

Irish Retail Interest Rates: Why do they differ from the rest of Europe?

By Rory McElligott*

ABSTRACT

In this paper, we compare Irish retail interest rates with similar rates in the euro area, and examine the likely factors causing any differences that exist. The comparison reveals that, with the exception of overdrafts, Irish households have enjoyed lower interest rates on their borrowings than most of their euro area counterparts. Of particular importance, interest rates on new Irish mortgages are slightly below the euro area average. In contrast to households, non-financial corporations (NFCs) pay above average interest rates on all significant loan categories. Both households and NFCs received lower than average interest rates on deposits over the study period.

There are a number of reasons for the gap in interest rates between Ireland and the euro area. Factors contributing to the differences include different product and charging structures, the level of competition within the banking sector, and firm size and sector. Many of these impediments to the convergence of retail interest rates are due to national market preferences and banking practices. The causes of differences are so varied that it makes the comparison of interest rates across countries difficult, and care should be taken before drawing conclusions from this exercise. The factors causing differences are often founded in national traditions and culture and may be slow to change, indicating that it is unlikely that significant convergence will take place in the near future.

1. Introduction

With the creation of Economic and Monetary Union (EMU) in 1999, it was expected that interest rates would converge across the euro area. Studies such as Baele et al (2004) and Cabral et al (2002) show that a high level of convergence has taken place in euro area money and government bond markets since the start of EMU. Despite this almost complete convergence in wholesale financial markets, an ECB report published in 2005 (ECB, 2005) showed that the same did not hold for retail financial markets. The report found that some convergence had taken place but significant cross-country differences still persist. This paper looks at the position of Irish retail interest rates among euro area countries and examines what are the likely causes of these differences.

The data employed in this study are the MFI Interest Rate (MIR) statistics. The statistics are derived from data collected from resident Monetary Financial Institutions (MFIs), and relate to

* The author is an Economist in the Bank's Statistics Department. The views expressed are the sole responsibility of the author, and are not necessarily those held by the CBFSAI or the European System of Central Banks. The author would like to thank John Kelly for helpful comments, and colleagues in the Statistics Department for assistance with data preparation and presentation.

euro-denominated loans and deposits *vis-à-vis* households and non-financial corporations (NFCs). The statistics have been collected in a harmonised manner across the euro area since January 2003, and are a substantial improvement on the retail interest rate statistics collected previously in an unharmonised manner by the National Central Banks (NCBs). For further details on the MIR statistics methodology and an early examination of interest rates see McNeill (2003).

In September 2006, the ECB published the findings of an expert group in the report 'Differences in MFI Interest Rates Across Euro Area Countries'¹. This report highlighted the most important factors in explaining the different levels of retail interest rates. These are differences in product features, national tax and regulatory frameworks, statistical and classification issues, differing credit risks and market structures. The report shows that non-interest charges may also be a significant factor in explaining cross-country differences. Overall, the report showed that, unlike the wholesale financial markets which are almost fully integrated, retail financial markets have not integrated to the same extent and many national differences still exist.

The next section outlines several of the potential sources of differences in interest rates. Section 3 presents a variety of descriptive data on Irish and euro area interest rates, allowing comparisons of interest rates in Ireland and the euro area. Details of how these differences have changed since the start of the survey are also presented. Sections 2 and 3 are then pulled together in Section 4, where the likely reasons for differences in Irish and euro area interest rates in the major loan/deposit categories are discussed. Section 5 concludes.

2. Potential Reasons for Cross-Country Differences in Interest Rates

Even if banks are in the same monetary area and face similar wholesale funding costs, there are still many other factors affecting the price of retail banking products. These factors can vary across countries and therefore can lead to different interest rates. Some of the potential causes of differences in retail interest rates are outlined below.

2.1 Risk and Market Structure

The pricing of interest rates by banks is dependent on the perceived credit default risk. It would be expected that higher risk to banks is associated with higher interest rates and any cross-country variation in risk levels will lead to different interest rates. The cross-country differences in perceived risks may be

¹ The MIR Expert Group was established to investigate the reasons for cross-country differences in interest rates and comprised compilers and users of the statistics from the Eurosystem.

due to many factors such as: expected developments in house prices; the strength of the domestic economy; the strength of the economies of major export markets; and the current financial strength of households and NFCs.

