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The use of the Eurosystem's monetary policy instruments and its monetary policy implementation framework in 2020 and 2021


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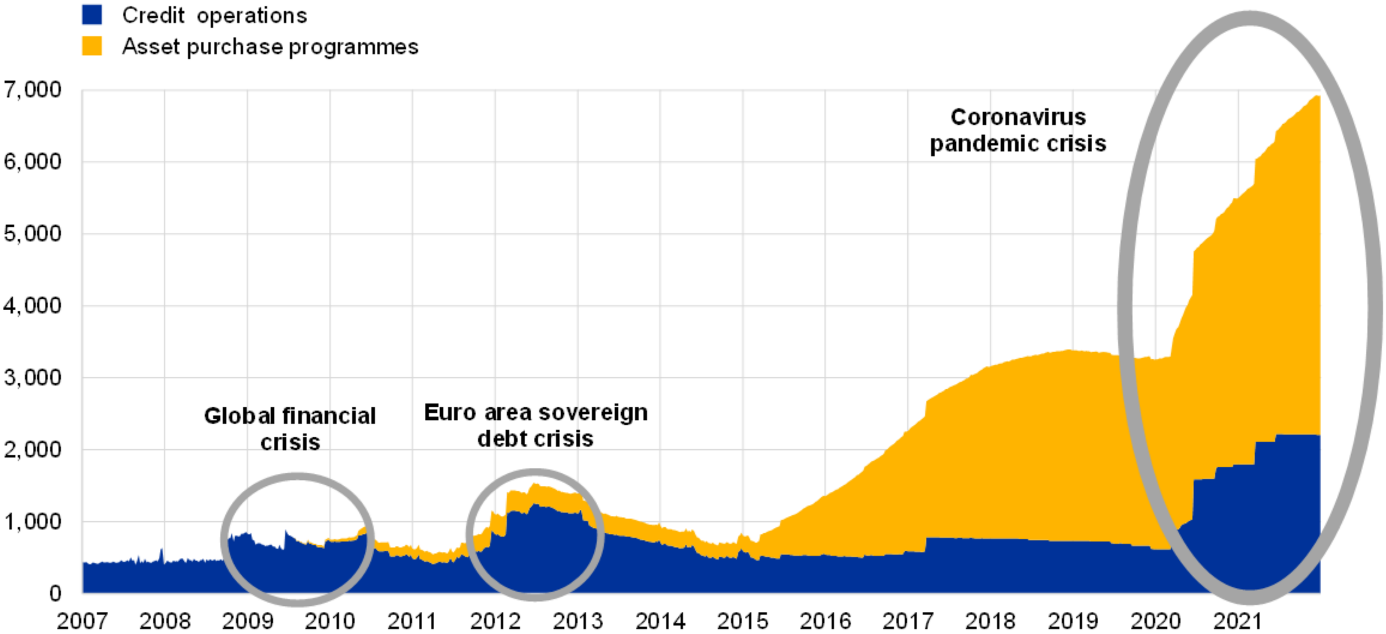
This policy brief provides an overview of the Eurosystem's monetary policy implementation during the years 2020 and 2021, with a focus on the key monetary policy instruments used to face the COVID-19 pandemic. Through its action, the Eurosystem continued to expand its balance sheet, in particular by scaling up its outright asset purchases and easing the conditions of its targeted longer-term refinancing operations (TLTROs), complemented by temporary changes in the collateral framework. As part of the swift ECB reaction to the outbreak of the COVID-19 crisis, the Eurosystem also enhanced its provision of US dollar liquidity to banks and created the Eurosystem repo facility for central banks (EUREP) to offer euro liquidity to foreign central banks. The accommodative monetary policy stance was preserved by maintaining the key ECB interest rates at record-low levels, reinforced by the ECB's forward guidance on policy rates.

