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The ECB's operational framework review: why? how?

On 18 September 2024, the Eurosystem will reduce the spread between its refinancing rate and that of its deposit facility. In March, against the backdrop of a normalisation of its balance sheet, the ECB announced this change to its monetary policy operational framework, confirming that it would steer monetary policy by adjusting the deposit facility rate.

On 13 March 2024, the European Central Bank (ECB) announced a review of its operational framework, an exercise it is undertaking for the first time. Indeed, since 1999, while monetary policy instruments have evolved considerably in line with economic and financial developments - notably through the creation of so-called “unconventional” tools and the transition to an excess liquidity regime - the conceptual framework has not been formally revised. This review, announced in 2022 in the context of a normalisation of the Eurosystem's monetary policy, is intended to supplement the monetary policy strategy review carried out in 2021.

From the standard framework to unconventional monetary policy tools with excess liquidity

Prior to 2008, the ECB sought to achieve its price stability objective by adjusting its main instrument: its key interest rates. These rates de facto created a corridor for its operational target, the overnight money market rate (Chart 1, left-hand side). This is because it is not in the interest of banks to borrow at a rate higher than its upper-bound (the marginal lending facility rate, at which they can borrow from the ECB on a daily basis), nor to lend at a rate lower than its lower-bound (the deposit facility rate). Between these two bounds, the main refinancing operations rate was considered to be the main rate in the operational framework, acting as an anchor for money market rates. The Eurosystem granted financing to eligible banks (the monetary policy counterparties) for a period of 1 week to 3 months, against collateral, at a variable rate determined at each operation by the banks' bids in the form of auctions. In this model, the amount of liquidity made available is determined by the central bank (known as “supply-driven”). The ECB then calibrates the amount of liquidity allocated to banks to meet their needs, taking into account factors under its control (i.e. reserve requirements) and factors outside its control (i.e. autonomous factors, such as banknotes or government deposits). It therefore steers the average refinancing rate so that it remains within its rate corridor: the more liquidity allocated, the lower the refinancing rate and vice versa. By using this corridor approach to steer rates, the Eurosystem's operational target therefore fluctuates around the refinancing rate.

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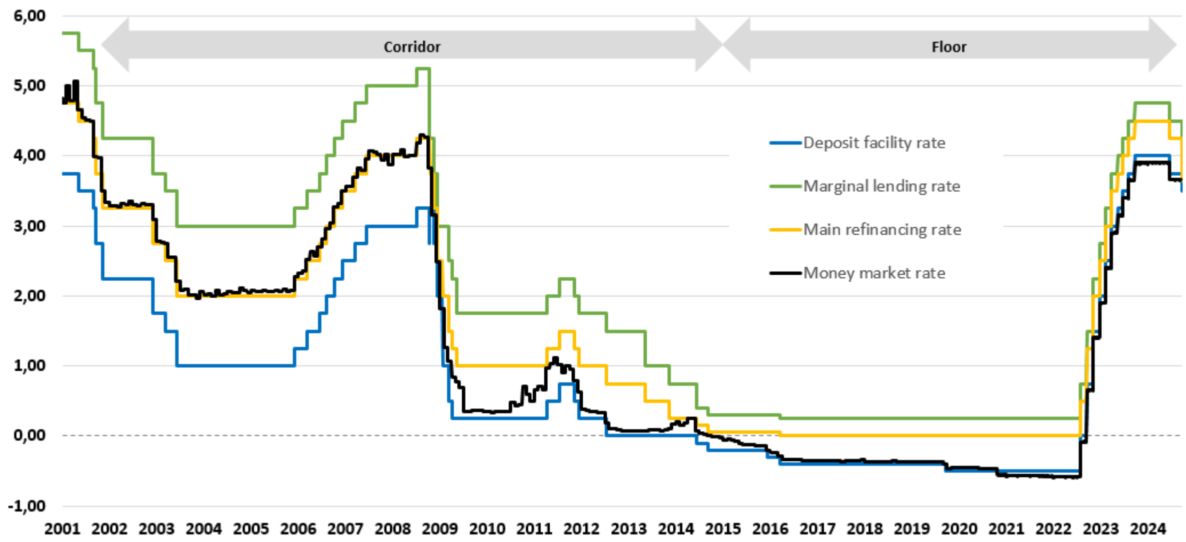
Chart 1: Changes in the ECB key rates and the overnight rate (%)



Source: *Banque de France, ECB*
Overnight rate: Eonia before October 2020, €STR after October 2020

In 2008, the financial crisis created a climate of mistrust between banks and a freeze on unsecured interbank transactions. To address this, central banks injected massive amounts of liquidity into the financial system. As of October 2008, the ECB changed its intervention method by allocating its refinancing at a fixed rate with unlimited amounts (fixed rate full allotment - FRFA). This model is known as “demand-driven” because the amount of liquidity granted by the central bank is determined by the demand for liquidity by banks. Subsequently, as of 2015, when the ECB's ability to lower its key rates into negative territory became limited, it resorted to non-standard measures to inject liquidity (asset purchase programmes and refinancing operations with maturities of up to 3 years).

The amount of liquidity provided by the Eurosystem via its monetary policy thus increased from EUR 1,000 billion to EUR 7,000 billion between 2008 and 2021 (Chart 2). This mechanically pushed money market rates down, steering them away from the refinancing rate and towards the deposit facility rate ever since (Chart 1, right-hand side). Against this backdrop of excess liquidity, banks recourse to the unsecured interbank market, i.e. not intermediated by the central bank's balance sheet, was very limited. The remaining transactions mainly involved non-banks placing their funds with banks with a monetary policy counterparty status. These banks then accept these deposits at an interest rate lower than that of the deposit facility and reinvest them with the central bank at a margin. This margin reflects the excess liquidity position and the regulatory cost.

