EUROPEAN CENTRAL BANK

EUROSYSTEM

The ECB's operations amid the financial turmoil: experience and policy lessons

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Overview

- Basic principles of the ECB's operational framework

  ⇨ main objectives and elements

- Liquidity management during turmoil

  ⇨ eligible collateral and counterparties

- Risk management considerations

- Policy lessons

  ⇨ usual disclaimers apply, views given are personal

ECB's operational framework: key objectives

- Signalling the stance of monetary policy
- Steering of (very) short term interest rates
- Provision of refinancing to the banking system in an efficient way and under all circumstances

ECB's operational framework: main elements

- Minimum reserves
  - ⇨ averaging provision over the maintenance period
- Regular open market operations
  - ⇨ main refinancing ops (MROs), 1-week frequency and maturity
  - ⇨ long-term refinancing ops, (LTROs), 1m frequency, 3m maturity
  - ⇨ fine-tuning ops (non-regular frequency, non-standardised maturity)
- Interest rate corridor set by standing facilities
  - ⇨ marginal lending facility (ceiling for overnight mkt interest rate)
  - ⇨ deposit facility (floor for overnight mkt interest rate)

ECB's operational framework: basic principles

- Clear distinction between monetary policy and liquidity management
- Steer overnight rate close to ECB's key policy rate
  ⇨ so as not to blur the monetary policy signal
- Support proper functioning of the money market
  ⇨ helping credit institutions to meet their liquidity needs smoothly

Liquidity management during turmoil

- In ‘normal’ times....

⇨ ECB calculates banking sector’s liquidity needs for each week of a reserve maintenance period, benchmark amount for MROs

⇨ banks want to fulfil reserve requirements smoothly during maintenance period → weekly allotment close to benchmark

- During turmoil...

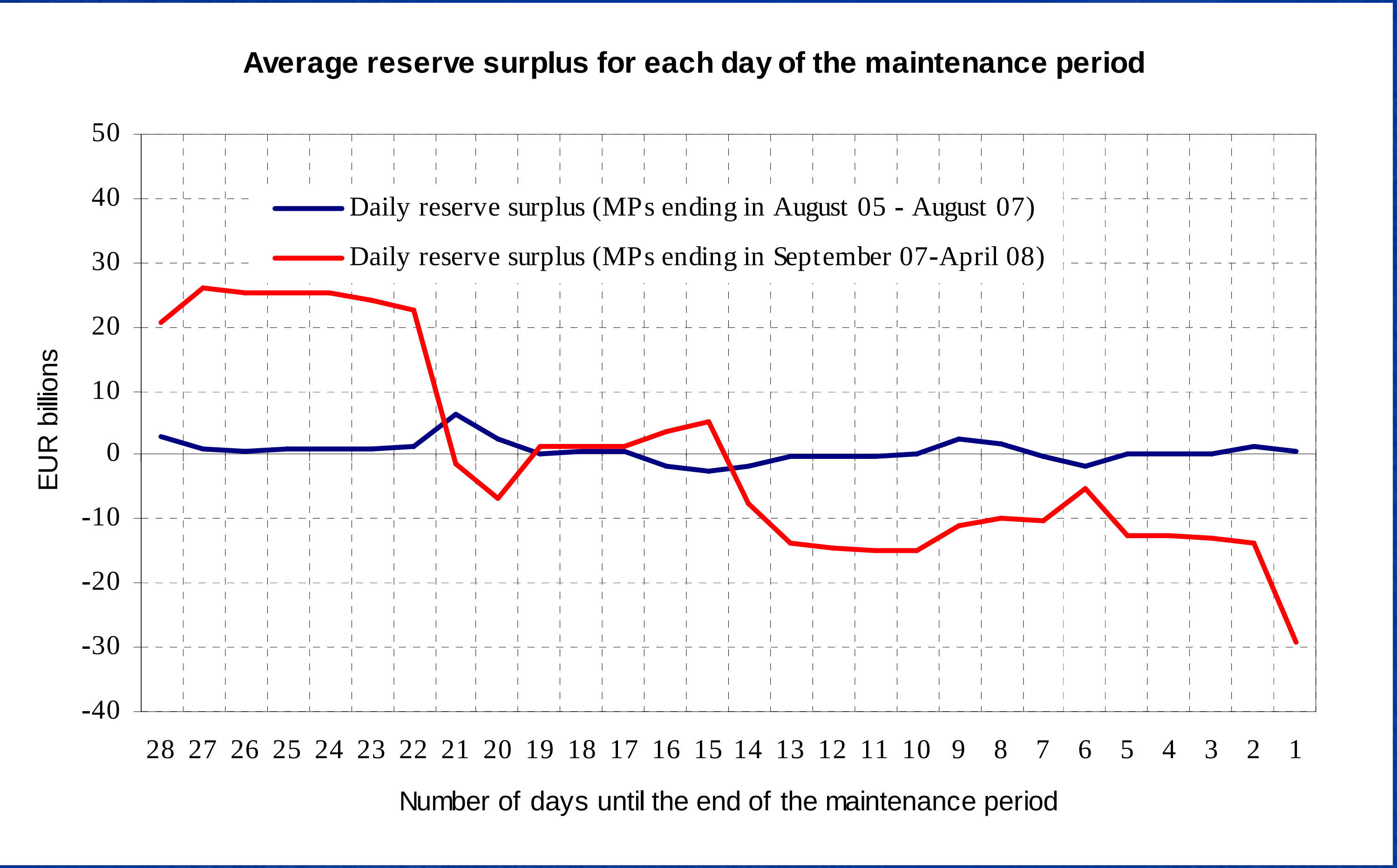
⇨ ECB accommodated bank’s desire to ‘frontload’ liquidity supply, larger share given early in maintenance period

