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The importance of the banking sector as a key player in interest rate passthrough has been recognized recently in literature concerning monetary policy transmission mechanisms. The interest rate channel, which operates when banks pass on changes in the monetary policy rate to interest rates for the customer, depends on how banks react to different shocks and to the state of the economy.

Given a change in the policy rate, the degree of rigidity in short-term interest rates is largely explained by the different features of the financial structure, such as the degree of competition in the banking sector, the size of the bank, the types of clients, and the loan-risk level financial institutions face.

The financial structure also can influence interest rate pass-through by affecting the way financial markets respond to macroeconomic conditions. In this respect, a macroeconomic shock can impact market interest rates directly, at the same time as the policy rate is responding to that shock. Therefore, when determining policy, monetary authorities should consider how the banks behave under different economic conditions.

The idea illustrated in this paper is that the way market interest rates respond to changes in the policy interest rate depends on how banks and financial markets react to the various shocks that affect the economy. A theoretical microeconomic model of the banking sector is used for that purpose and some evidence for the Colombian economy is presented.