The extent to which loans are collateralised can also have a significant effect on explaining differences in interest rates. The use of collateral reduces the risk on a loan and therefore lowers the interest rate on the loan compared with a similar loan without collateral. It may be unusual to require collateral on a product in one country and standard market practice to require collateral for a similar loan in another country. Other structural differences in the retail financial markets that may cause differences across countries are banking practices regarding charging structures (e.g. interest and non-interest charges) and different competition levels in national banking markets. Differing degrees of competition may cause differences in the interest rate level and also the speed with which changes in banks' funding structures are transmitted to retail interest rates.

2.2 Regulatory Framework and Tax Treatment

Differences in regulatory and tax policies can contribute to differences in interest rates across countries. Legislation can directly affect rates by controlling interest rates charged by banks. There are no such direct controls on bank interest rates in Ireland. On the other hand, in France, banks were not permitted to pay interest on overnight euro-denominated deposits until March 2005. Many countries have a cap on the interest rates on credit but this is often not binding, as the market price is often lower. Other regulations place a limit on the number of times the interest rates can change each year on a variable rate loan. For example in Italy, variable rate mortgages are only permitted to have one adjustment in interest rates per year. This restriction could lead to a case where consumers are paying substantially below or above the market rate at any time due to these sticky rates. In many countries, other more subtle regulatory policies dictate the charges a bank can impose for early repayment of loans. Depending on the size of this fee, banks may factor this into the initial interest rate charge.

Fiscal factors may also affect interest rates. Differing tax treatment of income from deposits and substitute products – such as life insurance policies and pensions – may influence deposit interest rates. In many countries interest payments on mortgages can be offset against income tax. Economic theory would suggest that in the absence of sufficiently strong competition, banks might take advantage of this lower net cost to borrowers by charging a higher interest rate. Another factor that can bias interest rates down in some countries is the existence of large dedicated housing schemes often backed by government, as in the Netherlands.

2.3 Non-Interest Charges

The retail interest rate statistics relate only to the interest charges on a bank product. Differences in non-interest charges could contribute to differences in interest rates across countries. A rational consumer will tend to view the total cost of a product rather than just the interest charge. If a country has a relatively low interest rate on a loan product, it may be the case that there are also non-interest charges, such as a set-up fee, that can lead to the loan being expensive relative to other countries. In the case of credit cards, Ireland is unique in typically not applying maintenance charges (Kelly and Reilly, 2005). The same may be true for deposits, where consumers are content to receive a lower interest rate on deposits, such as current accounts, in return for lower non-interest charges on transactions.

2.4 Differences in the Fixation Period of Loans and Deposits

In the MIR data, loans are categorised within bands according to their initial fixation period and deposits are classified according to their maturity. If the concentration of the fixation period of loans/maturity of deposits are at different points on these bands across countries then, depending on the slope of the yield curve, this may cause differences across countries. For example, in a loan category with a fixation period of over 1 year and up to 5 years, one country may have an average fixation period of two years and another country may have an average fixation period of four years. At present, no information is available on the average fixation period in the bands for each country, so it is not possible to calculate the effect of this on cross-country differences.

2.5 Statistical Influences

It is also possible that the survey design and statistical production process can explain a portion of cross-country differences. The first influence is possible misclassifications or errors in classifying products into the correct category. The second possible statistical influence is the sampling method applied in the MIR statistics. The sampling method is detailed in McNeill (2003). As in any survey, sampling errors can affect the results. Another statistical factor that can cause cross-country differences is the sectoral classification. In some countries, such as Germany, the sole proprietor sector accounts for a large proportion of the household sector, whereas in Ireland, the sole proprietor sector has a relatively small share of the household sector. This differing composition is another potential cause of differences in interest rates.

3. Differences between Irish and Euro Area Retail Interest Rates

3.1 Overview of Differences

Statistics on the average new business interest rates in the euro area, alongside the new business interest rates in Ireland are

presented in Tables 1 and 2. New business is defined as any new agreement between the customer and the credit institution. The advantage of collecting interest rates on the volume of new business agreements in a month is that it allows the user to look at the cost of funds at a point in time. The data also allows the user to compare interest rates on similar products/markets across countries. The interest rates reported are the average interest rates between January 2003 and September 2006. Information on the distribution of interest rates within the euro area, namely the coefficient of variation², and the minimum and maximum rates are also presented. The final column in the tables shows the difference between the Irish and euro area interest rates. The main findings are detailed below separately for households and NFCs. This section is purely descriptive; the potential reasons for differences will be examined in Section 4.