⇨ but over the whole maintenance period no additional liquidity was provided, less liquidity towards end or absorbed excess with FTOs

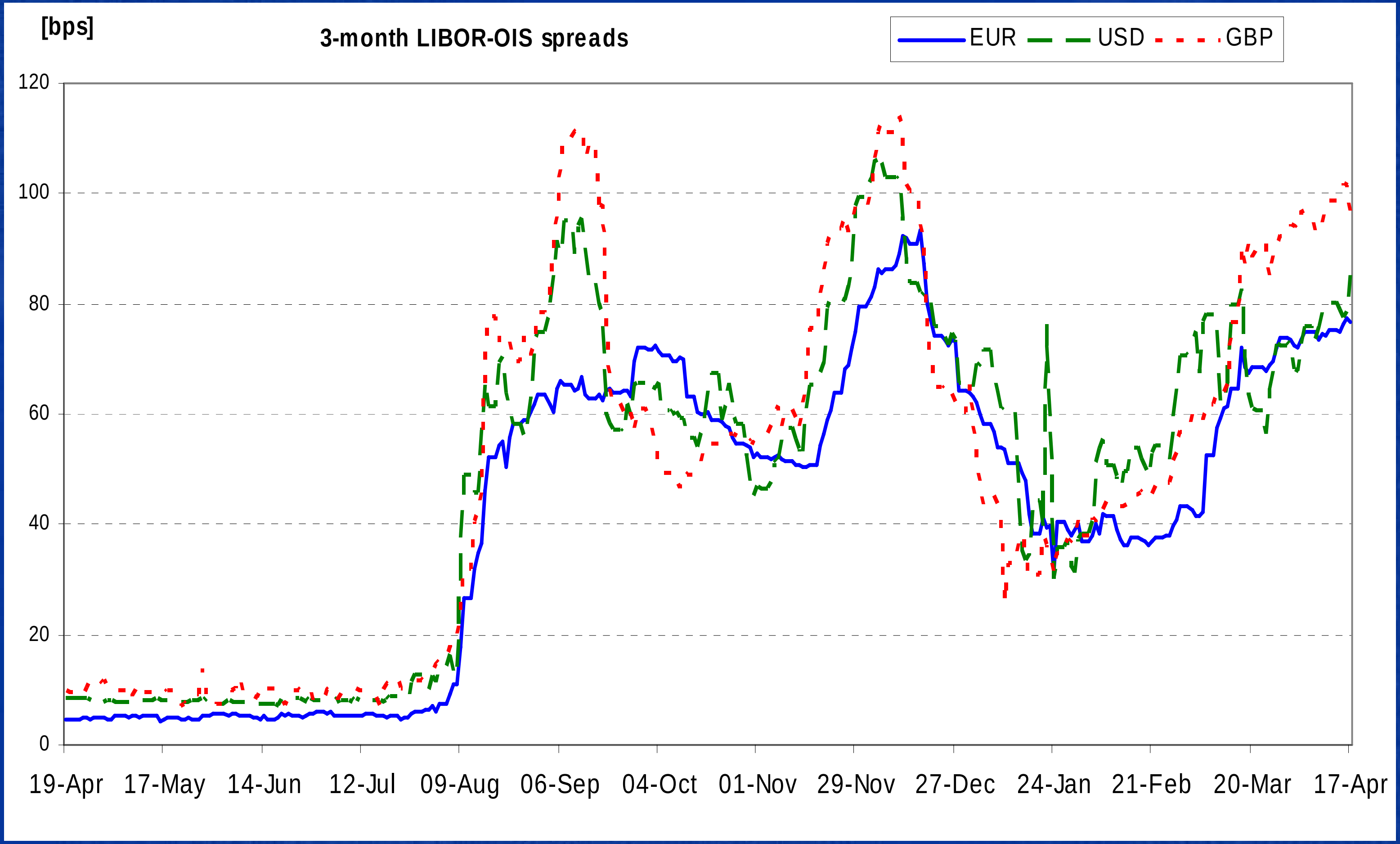
⇨ ECB also extended maturity of liquidity to accommodate demand → higher share of long-term refinancing ops (LTROs)

