2 Eurosystem monetary policy

The Eurosystem's accommodative monetary policy implementation in the form of non-standard monetary policy measures remained necessary in 2019

The standard channel of monetary policy transmission encompasses a range of policy instruments aimed at managing short-term money market interest rates. In 2014, in response to a prolonged period of low inflation and disruption of the transmission mechanism, non-standard monetary policy instruments were activated in order to influence also medium-term and long-term interest rates. These accommodative monetary conditions remained in place during the year under review. The Eurosystem has been active not only in the money market, but also, via the expanded asset purchase programme (APP), in the government bond market, the covered bond market, the corporate bond market, and the asset-backed securities (ASB) market. In addition, the Eurosystem has provided a substantial amount of funding through longer-term refinancing operations with a maturity of four years. Forward guidance on monetary policy has been a crucial element of the policy toolkit.

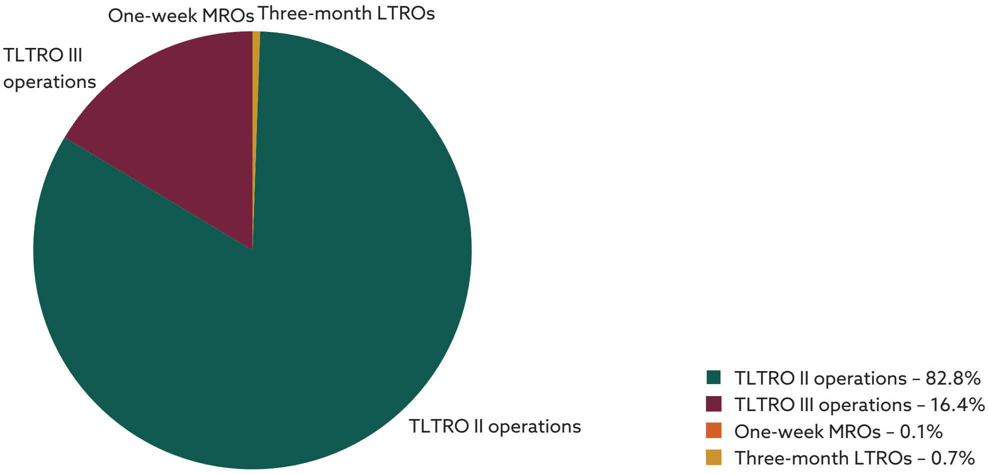
At its meeting in December 2018, the ECB's Governing Council decided to end net purchases under the APP, effective from the start of 2019. The Eurosystem continued to reinvest principal payments from maturing APP holdings, so as to keep the total amount of APP holdings unchanged at €2.6 trillion. In March 2019 the Governing Council announced a new series of quarterly targeted longer-term refinancing operations (TLTRO III) with the aim of preserving favourable bank lending conditions. In September 2019, in response to persistently low inflation, the Governing Council unveiled a package of measures to strengthen monetary policy accommodation in the euro area.

With inflation not converging sufficiently towards its target rate, the Governing Council decided to reduce the deposit facility (by 10 basis points, to -0.50%), but also to adopt additional measures

As part of the September package, the Governing Council decided to lower the interest rate on the deposit facility by 10 basis points to -0.50%. Another measure was the decision to restart net purchases under the APP at a monthly pace of €20 billion as from 1 November 2019. The Governing Council also decided to change the modalities of the TLTRO III operations so as to further support the accommodative stance of monetary policy. At the same time, there was a reformulation of the forward guidance on policy rates. Alongside these monetary policy measures, the Governing Council also decided to introduce a two-tier system for reserve remuneration in order to support the positive impact of negative interest rates on the transmission mechanism.

Chart 11

Outstanding amount of Eurosystem refinancing operations at end-2019 broken down by operation (percentages)



Sources: ECB, and NBS calculations.

As regards its **open market operations** in 2019, the Eurosystem continued to conduct weekly main refinancing operations (MROs) and three-month longer-term refinancing operations (LTROs). In March 2019 the Governing Council decided that it would continue conducting these operations as fixed rate tender procedures with full allotment until March 2021. The new TLTRO III operations began in September and are due to end in March 2021. The last of the TLTRO III operations will mature in 2024, ten years after the Eurosystem launched its first series of TLTROs in 2014 (the second series followed in 2016). The outstanding amount of Eurosystem refinancing operations stood at €624 billion at the end of 2019. MROs and three-month LTROs made up only a sliver of that total, since TLTROs accounted for the vast majority of it (see Chart 11). Besides conducting monetary policy operations, the Eurosystem also continued to conduct tenders providing US dollar liquidity based on the ECB's swap line with the US Federal Reserve System. There was minimal demand in these tenders.