Households

- Irish borrowers enjoy below average interest rates on loans for house purchase. This is significant because loans for house purchase account for 81 per cent of the total stock of personal credit at end-September 2006.
 - The main subcategory of loans for house purchase is floating and up to 1 year initial interest rate fixation. The average Irish rate over the period, at 3.55 per cent, is 9 basis points below the euro area average. Ireland has the fifth lowest rate in the euro area. The lowest and highest rates are 3.27 per cent (Finland) and 4.6 per cent (Germany), respectively.
 - In the remaining and growing mortgage category with an initial interest rate fixation of over 1 year, Ireland has the fourth lowest rate in the euro area. The interest rate at 3.83 per cent is 57 basis points below the euro area average.
- Irish overdraft interest rates to households (13.04 per cent) are the second highest in the euro area, behind Greece, and 318 basis points above the euro area average. Overdrafts account for 2 per cent of the total stock of personal credit and 10 per cent of non-mortgage credit. Overdraft interest rates display a high level of cross-country dispersion.
- The results for loans for consumption purposes are mixed. This category accounts for 14 per cent of total personal sector credit.
 - In the category of initial interest rate fixation of up to 1 year, the Irish interest rate is the sixth lowest in

² The coefficient of variation is independent of the level of interest rates and therefore allows comparisons of dispersion between instrument categories. A low value signifies a low level of dispersion and a high value signifies a high level of dispersion.

Table 1: New Business Retail Interest Rates for Households, January 2003 - September 2006

	Euro Area				Ireland		Interest Rate Difference
	Average	Low	High	Coeff. of Var.	Average	Volume ^a € million	<i>Irish less euro area average</i>
<i>Loans</i>							
Bank overdraft^b	9.86	5.63	13.76	0.17	13.04	2,123	3.18
For consumption purposes							
– Floating rate and up to 1 year initial rate fixation	6.90	3.76	10.75	0.26	5.42	253	-1.48
– Over 1 year initial rate fixation	7.23	4.58	10.26	0.10	7.72	230	0.49
For house purchases							
– Floating rate and up to 1 year initial rate fixation	3.64	3.27	4.60	0.10	3.55	2,630	-0.09
– Over 1 year initial rate fixation	4.40	3.51	6.86	0.09	3.83	559	-0.57
For other purposes	4.33	3.40	7.07	0.13	4.83	352	0.50
<i>Deposits</i>							
Overnight^b	0.74	0.13	1.31	0.51	0.54	27,425	-0.20
With agreed maturity	2.13	1.62	2.60	0.08	1.93	10,924	-0.20

^a Average monthly value of new business agreements. New business in these instrument categories is defined as any new agreement between the customer and the credit institution.

^b For these categories, new business is defined as outstanding amounts.

the euro area and 148 basis points below the average. This category has a particularly high level of dispersion, as measured by the coefficient of variation at 0.26.

– In the longer fixation period of over 1 year, the Irish interest rate is 49 basis points above the euro area average.

- Overnight deposits from households in Ireland receive lower than average interest rates. The Irish interest rate is the fifth lowest in the euro area. This category has by far the highest level of cross-country dispersion of any category.
- As can be seen in Table 1, large volumes of new business agreements in the deposit market are with agreed maturity. These deposits earn 20 basis points below the euro area average rate and are the second lowest in the euro area. The dispersion of interest rates is low in this category.

Non-Financial Corporations

- The interest rates on overdrafts to Irish NFCs are the fourth highest in the euro area and 128 basis points higher than the euro area average. The cross-country dispersion in this category is the highest of all loans to NFC categories.
- As shown in Table 2, loans other than overdrafts are broken down into two size categories: loans up to €1 million and loans over €1 million.

