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Public Consultation: Measures to Improve the Efficiency of the Operational Framework for Monetary Policy

European Central Bank (ECB)

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PUBLIC CONSULTATION

MEASURES TO IMPROVE THE EFFICIENCY OF THE OPERATIONAL FRAMEWORK FOR MONETARY POLICY

1 EXECUTIVE SUMMARY

It is generally recognised that the operational framework for the monetary policy of the Eurosystem[1] has been functioning well since the launch of the euro in 1999. There has been little need to conduct fine-tuning operations, because of the averaging provision of the minimum reserve system and the quality of the Eurosystem's liquidity forecasts. Also, credit institutions have had only limited recourse to the standing facilities, which shows that the money market has been working efficiently. And the small and fairly stable spread between the ECB's fixed or minimum bid rate on its main refinancing operations and the short-term money market rates displays the ability of the ECB to influence short-term interest rates.

Despite this generally positive assessment, some possible measures have been examined with the aim of further improving the efficiency of the operational framework.

There are three changes to be considered:

(1) changing the timing of the reserve maintenance period, so that it would always start on the settlement day of the main refinancing operation following the Governing Council meeting at which the discussion of monetary policy is pre-scheduled, so that – as a rule – the implementation of changes to the standing facility rates would be aligned with the start of a new reserve maintenance period;

(2) shortening the maturity of the main refinancing operations (MROs) from two weeks to one week; and

(3) suspending the longer-term refinancing operations (LTROs).

It should be noted that the proposed measures are of a technical nature, regarding the operational implementation of monetary policy. The change of the maintenance period would become effective, at

[1] The Eurosystem consists of the European Central Bank (ECB) and the 12 national central banks of the euro area.

the earliest, from 2004 onwards, given envisaged lead times at both banks and the national central banks.

The consultation is addressed to all credit institutions in the euro area, as well as to banking and financial market associations. Replies can be submitted to the ECB or to one of the national central banks, and contact details can be found on the appropriate websites.

2 THE CURRENT SET-UP OF THE OPERATIONAL FRAMEWORK REGARDING THE ABOVE-MENTIONED ELEMENTS

2.1 The reserve maintenance period and the minimum reserve system

The ECB requires credit institutions to hold minimum reserves on accounts with the national central banks, within the framework of the Eurosystem's minimum reserve system. The terms and conditions of the Eurosystem's minimum reserve system are uniform throughout the euro area. The main function of the Eurosystem's minimum reserve system is to stabilise money market interest rates and to create or enlarge a structural liquidity shortage.

The amount of minimum reserves to be held by each institution is determined in relation to its reserve base. The Eurosystem's minimum reserve system enables counterparties to make use of averaging provisions, implying that compliance with reserve requirements is determined on the basis of the average of the end-of-calendar-day balances on the counterparties' reserve accounts over a one-month maintenance period. Institutions' holdings of required reserves are remunerated at the rate on the Eurosystem's main refinancing operations.

Since January 1999 the reserve maintenance period has been one month, always starting on the 24th calendar day of each month and ending on the 23rd calendar day of the following month, regardless of whether these days are TARGET operating days or not. Hence, the start and end days can fall on a weekend or a TARGET holiday.

2.2 The main refinancing operations

The main refinancing operations (MROs) are the most important open market operations conducted by the Eurosystem, signalling the stance of monetary policy, playing a key role in the steering of interest rates and managing the liquidity situation in the market. The bulk of credit institutions' liquidity needs, on average 73.5% in the first three years of Monetary Union, has been met through the regular MROs.

The main features of these operations are described in European Central Bank (2002a).[2] In the context of the present consultation, it needs to be highlighted that:

- they are executed regularly each week and normally have a maturity of two weeks, so that two operations of this type are outstanding at any point in time; and

[2] See the bibliography at the end of the document.

- they were executed as fixed rate tenders until 27 June 2000. Since then, they have been executed as variable rate tenders with a minimum bid rate (see European Central Bank (2000)[3]).