⇨ plus swap line with Fed (in context of TAF) to reduce euro area banks’ liquidity gaps in USD

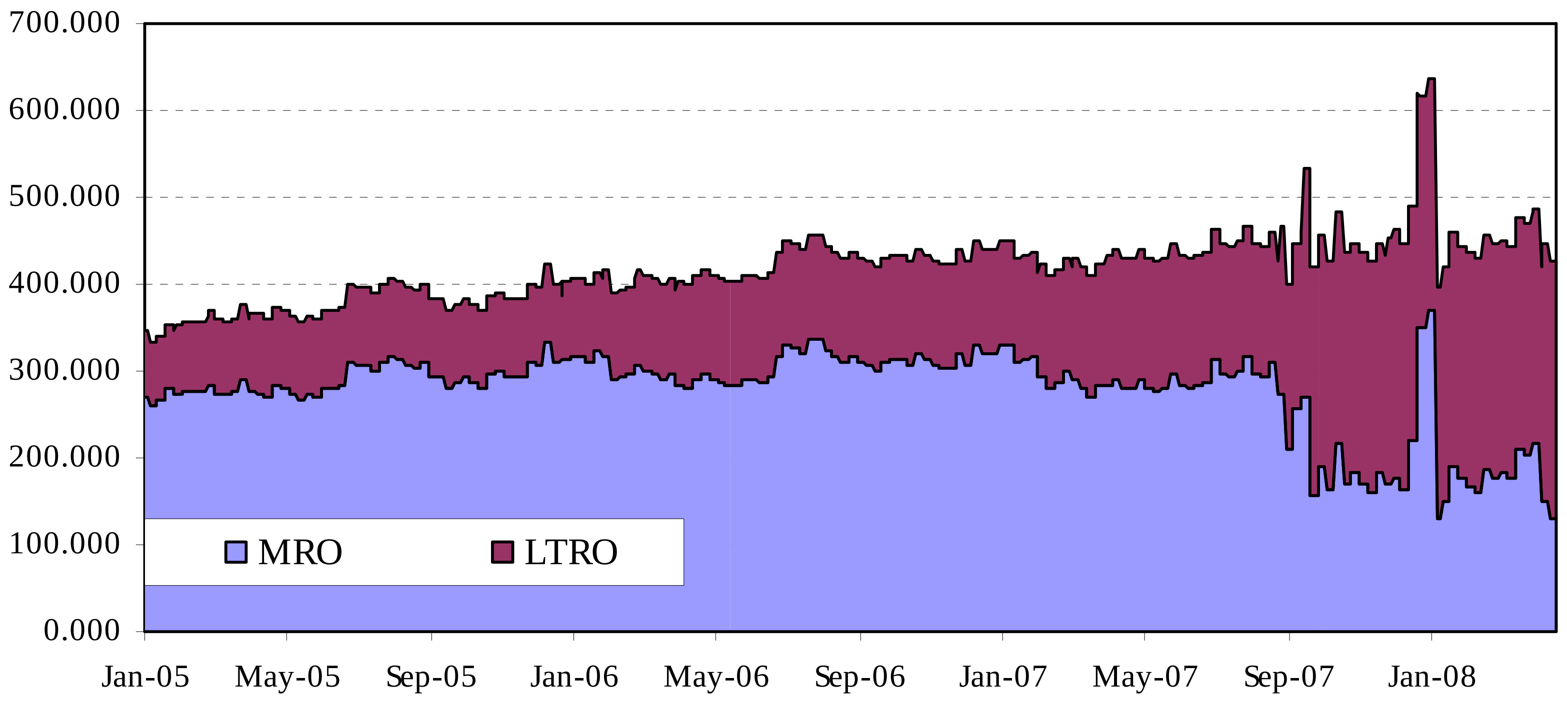
Modified liquidity supply pattern during turmoil