**Table 2: New Business Retail Interest Rates for Non-Financial Corporations,
January 2003 - September 2006**

	Euro Area				Ireland		Interest Rate Difference
	Average	Low	High	Coeff. of Var.	Average	Volume ^a € million	<i>Irish less euro area average</i>
<i>Per cent per annum</i>							
Loans							
Bank overdraft^b	5.44	4.12	16.98	0.20	6.72	4,367	1.28
Other loans up to €1 million							
– Floating rate and up to 1 year initial rate fixation	4.15	3.52	5.92	0.12	4.62	675	0.47
– Over 1 and up to 5 years initial rate fixation	4.74	3.86	6.31	0.07	5.17	113	0.43
– Over 5 years initial rate fixation	4.53	3.98	6.54	0.07	4.45	86	-0.08
Other loans over €1 million							
– Floating rate and up to 1 year initial rate fixation	3.20	2.96	4.30	0.08	4.30	1,999	1.10
– Over 1 and up to 5 years initial rate fixation	3.58	3.17	4.23	0.12	3.98	347	0.40
– Over 5 years initial rate fixation	4.19	3.66	4.47	0.09	4.05	248	-0.14
Deposits							
Overnight^b	1.00	0.33	1.73	0.44	0.41	16,903	-0.59
With agreed maturity	2.22	2.06	2.33	0.03	2.06	13,429	-0.16

^a Average monthly value of new business agreements. New business in these instrument categories is defined as any new agreement between the customer and the credit institution.

^b For these categories, new business is defined as outstanding amounts.

- Irish lending rates on loans to NFCs up to the value of €1 million are above the euro area average. The most important category is the fixation period of up to 1 year where the Irish rate is 4.62 per cent against a euro area average rate of 4.15 per cent. The Irish rate in the less important category of an initial fixation period of over 1 year and up to 5 years is 43 basis points above the euro area average.
- Loans over €1 million in Ireland, in general, also attract higher interest rates than the euro area average. Most of these loans have an initial period of fixation of up to 1 year. The Irish interest rate is 110 basis points higher than the euro area average, and ranks as the highest interest rate in the euro area. The fixation category of between 1 and 5 years is also relevant to Ireland, which has the fourth highest national rate in the euro area.
- Irish NFCs receive the second lowest interest rate on overnight deposits, receiving on average 0.41 per cent, while the average euro area rate is 1 per cent. This category has a very high level of cross-country dispersion.

3.2 Changes Over Time

The data discussed above relate to the average interest rates over the period January 2003 to September 2006. Of course, the

cross-country differences may not have been constant over time, so this sub-section examines the evolution of interest rates in Ireland and the euro area over the survey period. The focus is on six loan and deposit categories of particular importance to Ireland. These are: overdrafts (to households and NFCs), loans for house purchase with an initial fixation period of up to 1 year, loans over €1 million to NFCs with an initial interest rate fixation of up to 1 year and overnight deposits (from households and NFCs). Charts 1 to 6 present the data on these main loan/deposit categories.

The gap between the euro area and Irish interest rates on floating rate mortgages has always been relatively small, as is evident in Chart 1. The Irish rate has been below the euro area rate for most of the period but between the middle and end of 2005 the interest rate differential had almost disappeared. Since then, the rates in the euro area have increased at a faster rate than Ireland and the differential has reopened, where in September 2006, the Irish rate was 18 basis points below the euro area average. This indicates that Irish banks have not passed on the recent round of interest rate hikes to borrowers as much as their counterparts in the euro area. This slower pass-through of interest rates in Ireland is most likely due to increases in competition levels in the Irish mortgage market. The pass-through of interest rates in Ireland can be clearly seen in Chart 1, by the stepwise nature of the increase. Since the month prior to the most recent phase of interest rate increases starting in December 2005, the rate in this category has increased by 76 basis points.

Chart 1: Loans for House Purchase with an Initial Interest Rate Fixation of up to 1 Year

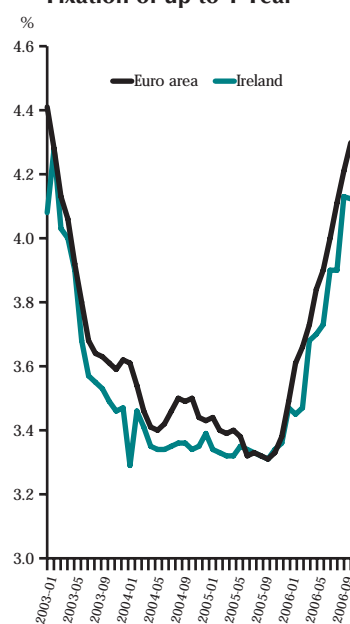
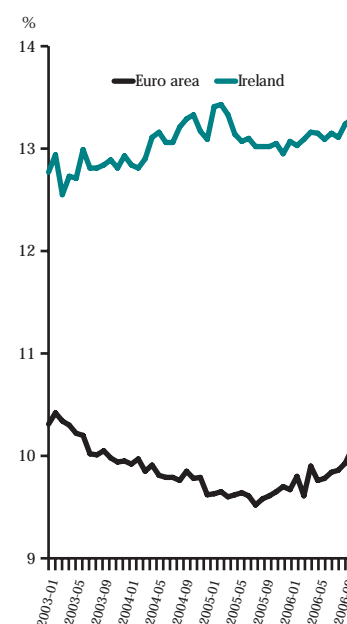