Introduction

In the years 2020 and 2021 monetary policy action was dominated by the Eurosystem's response to the negative economic effects of the outbreak of the COVID-19 pandemic. The outbreak of the COVID-19 pandemic - and the accompanying social measures to limit the spread of the virus - changed the economic and financial outlook drastically. The ECB faced the threat of a liquidity and credit crunch, serious risks to the monetary policy transmission mechanism, severe dislocations across market segments, and sharply decreasing inflation expectations. The ECB therefore substantially eased the monetary policy stance over the course of 2020 and the Eurosystem balance sheet therefore reached record levels (Chart 1).This policy brief focuses on the key monetary policy instruments used by the Eurosystem at the outbreak of the COVID-19 crisis. For a more comprehensive treatment of the Eurosystem monetary policy instruments over 2020 and 2021 please refer to the ECB Occasional Paper No 304.

Chart 1: Monetary policy operations (EUR billions)



Sources: ECB and ECB calculations.

Steering of short term rates

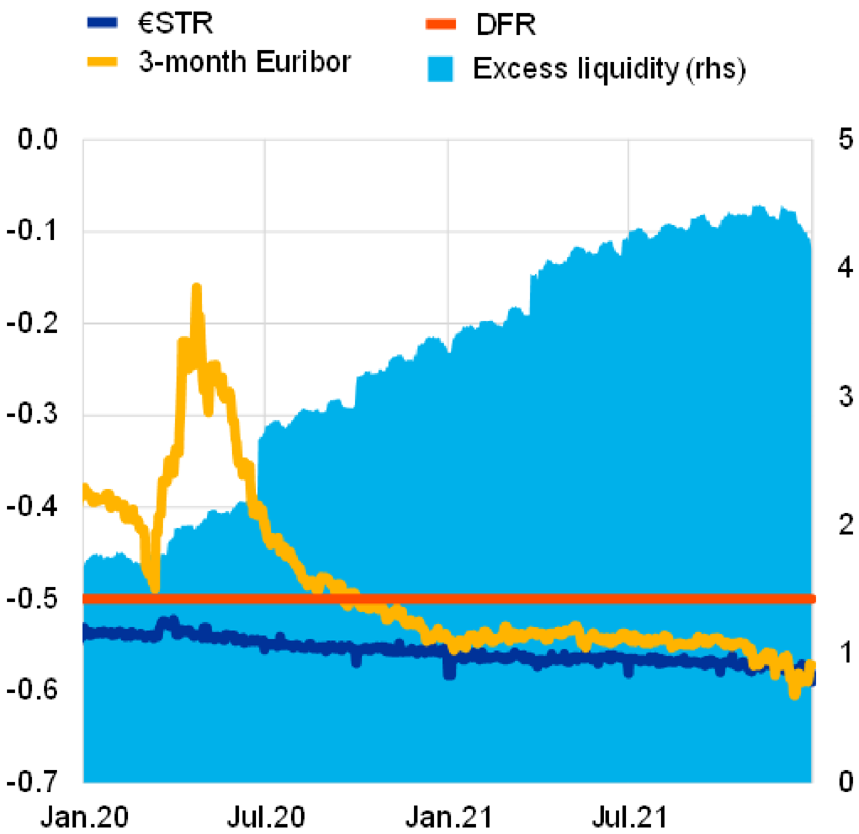
The level of the DFR and expectations about its future levels constitute the risk-free component of euro area interest rates and yield curves and thus serve as the starting point for the monetary policy transmission mechanism. The DFR was maintained at -0.50% during the pandemic.

In the environment of high excess liquidity short-term interest rates are suppressed closely to – or even below - the interest rate on the deposit facility (DFR), thereby preserving a very accommodative monetary policy stance. Money markets, and in particular the unsecured overnight rate (the €STR), traded steadily below the DFR. While the €STR market is characterised by transactions between banks and institutions that do not have direct access to the deposit facility (DF) (non-banks, e.g. funds), an arbitrage mechanism explains the differential between the DFR and the €STR.[1]

[1] Non-bank financial institutions (NBFIs) had been increasingly holding deposits often resulting from the sale of securities to the Eurosystem. Since NBFIs do not fulfil the necessary Eurosystem eligibility criteria and thus do not have access to the Eurosystem balance sheet, they resorted to banks for liquidity storage by lending them liquidity, which banks in turn deposited with the Eurosystem by charging a spread. As a result, benchmark rates, such as €STR, declined below the DFR.

