposit base; and, improved financial efficiency reduces costs in the system. Together, these create a favorable environment for lower bank rates. During the recent ECB tightening episode, two opposite forces influenced the passthrough to bank rates in Kosovo. While the ECB monetary tightening put an upward pressure on bank rates, ongoing financial developments created a downward pressure on already high rates. The acceleration of private credit growth during the recent ECB tightening may indicate advancing financial deepening. Although financial inclusion in Kosovo improved, the latest statistics from 2021 suggest that it remains well below the levels seen in other economies in the region. The implementation of new policies, such as the introduction of free basic accounts and formalization efforts which continued during the period of ECB tightening suggests further improvements in financial inclusion. Furthermore, the adoption of technology—such as introducing online loan applications—and enhanced risk management practices, driven by stronger financial supervision, suggests improved financial efficiency. All of these have likely placed downward pressure on bank rates, offsetting the upward pressure of the ECB tightening, which is argued to be stronger for economies with higher degree of financial development.

**Figure 5. Kosovo: Financial Inclusion, 2011–21**

(Percent)

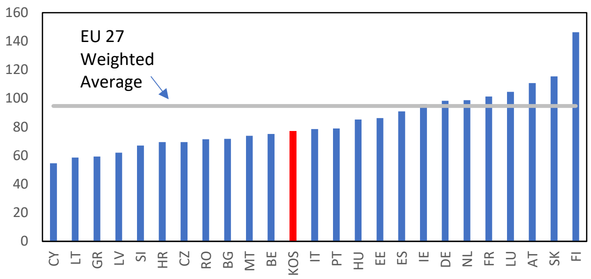



Sources: World Bank and FINDEX Database.

- **Liquidity.** Ample liquidity in the banking system of Kosovo during the ECB tightening episode could also explain the lower passthrough. The lower loan-to-deposit ratio in Kosovo compared to the euro area, along with a higher ratio of liquid assets to short-term liabilities relative to some large European economies, like France, the Netherlands, and Spain, suggest that banks in Kosovo had less incentives to compete for additional deposits. Moreover, despite the increase in remuneration on excess reserves from -0.7 percent to 0 percent in August 2022, bank excess reserves held at the CBK declined significantly during the ECB tightening, indicating that banks resorted to using their liquidity rather than attracting deposits.[7]

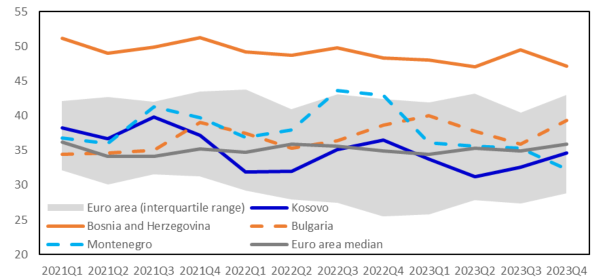
## Figure 6. Kosovo: Liquidity Indicators

**Loan-to-Deposit Ratio, 2022**
(Percent)



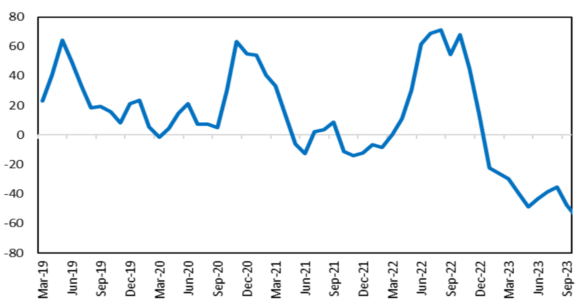

Sources: European Central Bank, other national central banks of respective countries, and Haver Analytics.

**Liquid Assets to Short-term Liabilities**
(Percent)



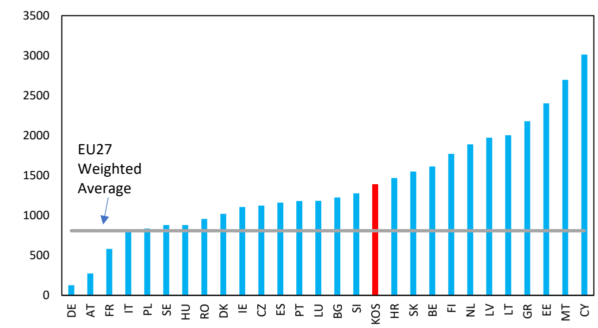

Sources: European Central Bank, other national central banks of respective countries, and Haver Analytics.

**Changes in Excess Reserves**
(Percent, year-over-year, 3-month moving average)




Sources: Central Bank of Kosovo and IMF staff calculations.

**Herfindahl Index for Credit Institutions Total Credit, 2022**
(Index ranging from 0 to 10.000, based on total assets)




Sources: European Central Bank, other national central banks of respective countries, and Haver Analytics.

- **Bank concentration:** Kosovo has higher bank concentration compared to the euro area average. Higher bank concentration, measured through the Herfindahl index of total assets of credit institutions, indicates lower competition and possibly lower passthrough of monetary policy rates to deposit rates during tightening episodes (Kho 2023). Banks in Kosovo may not need to compete as strongly to attract deposits. This observation is in line with the strong profitability ratios experienced in the banking sector of Kosovo in 2022–23. Moreover, in Kosovo, the impact of high bank concentration may be amplified by the fact that banks are dominant players in the financial sector as other forms of financial intermediation are relatively underdeveloped.

[7] One other dimension of increased liquidity in the banking system is that the government securities held by private banks have not been rolled over and as a result the banking sector had around €50 million of extra liquidity during the tightening episode.

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