Chart 2: Overdrafts to Households



In the two overdraft categories, Irish interest rates have been consistently above the euro area rates over the whole period. For household overdrafts (Chart 2), interest rates in both Ireland

and the euro area have been relatively constant, with the interest rate differential increasing slightly up to mid-2005 but remaining relatively stable since then. The initial increase in the differential was caused by both a slight fall in the euro area interest rate (due to pass-through of ECB rate cuts) and a slight increase in the Irish rate (in spite of ECB rate cuts).

There has been more movement in interest rates on overdrafts to NFCs as is evident in Chart 3. In both Ireland and the euro area, the official interest rate cuts were passed through to borrowers, but at a slightly faster pace in Ireland and this led to a slight decrease in the gap between Irish and euro area rates in 2003. This gap has since increased and the gap between Irish and euro area rates now stands close to a study period high.

Chart 3: Overdrafts to Non-Financial Corporations

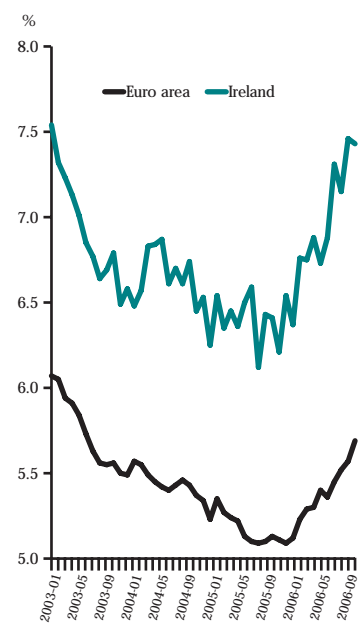
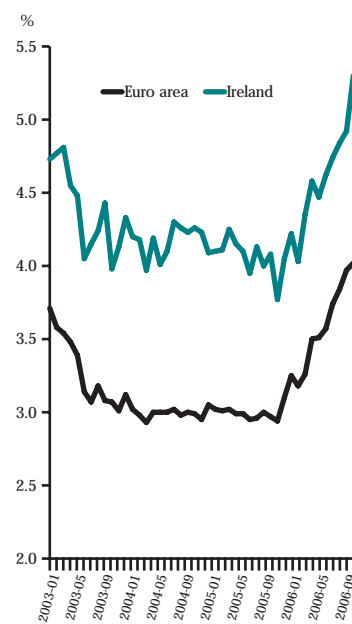


Chart 4: Loans to NFCs Over €1 million with an Initial Interest Rate Fixation of up to 1 Year