As at mid-September 2002, 191 MROs had been carried out with an average allotment volume of EUR 73 billion. The average number of credit institutions bidding in the MROs was 578 and the average absolute deviation from this average was 196.

2.3 Longer-term refinancing operations

The Eurosystem also executes, with a monthly frequency, regular refinancing operations with a three-month maturity, which are aimed at providing additional longer-term refinancing to the financial sector. At any one time, there are three operations of this type outstanding. These operations have represented only a limited part of the global refinancing volume (26.1%). In these operations, the Eurosystem does not, as a rule, intend to send signals to the market and therefore normally acts as a rate taker. Accordingly, longer-term refinancing operations (LTROs) are usually executed in the form of variable rate tenders and the ECB regularly indicates the operation volume to be allotted in forthcoming tenders.

The operational features of the LTROs are also summarised in European Central Bank (2002a).[4]

3 RATIONALE FOR CHANGING THE OPERATIONAL FRAMEWORK

3.1 Changing the timing of the reserve maintenance period

The Governing Council announced on 8 November 2001 that it would, as a rule, assess the stance of the ECB's monetary policy and change interest rates only at its first meeting of each month, which is usually the first Thursday. If the Governing Council decides to change the MRO minimum bid rate and the rates applied on the standing facilities, the new rates come into force immediately, i.e. they are applied to the next MRO being announced and to the standing facilities on the following day. The dates of the forthcoming Governing Council meetings are available on the ECB's website.

Currently, the dates of the Governing Council meetings are independent of the starting date of the reserve maintenance period. Under the changes proposed above, however, there would be a very direct relationship. The reserve maintenance period would then always start on the settlement day of the MRO following the Governing Council meeting at which the discussion of monetary policy is pre-scheduled, and, as a rule, the implementation of changes to the standing facility rates would also be aligned with the implementation of the change of the rate applied to the MROs, i.e. at the start of each new reserve maintenance period.

The proposed changes would help remove expectations of changes in interest rates during the maintenance period, reducing the impact of interest rate expectations on the behaviour of

[3] See the bibliography at the end of the document.

[4] See the bibliography at the end of the document.

counterparties bidding in the MROs. Therefore, in periods marked by expectations of interest rate decreases, it would reduce the possibility of underbidding. And in periods marked by expectations of interest rate increases, it would also avoid a significant departure of short-term market rates and MRO tender rates from the minimum bid rate, eliminating a source of noise for the signalling of the monetary policy stance. The changes also address overbidding, which occurred under the fixed rate tender procedure.

The changes would also ensure that the reserve maintenance period always starts on a TARGET operating day, and ending on a non-TARGET day would be very rare. In the present set-up, when a maintenance period starts on a weekend, the recourse to standing facilities in the last maintenance period is carried over to the new maintenance period, creating an unnecessary cost for banks. From January 1999 to August 2002, there were 43 maintenance periods, of which 14 started and 14 ended on a non-TARGET day.

The proposed change would imply a more variable length of the reserve maintenance periods. For instance, using 2003 as an example (bearing in mind that the possible changes would not be implemented until after 2003), the length of the reserve maintenance periods would vary between 21 and 37 days, if the new procedures were applied, as Table 1 below reveals.

Table 1: Reserve maintenance periods under the new procedures in 2003

Period	Governing Council meeting*	Start	End	Length in days
1st	9 January	15 January	11 February	28
2nd	6 February	12 February	11 March	28
3rd	6 March	12 March	8 April	28
4th	3 April	9 April	13 May	35
5th	8 May	14 May	8 June	26
6th	5 June	9 June	15 July	37
7th	10 July	16 July	5 August	21
8th	31 July	6 August	9 September	35
9th	4 September	10 September	7 October	28
10th	2 October	8 October	10 November	34
11th	6 November	11 November	9 December	29

* Meeting of the Governing Council with a pre-scheduled assessment of monetary policy stance.