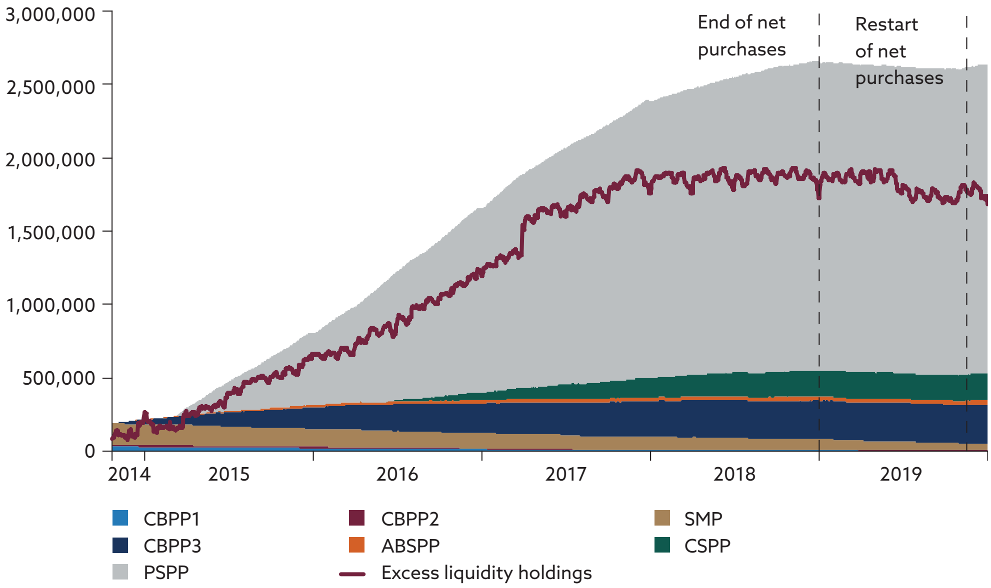
Restart of the asset purchase programme

Based on the ECB Governing Council's decision in September 2019, the Eurosystem restarted net asset purchases under its expanded asset purchase programme (APP). Of the four programmes that make up the APP, the public sector purchase programme (PSPP) accounts for the majority of APP holdings (see Chart 12). Under the PSPP, the ECB and Eurosystem national central banks (NCBs) purchased government bonds issued by Eurosystem countries, and some NCBs also purchased bonds issued by EU supranational institutions. The allocation of purchases to jurisdictions was guided by the respective NCB's subscription to the ECB capital key. At the end of 2019 total PSPP holdings amounted to €2.1 trillion. The APP's second largest component was the third covered bond purchase programme (CBPP3), which at the year-end accounted for €264 billion of the APP holdings. The other two components – the corporate sector purchase programme (CSPP) and the asset-backed securities purchase programme (ASBPP) – contributed €185 billion and €28 billion respectively. The Eurosystem's monetary policy-related assets amounted to €3.3 trillion at the end of 2019, which was slightly lower than their historical high at the end of 2018 (€3.4 trillion).

The drop was caused mainly by early repayments of funds raised through the second series of targeted longer-term refinancing operations (TLTRO II). In 2019 the APP continued to be the Eurosystem's main channel of liquidity provision, accounting for 79% of the annual total. The rest was provided through monetary policy operations. At the same time, in order to mitigate the negative effects of the APP on the securities market, the Eurosystem continued to make assets purchased under the APP available for securities lending.

Chart 12

Asset purchase programme (EUR millions)



Sources: ECB, and NBS calculations.
Note: CBPP1 – first covered bond purchase programme; CBPP2 – second covered bond purchase programme; CBPP3 – third covered bond purchase programme; SMP – Securities Markets Programme; ABSPP – asset-backed securities purchase programme; CSPP – corporates sector purchase programme; PSPP – public sector purchase programme.

Reformulation of forward guidance on monetary policy

An important part of the monetary policy toolkit is the **forward guidance** by which the Governing Council indicates its intentions regarding the future path of policy rates and the reinvestment horizon. Twice in 2019, in March and June, the Governing Council decided to shift out the period for which it expected key interest rates to remain unchanged. In March it said they should be kept at present levels at least through the end of 2019, and in June it extended that period through the first half of 2020. In July the Governing Council opened the possibility of an earlier decrease in rates. By its September decision to cut the deposit facility rate, the Governing Council removed the calendar-based leg of its forward guidance. Its forward guidance on the path of policy rates would now apply until such time as projected inflation converged to a level sufficiently close to the inflation target. At the same time, the Governing Council introduced forward guidance on the duration of the asset purchase programme, stating its expectation that APP purchases would be terminated shortly before the Governing Council started to raise key interest rates. In 2019 the Governing Council not only used forward guidance to shape expectations about the path of short-term interest rates, but also extended it to the longer term.