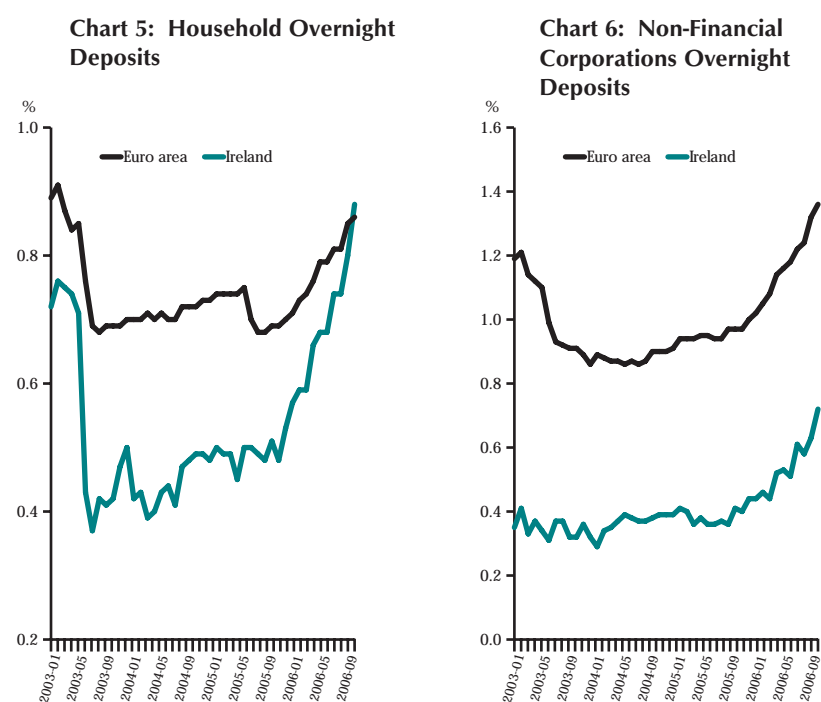


The largest loan category to NFCs, other than overdrafts, is for loans over €1 million with an initial interest rate fixation of up to 1 year. The evolution of interest rates in this loan category is displayed in Chart 4. The difference has remained relatively constant over time, with Irish interest rates being higher over the whole sample period. Both Irish and euro area banks passed on the 2003 rate cuts and the 2005 and 2006 rate increases to a similar extent.

The most dramatic convergence of interest rates has happened with respect to overnight deposits from households (Chart 5). The 2003 ECB interest rate decreases were passed on to a much greater extent in Ireland than in the euro area and this widened the interest rate differences significantly. The differential remained relatively stable until mid-2005 and has since narrowed rapidly. This is most likely due to the emergence of new competitive instant access savings accounts in the Irish market,

rather than increased remuneration of deposits in current accounts.

In contrast, interest rates on overnight deposits from NFCs in Ireland changed little over the period under study as seen in Chart 6. The interest rate gap narrowed in 2003 as interest rate cuts were passed on to depositors in the euro area while Irish rates remained relatively constant. The gap has increased again in 2006 as the ECB interest rate increases were passed through more to euro area depositors than Irish depositors.



4. Potential Reasons for Differences in the Irish Case

The examination of deviations of Irish interest rates from the euro area average reveals a mixed picture. Overall, Irish households enjoy lower interest rates on loans, while NFCs generally pay higher rates. Irish deposits are in general less well remunerated than the euro area average. The ECB has identified a number of possible causes for inter-country differences. The most likely general and specific causes for the spreads between Irish and euro area interest rates are discussed in this section.

4.1 Loans for House Purchase

The most important category for households in Ireland is loans for house purchase and, within this category, the fixation period of up to 1 year (including variable rate mortgages) is by far the largest. For such loans, the Irish interest rate is slightly lower than the euro area average but the difference is relatively small. The level of competition in the Irish banking market is a major factor in explaining the below average interest rates. The fixation periods for mortgages differ widely across the euro area. In

Ireland, over 82 per cent of the newly agreed mortgages in the sample period were in the category of up to 1 year initial interest rate fixation, and the vast majority of the remainder had an initial interest rate fixation of over 1 year and up to 5 years. In other countries, such as France and Germany, most mortgages have much longer fixation periods. As the variable rate mortgage market is not of high importance in these countries, banks may not concentrate their competitive efforts in this segment and this may explain the lower than average Irish interest rate. In the second most important mortgage category, 1 to 5 years initial interest rate fixation, Central Bank of Ireland data suggest that the bulk of Irish mortgages are in the 1 to 3 years initial interest rate fixation band. This will cause the average fixation period for Ireland in this category to be towards the lower end of the fixation band. Assuming an upwards sloping yield curve, as is evidenced in the data, this may partially explain Ireland's below average rate in the over 1 year fixation category.

4.2 Overdrafts

The reasons for differences in cross-country overdraft interest rates are similar for both households and NFCs. The primary reason for the large cross-country differences is product differentiation. Overdrafts are not widely available in many countries of the euro area. In these countries very small volumes are reported and the interest rates reflect characteristics of atypical borrowers. In some countries these atypical borrowers are high net worth clients who pay relatively low interest rates, while in other countries the overdrafts are unauthorised and have punitive interest rates. Two specific factors help explain the high rates on overdrafts in Ireland. The first is the pronounced differences in collateral practices on overdrafts. In Ireland, overdrafts are typically unsecured. In many euro area countries it is standard practice for overdrafts to be secured. For households this security could be the next pay cheque (Austria and the Netherlands) and in the case of NFCs the collateral is often invoices (France). The collateralised overdrafts attract a lower interest rate due to the lower level of credit risk carried by banks.

