Media briefing: responding to the ECB's revised operational framework

On Wednesday 13 March the European Central Bank (ECB) unveiled plans to revise its operational framework, a vital component of its monetary policy strategy. The operational framework is essentially a set of tools and guidelines the ECB uses to adjust short-term interest rates in the Eurozone, aiming to keep prices stable. The ECB has decided that once it completes the ongoing process of reducing its balance sheet, it will in future aim for a lean balance sheet. The ECB will provide liquidity through a mix of instruments, ranging from the Marginal Refinancing Operations facility, longer-term refinancing operations, structural longer-term refinancing operations and a structural portfolio of securities. As we explain below, the new system is a mix of the Bank of England and the Federal Reserve's systems.

We believe that there are positive elements to the ECB's revision. The ECB is considering key aspects, like the secondary mandate or the green transition, into its operational framework. Nonetheless, how effectively the revised operational framework can tackle those will depend on the correct design of these liquidity provision instruments. However, there are also shortcomings, such as a limited firepower to back-up this supportive role. This media briefing provides an overview of the ECB's operational framework dynamics, suggesting modifications to further enhance monetary policy with progressive changes. A detailed analysis and an in-depth exploration of the operational framework's functioning will follow soon.

How the operational framework works

Within the operational framework, the ECB sets the operational target: this is the short-term interest rate in financial markets (the €STR), the main tool by which the ECB upholds price stability. The ECB sets its three key policy rates to directly influence the €STR. The three key policy rates are the Marginal Lending Facility (MLF) rate, the Main Refinancing Operations (MRO) rate and the Deposit Facility (DF) rate, collectively forming a corridor. In this corridor, the MLF rate sits at the ceiling, the DF rate at the floor and the MRO rate in the middle. The €STR fluctuates within this corridor depending on the reserves provided to commercial banks by the ECB. Since the ECB provides reserves by increasing the size of its balance sheet, there is a direct connection between the ECB's balance sheet and the operational framework.

The revision of the operational framework hinges on three critical aspects:

1. The ECB's operational framework determines the position of the operational target within the corridor. This means that the ECB decides whether the short-term interest rate should remain at the corridor's floor, shift to the middle as it was before the Global Financial Crisis (GFC), or ascend to the ceiling.
2. Defining the volume of reserves. Commercial banks are the only financial institutions to have deposits in the central bank. We call these deposits reserves. Historically, the ECB provided scarce reserves to banks in order to have a small footprint in the financial system. This maintained the operational target in the middle of the corridor.

However, unconventional monetary policies, in which the ECB increased the size of its balance sheet, such as long-term lending operations and asset purchase programmes, flooded the banking system with reserves, shifting the operational target to the corridor's floor.

3. Determining the way in which the ECB provides reserves to the banking system. Before the GFC, the majority of reserves were provided through the MRO facility. After the GFC, however, asset purchases and longer-term lending facilities became the primary sources of reserves.

How the ECB is reviewing its balance sheet

When the ECB started conducting unconventional policies, these increased the ECB's balance sheet, which is the statement of assets, liabilities and capital that the ECB holds. For example, whenever the ECB bought bonds, it increased its balance sheet. After the bond purchase, the ECB held one extra bond on its asset side, and it increased the amount of reserves on its liability side. These policies became necessary because the traditional tool, the short-term interest rate, reached its lower limit (the zero-lower bound). Simply put, the ECB could not decrease it any further to stimulate the economy. Therefore, it started lowering the interest rate of long-term financial assets. This was done, for example, by directly purchasing these long-term assets.

Once inflation began to rise, the ECB responded by increasing interest rates and initiating the process of unwinding its balance sheet. Policies that increased the balance sheet size were conducted to increase inflation. Therefore, once inflation started rising, the ECB responded by raising interest rates and "normalising" its balance sheet by decreasing its size. The new ECB system is a mix between the Fed and the BoE. On the one hand, the ECB will provide a share of reserves through structural operations—structural longer-term refinancing operations and a structural portfolio of securities. This share of reserves will be determined by the ECB, covering a portion of banks' liquidity needs. However, the other part of banks' demand for reserves will be covered through 1-week loans and 3-month loans. As such, banks' demand will decide the amount of reserves provided through these loans. Therefore, the ECB's operational framework will stand in the middle between a supply - and a demand-driven system.

Positive Money Europe's proposal for a new operational framework

There are positive elements to the revised framework. However, the real outcome will depend on the specific design of the toolbox by which the ECB will provide liquidity. We suggest that the structural longer-term refinancing operations should be conducted through green-targeted longer-term refinancing operations (gTLTRO). Through a gTLTRO, the ECB would provide long-term financing with advantageous conditions to banks that lend to green sectors, such as clean energy projects and house retrofitting. Additionally, we propose that the ECB holds a significant share of green bonds and supranational bonds within its structural portfolio of securities. This design would accommodate the secondary objective principle, especially supporting the transition to a green economy.

That said, there are some shortcomings to the ECB's new approach. First, it is the timing. The provision of liquidity through these structural operations will not come about until the current balance sheet is run down, around 2026. Second, is its firepower. The ECB will aim to keep the balance sheet "as lean as possible", in the words of Isabel Schnabel. This means that the volume of liquidity provision that the ECB will be able to do through these facilities will be rather small, especially if we compare it with previous asset purchase programmes or any of the TLTROs.

Additionally, we suggest that the remuneration of reserves should be taken into account. The ECB should implement a tiered interest system for bank reserves. This would mean applying different interest rates to different portions of these reserves, and would allow the ECB to consider the distributive effects of their policies. For instance, by increasing the minimum reserve requirements that banks are required to hold without any interest (non-remunerated), the ECB can ensure that these reserves do not contribute to excessive profits for the banks.

Our proposal entails several benefits:

- Support for the green transition: Allocating liquidity through targeted credit operations, as well as green and supranational bonds, supports sectors critical to the green transition, aligning with the ECB's mandate and climate goals.
- Considering distributive issues: Tiering the remuneration of reserves would avoid banks accruing windfall profits from interest rate hikes.
- Stability in sovereign bond markets: An ample and flexible balance sheet stabilises government bond markets, as demonstrated during the Eurozone crisis and the COVID-19 pandemic. It does so by the ECB acting as lender of last resort whenever financial instability arises in government bond markets.
- Effective monetary policy transmission: A central bank's balance sheet flexibility is vital in ensuring that interest rate changes effectively influence financial conditions and have a real impact on the economy. This is particularly important when the usual policy tools don't work as expected. For instance, during the Eurozone crisis, the short-term rate wasn't influencing the rate of long-term financial assets. In these circumstances, the ECB had to directly influence long-term rates through asset purchase programmes. This approach helps in steering the economy in the desired direction when standard tools are insufficient, ensuring that monetary policy remains effective even under challenging conditions.
- Financial stability interventions: Flexible balance sheets enable central banks to intervene as lenders of last resort during financial distress, mitigating liquidity shortages and market panics.
- Adaptation to destabilising shocks: Flexible balance sheets allow for effective responses to diverse shocks, including negative supply shocks and geopolitical tensions, which can raise inflation at the same time that they trigger financial instability.

This proposed framework considers technical aspects while placing the revision of the operational framework in the current context, learning from past policymaking errors and successes, and considering future societal challenges.

Notes for editors:
* Positive Money Europe is a research and advocacy nonprofit organisation working towards a money and banking system which supports a fair, democratic and sustainable economy. www.positivemoney.eu
* For further information and to arrange interviews please contact our Press Officer Chris Ancil, +32486816541 X: @christoffler
Follow Positive Money Europe on Twitter for the latest developments.