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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, especially credit rates. Finally, the evidence presented shows the importance of banks' characteristics and inflation as long-run drivers of interest rates.

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