The second factor contributing to the high overdraft rate for Ireland is the inclusion of credit card balances in the data. Under the ECB regulation underpinning the data collection, interest bearing credit card balances are included in the overdraft category. Credit cards usually have a higher interest rate than overdrafts and hence bias up the interest rate for this category. In the MIR statistics, only the interest-bearing balance on credit card accounts is included. In many euro area countries, credit cards are structured very differently to Ireland. In the simplest case, some countries' credit cards are primarily granted by non-MFIs (and therefore are not included in the MIR statistics). In a number of countries, credit cards have significant annual or

quarterly fees and this is then accompanied by lower interest charges. In other countries credit cards act more as delayed debit cards (linked to a current account or term loan account). Since these cards only offer interest free convenience credit, they are therefore not included in the overdraft categories. The MIR Expert Group found that overdraft rates in Germany and Ireland were most affected by the inclusion of credit card balances in the overdraft category.

4.3 Loans for Consumption Purposes

Interest rates on loans to Irish households for consumption purposes are below the euro area average. This may be due to the higher use of collateral in Ireland than the euro area. Anecdotal evidence also suggests that relationship banking has a strong influence on lowering the average rate in Ireland. When Irish banks were surveyed about the relatively low rates in Ireland, many banks said that the low rates were due to loans advanced by their private banking divisions. These loans are usually priced at preferential terms and are often for significant volumes to high net worth individuals and hence lower the reported interest rates. It has also been indicated by several banks that borrowing for consumption that is secured on property has a downward influence on interest rates in this category.

4.4 Loans to Non-Financial Corporations

The ECB report on cross-country differences (ECB, 2006) found it difficult to explain the gaps in interest rates on loans to NFCs, where interest rates in Ireland are generally above the euro area average. It is thought that collateral practices, market environments and non-interest charges may explain some of the differences, while firm size may have an important impact. Smaller countries such as Ireland tend to have a higher concentration of smaller firms. For any given size of loan, larger companies, in general, present less credit risk than smaller companies. Information on the financial position of larger companies may also be easier to access through rating agencies and published accounts than similar information on smaller companies, thus increased knowledge about large companies' financial positions may decrease the credit default risk.

These large companies also have alternative sources of funding and these alternative sources increase the level of competition, in particular for loans over €1 million. For these large loans (primarily to large companies), banks not only face competition from each other, but would also face competition from alternative financing sources such as capital markets.

In comparison to the household sector, the NFC sector is a relatively heterogeneous sector, and in addition to comprising

small and extremely large companies as discussed above, it includes firms operating in all areas of the economy from construction to manufacturing to the services sectors. It is possible that differences in the sectoral composition of the new business lending across countries may be a cause for differences in interest rates. Credit institutions will take sector specific factors into account as they price risk.

In Ireland, real estate and construction sectors have recently accounted for a large proportion of credit growth to the NFC sector, while the more traditional sectors such as agriculture and manufacturing have lagged behind. These changes have been highlighted in the CBFSAI's quarterly release 'Sectoral Developments in Private-Sector Credit' (CBFSAI, 2006). A sectoral breakdown of new business lending is not available but the quarterly outstanding amount sectoral data, collected by the CBFSAI, can be examined. From the data it is possible to calculate each sector's contribution to the increase in NFC lending over the study period. This net increase can be used as a proxy for the sectoral breakdown of the gross lending data. Table 3 shows the contribution of each sector to the total increase in NFC lending from end-December 2002 to end-September 2006.

Table 3: Sectoral Distribution of Increases in NFC Credit, December 2002 - September 2006

	€ million	% share of total change
Agriculture & Forestry	1,057	1.6
Construction	15,010	22.7
Hotels & Restaurants	4,703	7.1
Manufacturing	1,340	2.0
Real Estate Activities	35,462	53.7
Wholesale/Retail Trade & Repairs	5,646	8.6
Other	2,799	4.2
Total increase	66,018	100.0