Widened 3-month deposit-OIS spreads

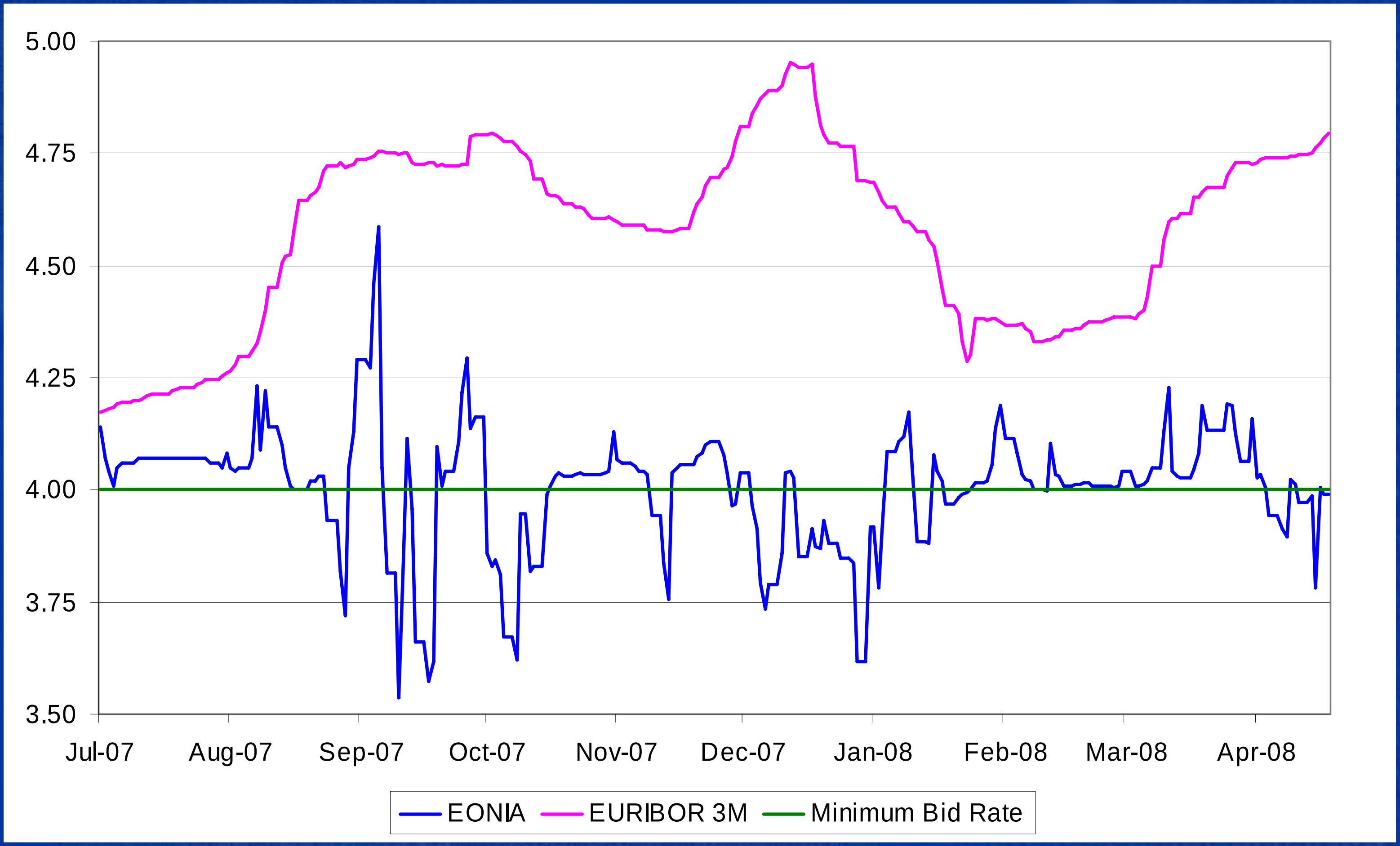


Extended maturity of liquidity during turmoil