The Governing Council introduced a measure to support the positive impact of negative interest rates on the monetary policy transmission mechanism, given the need to maintain negative rates for an extended period

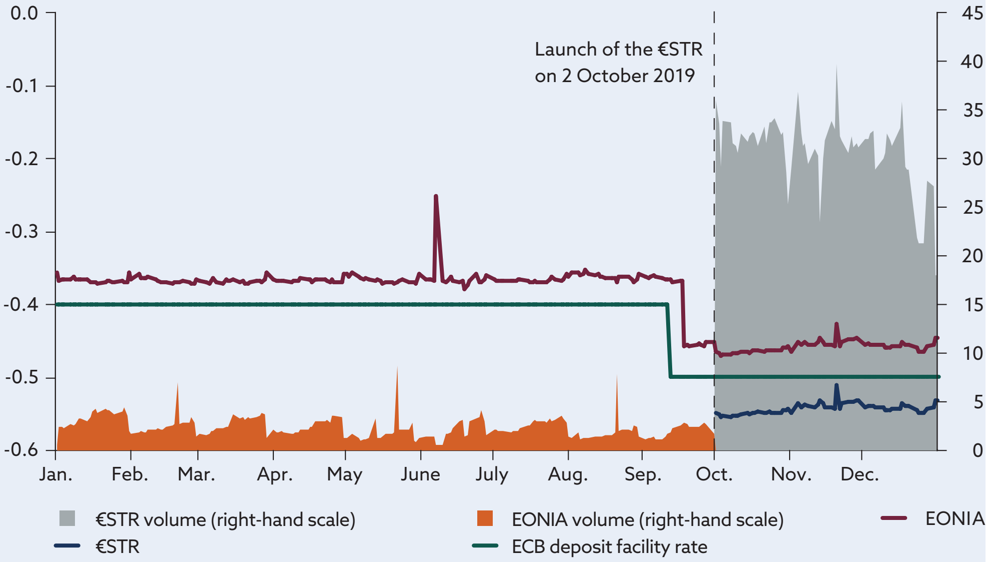
From 30 October 2019, i.e. the start of the seventh maintenance period of 2019, the Eurosystem began implementing a **two-tier system for reserve remuneration (so-called 'tiering')**. Since banks' reserve holdings in excess of their minimum reserve requirements were being remunerated at the negative deposit facility rate, the Governing Council decided that a portion of banks' excess liquidity holdings – set at six times the mandatory reserves – would be exempted from that rate, seeing this step as necessary to ensure the continuing positive impact of negative rates on the monetary policy transmission mechanism. The exemption applies to around €800 billion of the total €1.8 trillion of excess liquidity holdings.

Daily fine-tuning of the banking sector's liquidity is ensured by **overnight liquidity-providing and liquidity-absorbing operations, i.e. standing facilities.** While demand for overnight liquidity provision was close to zero in 2019 (owing mainly to the substantial liquidity surplus in the European banking sector), there continued to be significant recourse to the deposit facility. Nevertheless, due to the local and cross-border reallocation of excess liquidity triggered by the tiering system, the total amount of banks' holdings in the deposit facility was notably lower at the end of 2019 (€250 billion) than at the end of 2018 (around €650 billion).

Box 1
Euro short-term rate (€STR)

In 2017 the ECB's Governing Council decided to develop a new euro short-term interest rate to complement existing benchmarks. After two years of preparation, **the ECB published the euro short-term rate (€STR) for the first time on 2 October 2019. The new rate is published on every business day and is based on banks' actual transactions in the euro area money market.** In substance, the €STR reflects the wholesale euro unsecured overnight borrowing costs of euro area banks. The €STR is calculated by the ECB on every business day on the basis of banks' trading during the previous business day under normal market conditions, so providing an objective representation of current market rates. In contrast to the ECB's key interest rates, which are set by the Governing Council at its monetary policy meetings, the €STR is a weighted average interest rate based on market transactions.

Chart 13
The EONIA and €STR rates (percentages, EUR billions)



Sources: Bloomberg, ECB, and NBS calculations.

In May 2018 the administrator of the euro overnight index average (EONIA) – the European Money Markets Institute – announced that a review of the EONIA aimed at making the benchmark compliant with the EU Benchmarks Regulation had not been successful. At the recommendation of leading representatives of the European banking sector, market participants are expected to replace the existing EONIA benchmark with the new €STR. Although there are several technical differences between the two rates, each represents the overnight interest rate for euro unsecured market transactions. The €STR, however, is more representative since its calculation derives from transactions amounting around €30 billion, while the

EONIA is determined according to transactions worth only around €2 billion. The first publication of the €STR was accompanied by a change in the methodology used to set the EONIA. As a result, the EONIA was redefined as the €STR plus a fixed spread of 8.5 basis points, and this spread will be applied until the EONIA is discontinued on 3 January 2022. The reason for publishing the modified EONIA for a temporary period is to give market participants sufficient time to make the transition from the EONIA to the €STR. Chart 13 shows the EONIA and €STR rates in 2019.