The transmission of €STR to other money market segments of longer tenors or secured rates is naturally also subject to risk premia and market conditions. During the early phase of the pandemic, the three-month euro interbank offered rate (EURIBOR) peaked, as increased market volatility and economic uncertainty caused MMFs to experience significant outflows (Chart 2). The stress placed on MMFs had implications for monetary policy transmission, especially given its impact on EURIBOR – an important reference rate for the euro area – and on banks' liquidity management. However, the spread recovered after the ECB started to purchase short term paper of corporate issuers, the accept more broadly uncovered bank bonds as collateral and ease conditions on the refinancing conditions to the banking sector.

Chart 2: The DFR and main money market rates vs excess liquidity
(left-hand scale: percentages per annum; right-hand scale (rhs): EUR trillions)

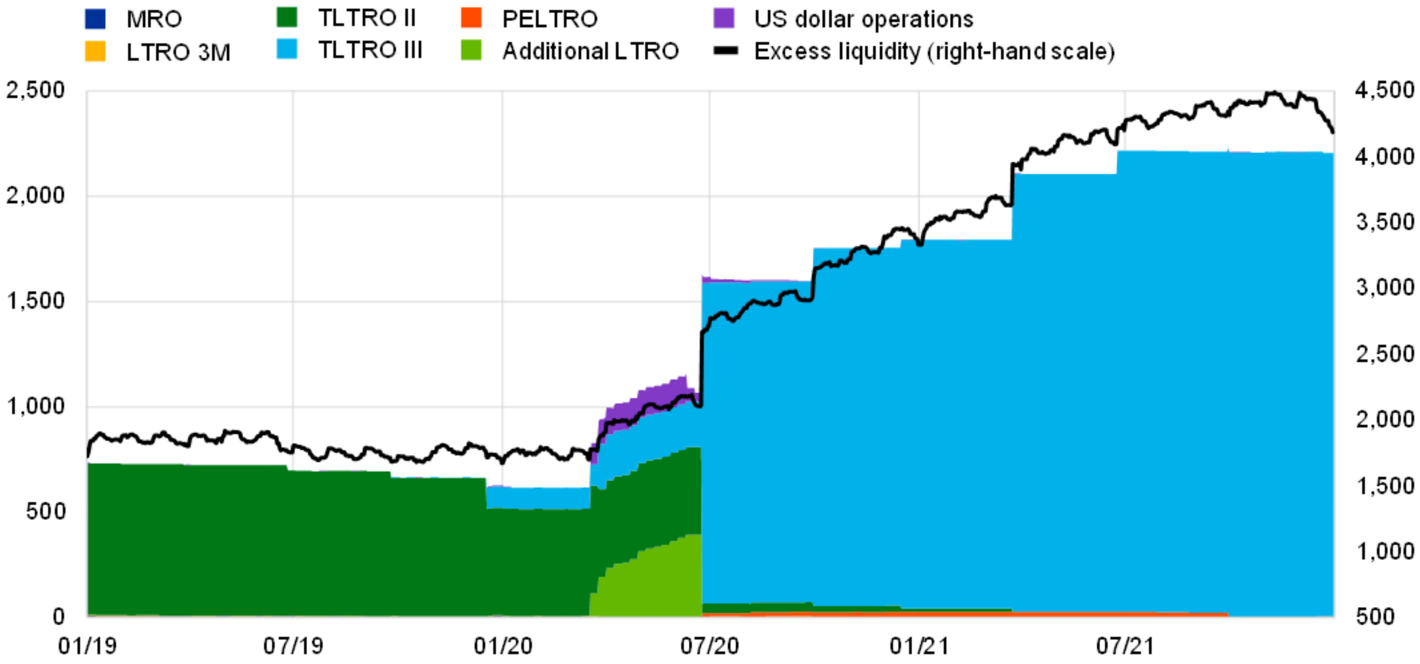


Sources: ECB, European Money Market Institute.