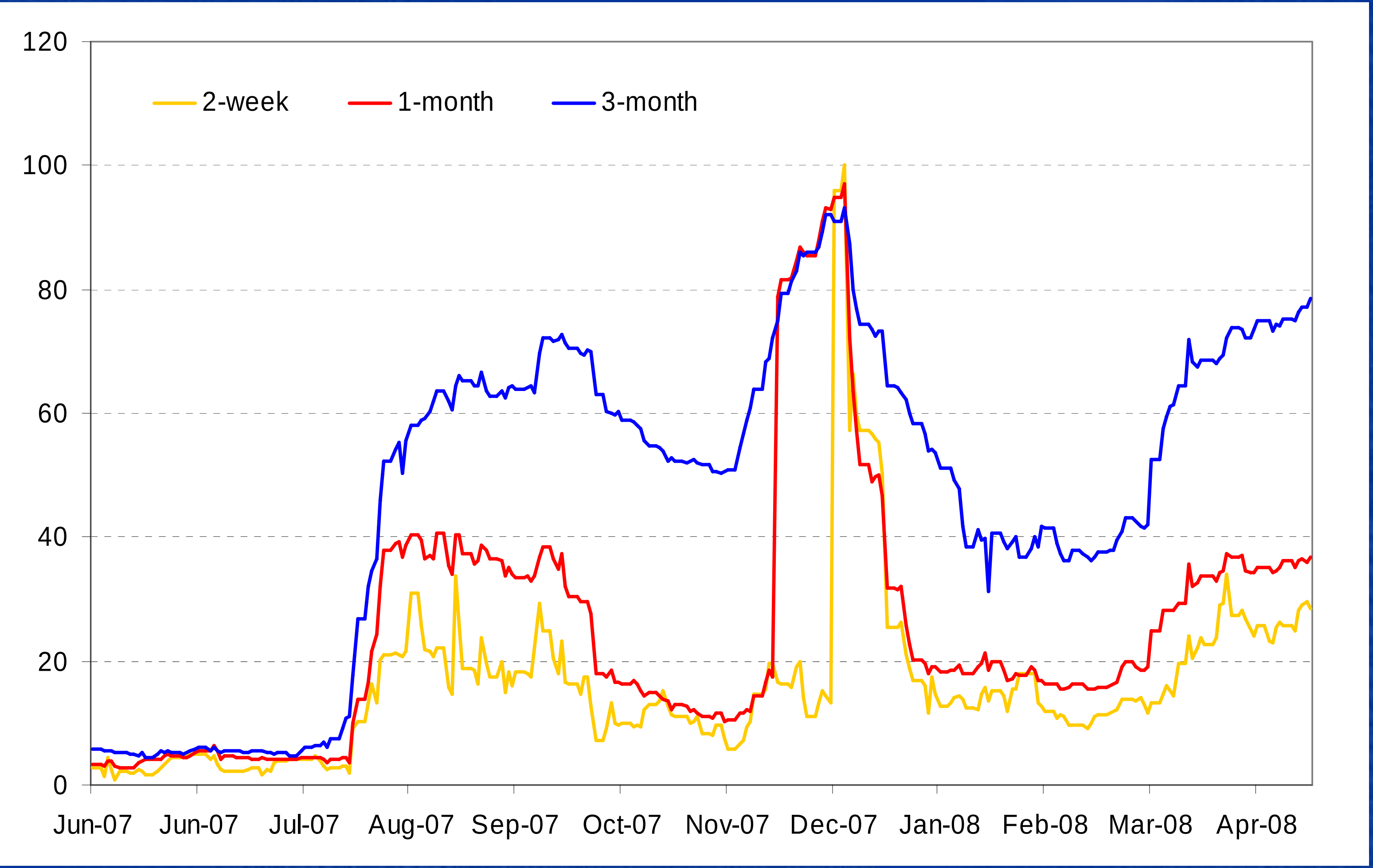
⇨ ECB also enhanced communication efforts with markets in order to explain adjustments to liquidity supply pattern and maturity