Since 2022, the ECB has been normalising its monetary policy in order to combat inflationary shocks, raising key interest rates and gradually reducing the size of its balance sheet. Indeed, the fact that it

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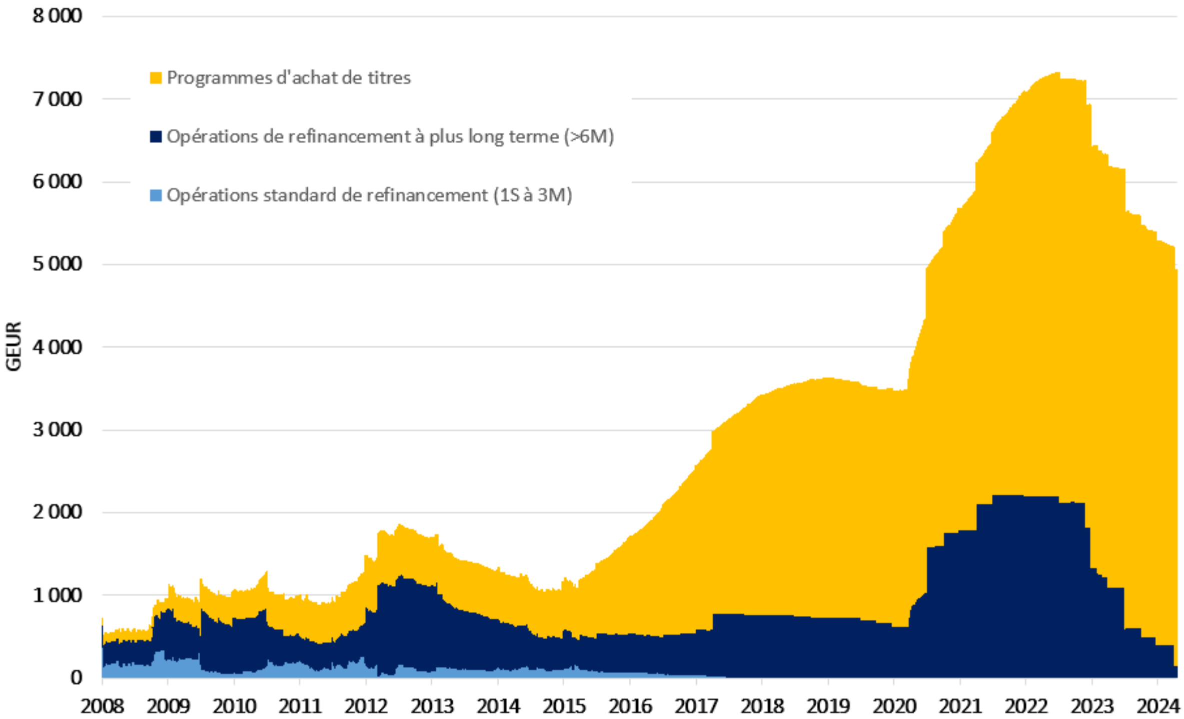
discontinued its targeted longer-term refinancing operations (TLTRO III) and ceased to roll over maturing securities purchased under the asset purchase programmes reduced the overall amount of liquidity provided by the central bank, which fell back to EUR 5,000 billion in March 2024.

Chart 2: Gross liquidity injections by the ECB monetary policy operations (EUR billion) Ass



Source: Banque de France, ECB

The ECB confirms that it will steer monetary policy through the deposit facility rate

Against this backdrop, the ECB has decided to review its operational framework in order to ensure that its monetary policy is smoothly transmitted irrespective of the economic and financial environment, while adapting to the diversity of banking models in the euro area. This framework is built on six key principles: effectiveness, soundness, flexibility, efficiency, market economy, and taking account of the ECB's secondary objectives, in particular climate-related risks.

After a period of exceptionally high excess liquidity, the ECB will continue to provide ample liquidity to the financial system via a broad set of instruments, including standard refinancing operations (one-week and three-month) and structural operations - in the form of longer-term refinancing operations and securities portfolio. Standard refinancing operations will be conducted on a fixed rate full allotment (FRFA) basis in order to meet banks' liquidity needs, and will continue to be backed by a broad collateral framework. Structural operations, whose characteristics and timing have yet to be defined, will incorporate climate-related criteria wherever possible, in line with the ECB's secondary objective.

This means, in practice, that the anchoring of money market rates at the floor of the corridor, as practised since 2015 (Chart 1), has been formalised. Some volatility in money market rates around the deposit facility rate will nevertheless be tolerated and will not systematically lead to intervention by the central bank, as long as these movements do not affect the monetary policy stance.

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These changes reflect developments in the financial system since 2008, with the central bank adapting elastically to banks' liquidity needs, which are larger than before for regulatory and precautionary reasons.

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Lastly, the ECB announced that it was reducing the width of its corridor by narrowing the spread between the deposit rate and the refinancing rate to 0.15% (from the current 0.50%). This decision will take effect on 18 September 2024 and is designed to make the use of main refinancing operations more attractive, by reducing the spread between the cost at which banks obtain refinancing from the central bank and the rate at which they can deposit funds with the central bank. Maintaining a spread nevertheless leaves room for money market transactions and market financing for banks.