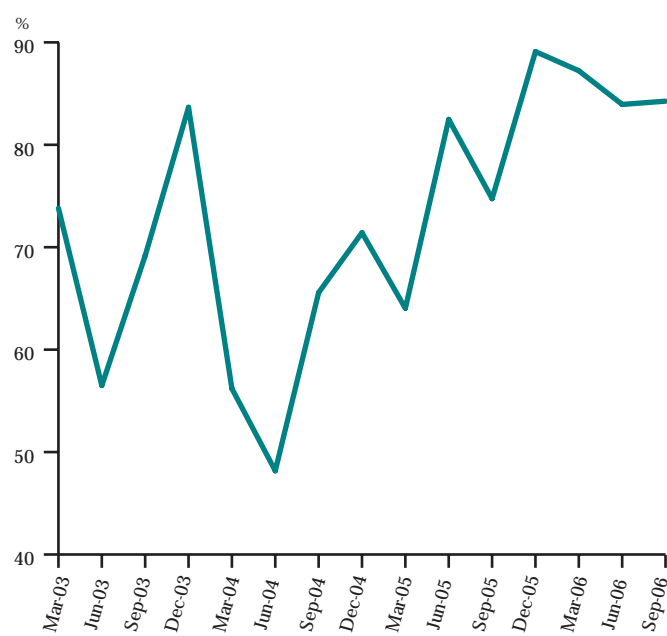
Source: Table C8 of Statistical Appendix to CBFSAI Quarterly Bulletin.

Note: The increase in NFC credit is estimated by excluding the sectors that are not NFCs (Financial Intermediation, Education, Health and Social Work, Other Community, Social and Personal Services and Personal sectors) from Table C8.

It can be seen that two sectors dominate the lending. They are the Real Estate and Construction sectors. The Real Estate sector accounted for 53.7 per cent of the net increase in lending over the period and the Construction sector accounted for a further 22.7 per cent. The joint contribution of the Construction and the Real Estate sectors to the net increase in NFC lending for each quarter since March 2003 is illustrated in Chart 7. This shows that although volatile, these sectors have consistently been an important and increasing component of credit to NFCs. This indicates that a very high concentration of new business loans are going to the Construction and Real Estate sectors. Another sector of interest is the Hotel and Restaurant sector, which

accounted for over 7 per cent of the net lending and it is possible that much of this lending may also be construction/real estate related. With such a high level of concentration in specific sectors in Ireland, the MIR NFC data is strongly skewed towards construction and real estate markets and thus potentially reflects banks' pricing of risks in these markets rather than an economy wide price of loans to NFCs.

Chart 7: Construction and Real Estate Sectors' Share of NFC Net Lending



4.5 Overnight Deposits

The interest rate on household overnight deposits in Ireland is below the euro area average although recently this has narrowed significantly and for the first time in September 2006, was above the euro area average. This low rate over the period is due to a large share of current accounts that earn very low or zero interest. Money market fund type deposits that pay interest similar to the prevailing wholesale money market rate dominate the overnight deposit category in many countries. Different business practices also play a role; for instance, in Belgium interest rates are high on current accounts to attract customers and this is then offset by charging fees relating to transactions. The situation in Ireland has improved recently with the increase in popularity of instant access savings accounts that pay a competitive interest rate, and, in particular, online accounts.

5. Conclusions

Retail interest rates in the euro area have not converged to the same extent as those in wholesale financial markets since the creation of EMU. This is primarily due to a lack of integration in retail financial markets. The ECB has investigated the reasons for this and has identified a number of specific factors which explain differences in interest rates across countries.

A comparison of Irish and euro area interest rates reveals that, with the exception of overdrafts, Irish households have enjoyed lower interest rates on their borrowing than most of their euro area counterparts. In contrast, NFCs pay above average interest rates on all significant loan categories. Both households and NFCs receive a lower level of interest rates on deposits, although there has recently been a marked improvement in the interest rates received by Irish households on overnight deposits, which have converged to the euro area average.

There are many reasons for the gap in interest rates between Ireland and the euro area. There is no 'one way' of doing retail banking in euro area retail financial markets. National market conventions differ widely on seemingly straightforward products such as overdrafts. Different regulations across euro area countries contribute to differences in interest rates. The high level of competition in the Irish mortgage market in recent years is an important factor in explaining the below average mortgage rates. Although it is difficult to account for, two likely factors that help explain the high Irish rates on loans to NFCs are firm size and the sectoral distribution of loans.

Many of the impediments to the integration of retail financial markets are due to national market preferences and banking practices. Consumer preferences and product structures are often based on the traditional national legal and cultural conventions and these may be slow to change. Considering these factors, it is difficult to envisage complete convergence of retail interest rates in the euro area in the short term.

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