EONIA a bit more stable, closer to ECB policy rate...

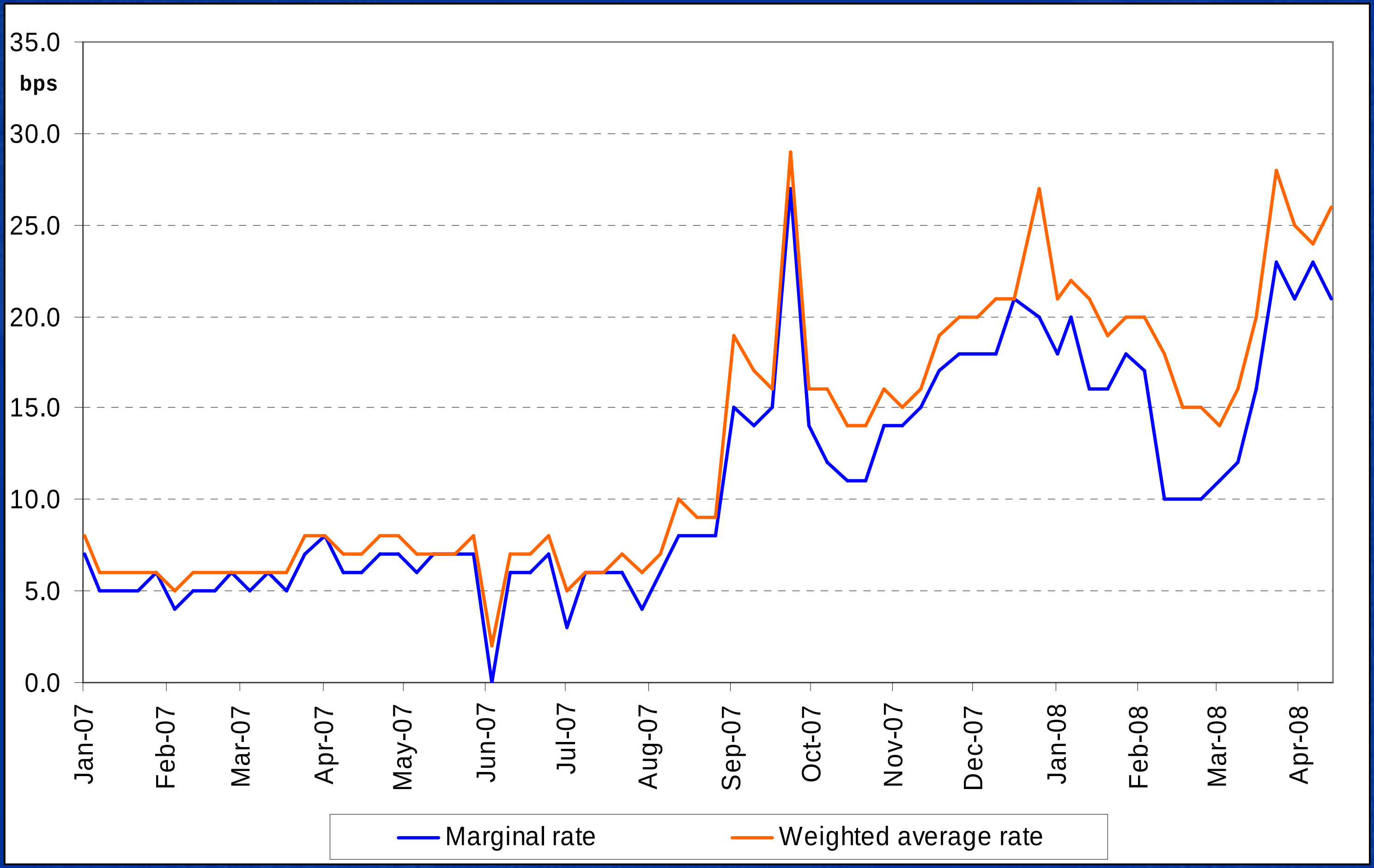


...but market conditions have yet to settle...

EURIBOR versus Overnight Index Swap spreads



..and spread between MRO and min bid rate persists



Collateral and counterparties: Eurosystem set-up

- Wide range of debt instruments accepted as collateral