Credit operations and collateral

Credit operations are one of the cornerstones of the Eurosystem's monetary policy framework. The European banking sector plays an essential role in the transmission of the ECB's monetary policy. Through its credit operations, the ECB is able to directly affect banks' funding conditions, thereby preserving or stimulating bank lending conditions. From the start of 2020, recourse to Eurosystem funding significantly increased, moving from €627 billion to €2,207 billion, reversing the downward trend seen in previous years (Chart 3).

Chart 3: Participation in Eurosystem credit operations with eligible counterparties (EUR trillions)



Source: ECB.

In the first phase of the pandemic, the ECB ensured the availability of liquidity to the banking sector by launching additional LTROs as temporary liquidity backstops. The additional LTROs were offered at the DFR and thereby allowed banks to swiftly participate and build (precautionary) liquidity buffers. The LTROs were complemented by PELTROs, introduced in April 2020, to ensure sufficient liquidity provision for banks that did not, or could not, participate in the TLTRO III series (see below), given their business models and the related availability and type of loan portfolios. At the same time, three-month LTROs and MROs continued to be offered under their customary conditions and played a role in providing liquidity to smaller and/or specialised banks. In addition, as part of the swift ECB reaction to the outbreak of the COVID-19 crisis the Eurosystem also enhanced its provision of US dollar liquidity to banks and created the Eurosystem repo facility for central banks (EUREP) to offer euro liquidity to foreign central banks. US dollar tenders proved to be an important stabilising tool after the outbreak of the pandemic, easing US dollar funding strains. Finally, to address euro liquidity needs outside the euro area the ECB introduced EUREP in June 2020 as a precautionary backstop, as well as reactivated swap lines with some non-euro area central banks and established temporary bilateral repo lines with several other non-euro area central banks.

The easing of the TLTRO III conditions ensured very favourable funding conditions for the banking sector and was one of the key responses to the pandemic. The TLTRO III programme provides banks with longer-term funding at attractive conditions conditional on banks meeting a bank-specific pre-determined lending benchmark. The operations are aimed at preserving favourable borrowing conditions and are specifically designed to stimulate bank lending to the real economy. Amid the outbreak of the COVID-19 pandemic, the ongoing series of TLTRO III operations was adjusted in order to preserve bank lending. By April 2020, the ECB had introduced a special interest rate period, running from June 2020 to June 2021, during which the interest rate on TLTRO III operations was reduced to 50 basis points below the average interest rate prevailing in the Eurosystem's MRO rate over the same period. Moreover, for counterparties whose eligible net lending reached the lending performance threshold, the interest rate over the period from June 2020 to June 2021 would be 50 basis points below the average DFR prevailing over the same period. Finally, the ECB raised the maximum total amount that counterparties were allowed to borrow under TLTRO III. In December 2020, in response to the economic fallout from the resurgence of the pandemic in the euro area, the terms and conditions of the TLTRO III programme were prolonged further.

