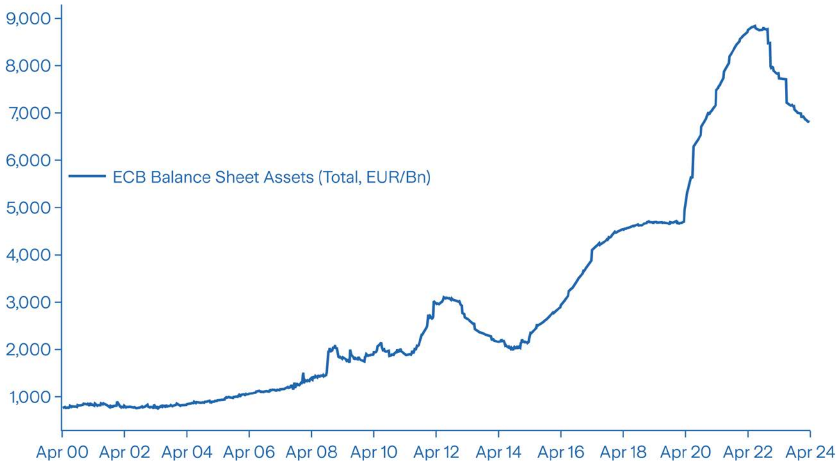
Topical Thoughts
April 2024

The ECB in the modern era

On March 13th the European Central Bank (ECB) announced its new 'Operational Framework', to the excitement of approximately 10 people! This formalises profound changes in how the ECB have generally conducted monetary policy since the Global Financial Crisis, and brings with it additional tools. The details of these operations are often referred to as the "plumbing" of our financial system, understandably seen as arcane and opaque even by those interested in markets. But it really does matter, and the ECB's plans are a positive for stability in the Eurozone's monetary and financial system.

Central banks play a hugely important role in our current financial system, far broader than simply setting the price of short-term interest rates. Historically large balance sheets, 'unconventional policies' such as Quantitative Easing (QE) becoming standard, and increasing flexibility to announce creative policy during crises are all part of the modern playbook. The ECB is no exception, and the new framework formally encapsulates this. The ECB's new framework is likely to mean easier and more evenly distributed access to liquidity across the Eurozone, greater flexibility during times of stress, a portfolio of securities outside of QE, and for the first time adds an explicit climate angle to monetary policy. While there are political implications and debates yet to be had, we see this framework as another step in building robustness and unity within the Eurozone.

Chart 1: Balance sheet expansion during the ECB's 25 year history



Source: Bloomberg, European Central Bank

The announcement

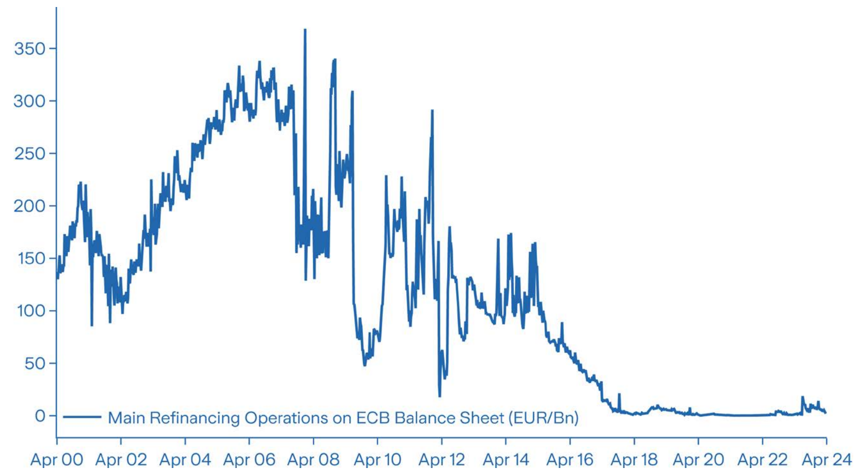
ECB President Christine Lagarde announced a formal review into monetary operations in December 2022, with the results recently published in March 2024. We've received a mixture of specific changes and vaguer principles, with the central bank giving itself deliberate flexibility in the future. The ECB will set policy primarily with the deposit rate, but will encourage banks to use the weekly Main Refinancing Operation (MRO) by decreasing it's price to 0.15% higher than the deposit rate from 0.5% previously. It will provide banks with as much liquidity as they want, backed by (broad) eligible collateral. It has committed to a variety of as yet unspecified additional lending operations, referred to as "structural credit operations", some of which are likely to be similar to previous 3-month Long-Term Refinancing Operations (LTROs). They will also hold a "structural portfolio of securities" at a later stage. Importantly, and as yet not fully defined, all operations will take into account a secondary objective to "incorporate climate change-related considerations" into monetary policy.