  ⇨ government bonds, covered bonds, asset-backed securities, uncovered bank bonds, corporate bonds, credit claims

- No differentiation between tender operations, standing facilities, intraday credit for collateral purposes

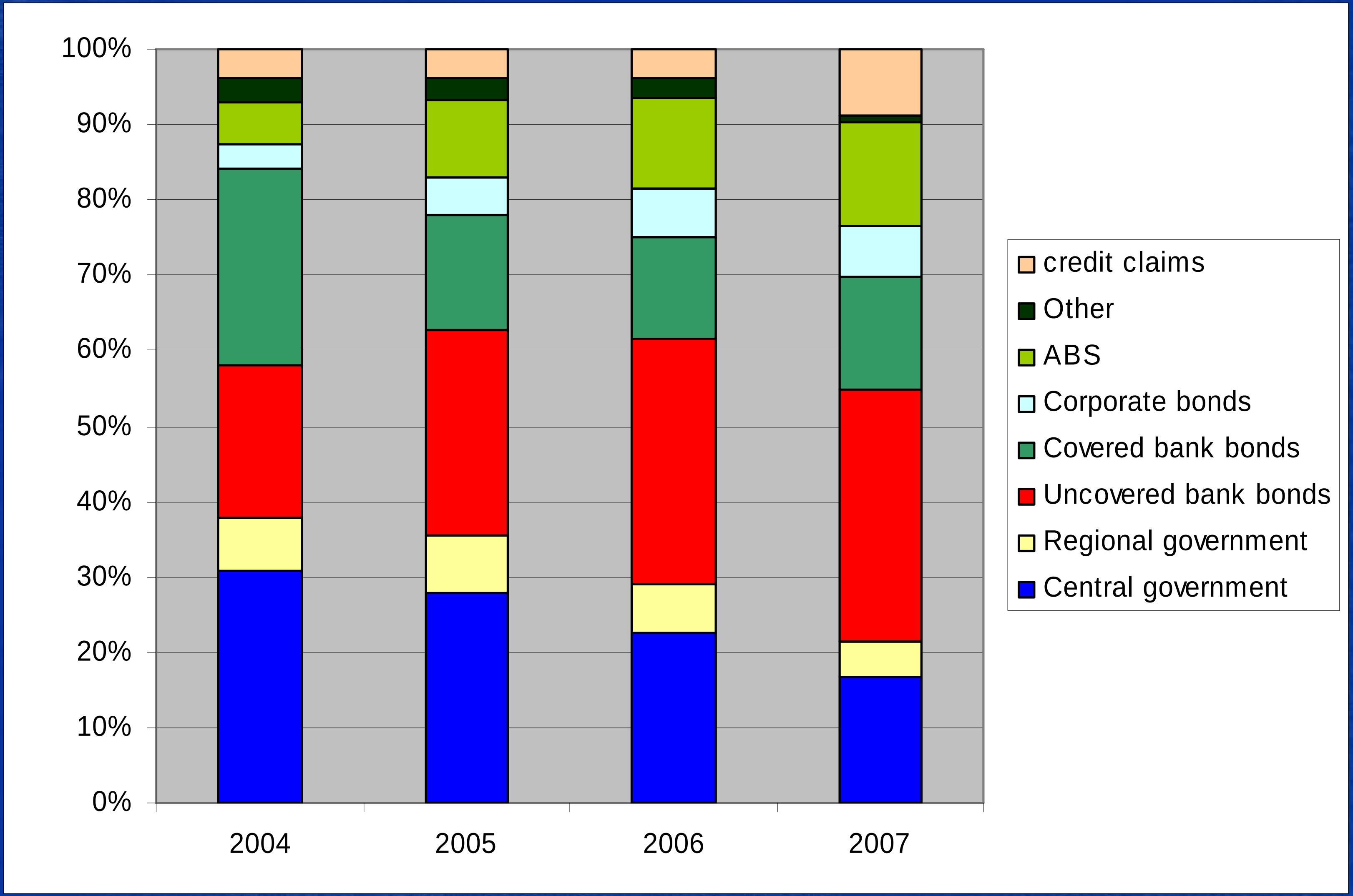
- Large set of counterparties with potential access to Eurosystem's refinancing operations