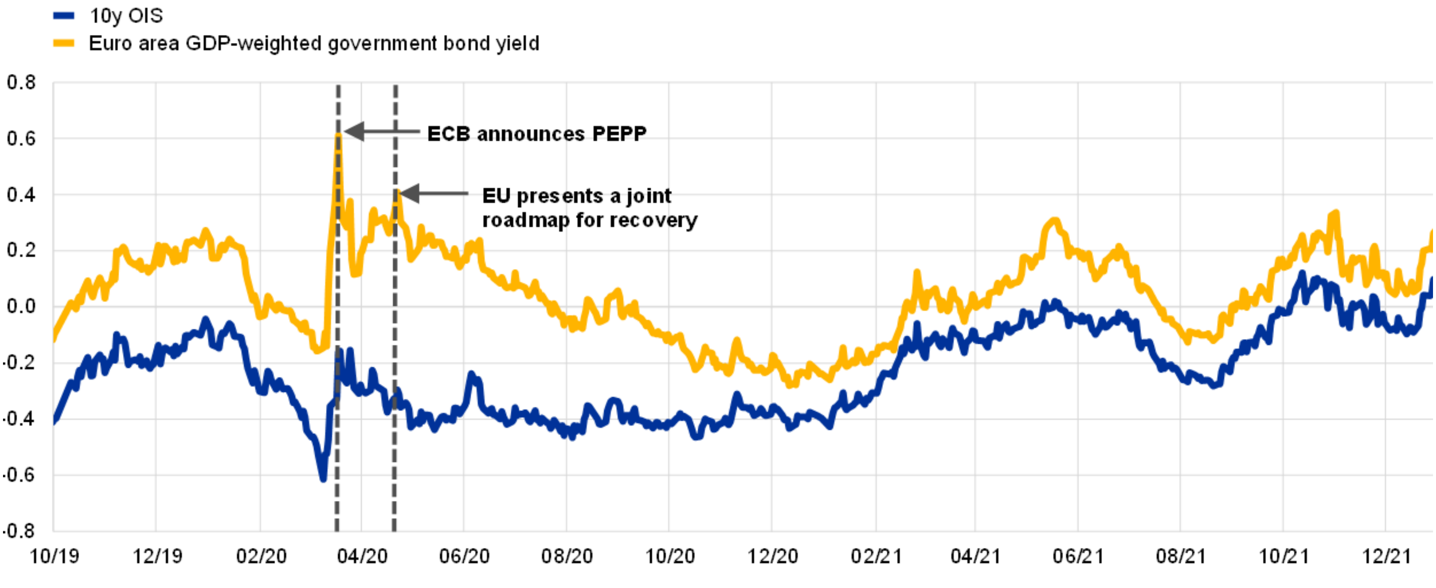
At the same time, the Eurosystem also decided to temporarily broaden its collateral rules to facilitate the availability of eligible collateral for Eurosystem counterparties to be able to participate in liquidity-providing operations, such as the TLTRO III series, and to facilitate an increase in bank funding against loans to corporates and households. The measures included an increase in the types of credit claims that were eligible as collateral (including loans benefiting from the guarantee schemes adopted in euro area Member States in response to the pandemic), the maintenance of eligibility – under some conditions – for assets that fulfilled credit quality requirements at the onset of the pandemic, a reduction in collateral valuation haircuts by a fixed factor of 20%, and a waiver of the minimum rating requirement for marketable debt securities issued by the Hellenic Republic.

Asset purchase programmes

Asset purchases are generally an important tool to support the monetary policy transmission mechanism and to provide the degree of policy accommodation needed to ensure price stability. Several asset purchase programmes were introduced over the past decade to complement the regular MPOs of the Eurosystem.

The Pandemic emergency purchase programme (PEPP) was launched to counter the serious risks to the monetary policy transmission mechanism and to the outlook for euro area price stability posed by the COVID-19 outbreak. The PEPP therefore had a dual role. First, the asset purchases under the PEPP delivered the monetary accommodation required to ensure that medium-term price stability continued to be preserved by supporting the economic recovery from the pandemic crisis. Second, the flexible nature of the PEPP across time, asset classes and jurisdictions was designed to fulfil a market stabilisation role in an efficient manner. The PEPP, together the fiscal EU responds in the form of the NGEU programme, sent a signal of increased EU cohesion and solidarity, contributing to reducing risk premia across the euro area (Chart 4).

Chart 4: Euro area GDP-weighted sovereign bond yields and OIS rates (percentages per annum)



Source: ECB, Bloomberg.