3.2 Shortening the maturity of the main refinancing operations to one week

In order to mitigate the effects of expectations of interest rate changes on the bidding behaviour of counterparties, MROs should not hang over into the following reserve maintenance period. This would only be the case if the maintenance period started on the day of the settlement of the MRO and if the maturity of the MRO was one week. Thus, the shortening of the maturity is complementary to the change in the timing of the reserve maintenance period.

Regarding the impact on the controllability of short-term money market interest rates, there is little difference between a one-week and a two-week maturity of the MROs. What is more relevant for controllability of short-term interest rates is the frequency of operations, which is not affected by the shortening of the maturity.

The shortening of the maturity of the MRO would, however, imply an increased turnover of central bank refinancing. The allotment amounts in the MROs would double, if all other factors were unchanged.

3.3 Suspending the longer-term refinancing operations

When the Eurosystem's operational framework was originally discussed, it was decided that a proportion of the total refinancing needs would be supplied by longer-term refinancing operations (LTROs), because they provide "a good opportunity for smaller counterparties, which have limited or no access to the interbank market, to receive liquidity for a longer period (i.e. three months)". The ECB acts as a rate-taker in the LTROs, and does not use these operations for steering short-term interest rates. Indeed, if the proportion of LTROs in the total refinancing operations were to be very high, it could hinder the implementation of monetary policy.

There has been a trend decline in the number of banks that participate in LTROs. The highest number of bidders in the LTROs was 466 in the first operation on 13 January 1999. Participation reached an all-time low of only 158 bidders in the last operation of August 2002. For the first three years of Monetary Union, the average number of bidders was 272, but, if only operations in 2001 and the first eight months of 2002 are included, the average falls to 197. This indicates that LTROs are a source of refinancing for a limited number of banks.

Considering the rapid pace of developments in the European financial markets over the past three-and-a-half years, it is therefore time to consider whether the LTROs do indeed play the role for which they were originally intended – that of providing refinancing to smaller counterparties which have less access to the interbank market for a longer period. If not, one should envisage suspending this type of operation for the sake of a lean implementation of monetary policy. If the LTROs were to be suspended, the shortfall in refinancing would be provided by the regular weekly MROs.

3.4 Relationship between the three envisaged changes

The relationship between the shortening of the MRO maturity and a change in the definition of the reserve maintenance period was described in Section 3.2 above.

Furthermore, there is a relationship between the shortening of the MRO maturity and a possible suspension of the LTROs, as both have the effect of reducing the average maturity of outstanding open market operations, and hence increase the turnover of central bank refinancing.

4 PROCEDURAL MATTERS

All credit institutions in the euro area, as well as all banking and financial market associations, are invited to express their views on the changes to the operational framework proposed above. The Eurosystem would like to encourage credit institutions to co-ordinate their replies through associations whenever this is appropriate. It is emphasised that each of the three proposed changes above can be commented upon independently and that opinions can be submitted on just one of the three changes. As a general rule, the comments will not be published.

Replies can be sent in English or in the relevant official EU language to the ECB at the following address or to the relevant national central bank:

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Secretariat Division
Kaiserstrasse 29
D-60311 Frankfurt am Main
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Fax: +49 69 1344 6170
E-mail: ecb.secretariat@ecb.int

The deadline for sending contributions is:

29 November 2002

5. BIBLIOGRAPHY

Further information on the operational framework can be found in the following ECB publications, which are available on the ECB's website:

European Central Bank (2002a), "The single monetary policy in the euro area: General documentation on Eurosystem monetary policy instruments and procedures".

European Central Bank (2000), "The switch to variable rate tenders in the main refinancing operations", Monthly Bulletin, July 2000, pp. 37-42.

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European Central Bank (2002b), "The liquidity management of the ECB", Monthly Bulletin, May 2002, pp. 41-53.