- Framework has worked well amid the financial turmoil

  ⇨ eligibility criteria for accepted collateral have not been softened

  ⇨ no structural changes made to existing arrangements

Collateral held with Eurosystem by type



Risk management considerations

- Marginal deterioration of credit quality of counterparties

  ⇨ decline in ratings and rating outlooks of major euro area bank groups

- Slight deterioration of credit quality of collateral

  ⇨ increased use of bank bonds (lower average ratings than gov't bonds)

- Deterioration of average liquidity of collateral

  ⇨ shift to less liquid asset classes (bank bonds, ABSs)

- Concentration risk has increased

  ⇨ bank bonds (liabilities from the same industry as the counterparties with whom the Eurosystem credit operations are conducted)

  ⇨ ABSs (financial links with the counterparty that submits them, e.g. originator, liquidity provider, swap counterparty)

⇨ Higher financial risk-taking by the Eurosystem

Policy lessons: Eurosystem-specific

For the ECB…

- ⇨ Eurosystem’s operational framework has adequate features (broad range of collateral and counterparties), level of inherent flexibility
- ⇨ ECB actions during turmoil in line with dichotomy between monetary policy and implementation → importance of communication
- ⇨ patterns of liquidity supply and maturity structure adjusted in response to liquidity demand → monitor conditions of short-term money markets
- ⇨ collateral framework ensured that assets which became illiquid during the turmoil could still be used to raise liquidity from the Eurosystem
- ⇨ financial risk taking by Eurosystem increased. Risks deemed to be justifiable, but changes to the risk control framework may be considered to address trends in the use of collateral that intensified during turmoil

Policy lessons: role of central bank operations

For central banks more broadly...

⇨ recent FSF report recommends flexibility in operational framework as regards central bank ops (collateral, counterparties, maturities, swaps)

⇨ may lead to some revision of (and convergence in) central bank operational objectives and policy instruments

⇨ recall that broad role for central banks is to steer aggregate market liquidity conditions in a way that supports banks' liquidity management across time consistent with price stability

⇨ underlying sources of turmoil lie beyond scope of central bank ops. Central bank ops not designed to solve fundamental problems of individual banks and credit markets