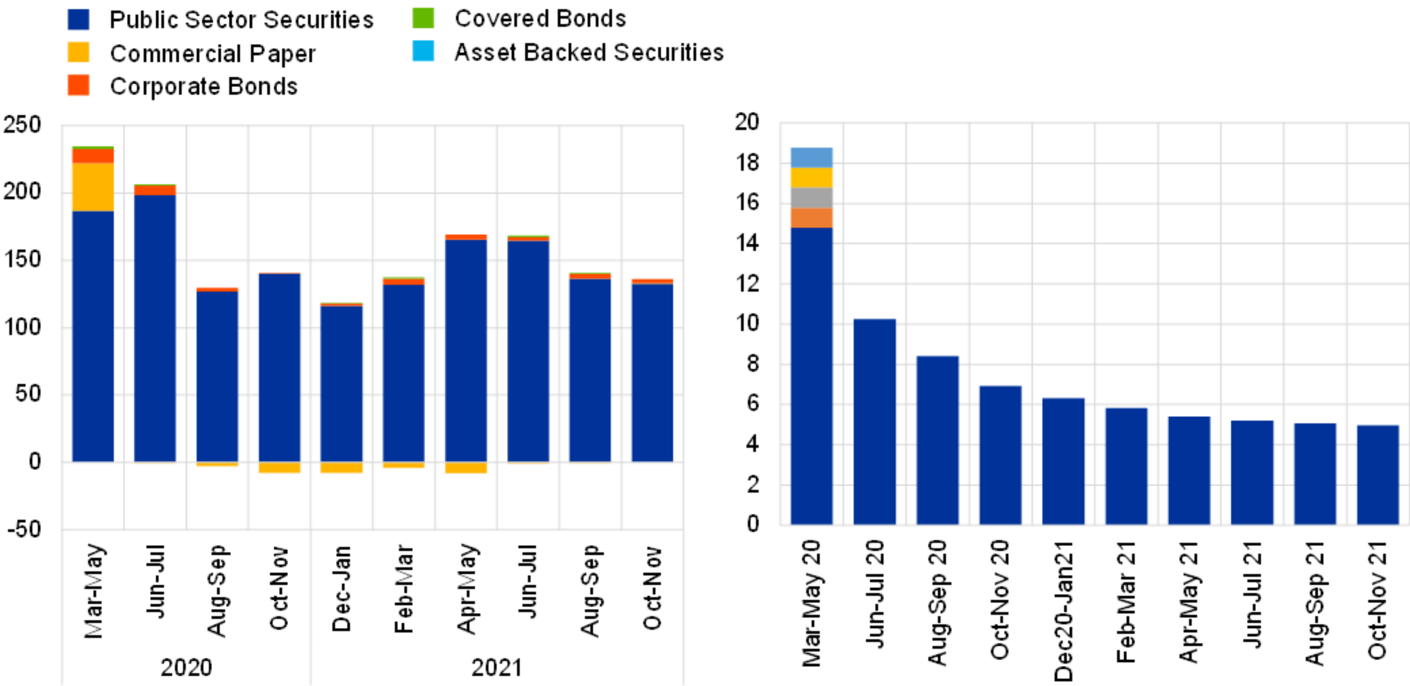
The design of the PEPP entailed flexibility of purchases over time, asset categories and jurisdictions, allowing the programme to be effective as a market stabiliser. While the benchmark allocation for purchases of public-sector securities was based on the Eurosystem capital key of the NCBs, the actual purchases could be conducted in a flexible manner, likewise over time and across asset classes, on the basis of market conditions (Chart 5). Moreover, in addition to the asset categories eligible under the existing APP, a waiver of the eligibility requirements was granted for securities issued by the Greek Government. Finally, the eligibility of non-financial CP under the CSPP was expanded to include securities with a remaining maturity of at least 28 days. These securities could be purchased under both the CSPP and the PEPP. The residual maturity of public-sector securities eligible for purchase under the PEPP range from 70 days up to a maximum of 30 years and 364 days.

The Eurosystem's PEPP was one of the key responses to the outbreak of the pandemic. The programme was announced on 18 March 2020, and initially consisted of an envelope of purchases amounting to €750 billion. After two increases – €600 billion on 4 June 2020 and €500 billion on 10 December 2020 – the envelope amounts to a total of €1,850 billion. Net purchases under the programme ended in March 2022. The maturing principal payments from securities purchased under the PEPP will be reinvested until at least the end of 2024. The APP continued to support broad-based monetary accommodation during the review period.

Chart 5: PEPP flexibility

a) Net PEPP purchase volumes (EUR billions)

b) Absolute capital key deviations in public-sector purchases (percentage points)



Source: ECB and ECB calculations.

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