Plenty in reserve

The purest form of 'money' in our modern financial system are central bank reserves, which the ECB creates and sets the price for in the Eurozone. Commercial banks need to hold these reserves for numerous reasons, including settling payments between each other, while the ECB itself stipulates that a minimum of 1% of certain liabilities for any given bank must be held in reserves. Typically, a larger ECB balance sheet means more reserves for the overall financial system, and the more 'liquidity' we say there is. The ECB grows its balance sheet by lending to banks in various ways, and since 2015 by buying securities directly in the market via an official QE program. Although the ECB's balance sheet is currently shrinking as QE and credit operations run-off in a period of tighter monetary policy, a crucial point in the operational review is the expectation that the balance sheet (and thus reserves) will likely sit at permanently higher levels than the traditional 'scarce-reserve' world that prevailed in the late 20th century and early 21st.

The ECB is moving officially to a 'demand-driven' reserve supply system. At the highest level the ECB will set monetary policy primarily with reference to the Deposit Facility Rate (DFR), which is the rate at which commercial banks get paid to deposit money at the ECB above their minimum reserve amount. Since its inception in 1999, the ECB has had three key interest rates that it sets: 1) the DFR, 2) the Main Refinancing Operation (MRO), and 3) the Marginal Lending Facility (MLF). This is often referred to as a corridor, where the DFR is the minimum rate, the MLF is the upper rate, and the MRO is in the middle. The actual rate for market transactions is a function of whether banks want to on aggregate lend more money to or borrow more money from the ECB. Before the financial crisis of 2008, the ECB limited the supply of reserves by deciding how much to offer to banks in its weekly MRO operations, which were set at the DFR +0.5%. Part of the job of the central bank was to predict how many reserves would be needed, and reserve-scarcity was a deliberate policy choice. Urgent changes were needed during the crisis as banks and other financial institutions bid up the price of money aggressively, leading to the ECB (and other central banks) offering unlimited borrowing against eligible collateral. This change, combined with longer-term lending operations and eventually QE meant that the market rate tended to be very close to the deposit rate, and banks were reluctant to borrow at the MRO. The ECB has now lowered the 'price' of the MRO to DFR+0.15%, and aim to encourage banks to use this regularly, for as much or as little as they want to borrow. There is an element of back-to-the-future here as the corridor system becomes relevant again, but without old-fashioned reserve scarcity.

Chart 2: The MRO was out of vogue



Source: Bloomberg, European Central Bank

When is QE not QE?

Aside from the newly attractive MRO, the ECB has announced its intention to provide a variety of additional lending programs. Isabel Schnabel, an ECB executive board member who has played a key role in designing and communicating the new framework, emphasises the importance of different liquidity sources to increase systemic robustness. The most notable of these is the intention to hold a structural portfolio of securities outside of a specific quantitative easing program. The review provides little in the way of specifics on timing or composition, but the intention is hugely significant in itself. While QE programs have existed to complement monetary policy easing, the ECB will now have a permanent portfolio of securities and a new monetary tool where size and inclusions into the portfolio can be actively tweaked. While this will likely be heavily scrutinised to ensure compliance with EU Treaties, for example to ensure there is no direct state financing, it is also likely that the ECB's intention to hold such a portfolio is a positive for assets that may be included, such as sovereign and supra-national fixed income. The lack of detail and implicit flexibility could also positively impact broader assets across the risk-spectrum, an example of which is the existing precedent for ECB ownership of corporate credit.

Climate

Another area with significant implications amid deliberate ambiguity is the ECB's intention to incorporate climate goals into its operations. The ECB's communication refers to climate change under a "secondary objective" section, where monetary policy operations will take the "transition to the green economy" into account. The language does emphasise the importance of the primary price stability mandate, but the climate goal is notable. Depending on the specifics of implementation, this could have implications for asset prices and economic incentives in the Eurozone. The most likely impact is one signposted by Schnabel in a speech on the 14th of March, where climate considerations are explicitly referenced in conjunction with the design of the structural portfolio. This could mean, for example, that the portfolio may be tilted towards 'green' assets. Other forms of climate policy could be favourable collateral status for "green" or transition-related assets, with the asset holder able to borrow from the ECB at more favourable rates. The broad implication is that climate transition-related financial assets could command a premium in the Eurosystem. However, as with the importance of legality for the new structural portfolio, the ECB will be highly attuned to possible criticism over playing too pro-active a role in price setting in a market economy.

It's a central bank world, and we just live in it

The history of the ECB is not dissimilar from that of the EU overall, where policy is often formed during tumultuous periods that have ultimately strengthened the system. The operational review combines the lessons learned from past crises, and deliberately builds flexibility into the future. While neither ourselves nor the ECB knows the form a future crisis may take, the ECB has an ample toolkit to lessen any potential impact on the financial system. As a result, it is unlikely that we will see a crisis in which credit provision to the European economy freezes as commercial banks scramble for scarce reserves. Other facilities such as the Transmission Protection Instrument (TPI), where the ECB can intervene and support individual sovereign issuers in specific circumstances, would have been thought highly unlikely a decade ago. We are in a world of persistently-higher central bank involvement, which may bring separate issues and criticisms. Even with the balance sheet shrinking for the time being, the commitment to a permanent securities portfolio , the ability to ease collateral requirements in times of stress and the possibility of explicitly favouring green assets are just some examples of how far the nature of central banking has changed in the ECB's 25 year history. We think this new framework represents a sensible development, and one which strengthens the stability of the monetary union.

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