SIMPLY SHORT

European Central Bank to review how it controls interest rates

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The European Central Bank (ECB) tightens or loosens financing conditions in the economy primarily through raising or cutting its key interest rates. These key ECB interest rates, or policy rates, directly affect short-term money market interest rates, as policy rates determine the interest paid by banks when borrowing from the central bank and the interest banks receive when making deposits with the central bank. In recent years, with the ECB's asset purchase programmes and credit granted to banks, the ECB's deposit facility rate has become the principal policy rate. The gradual reduction in the asset purchase programmes and in the volume of credit have prompted the ECB to review how it will control short-term money market interest rates in the future. It must also consider how to take climate change into account in its implementation of monetary policy.

The ECB´s key interest rates are again prominent in monetary policy. The most important of these is the deposit facility rate. The Eurosystem´s balance sheet is shrinking gradually and predictably.
The time is right to review how the ECB controls interest rates and how it will take climate change into account.

To efficiently transmit its monetary policy measures to the economy, the ECB has to be able to steer short-term money market interest rates towards the desired level through the use of its key interest rates.

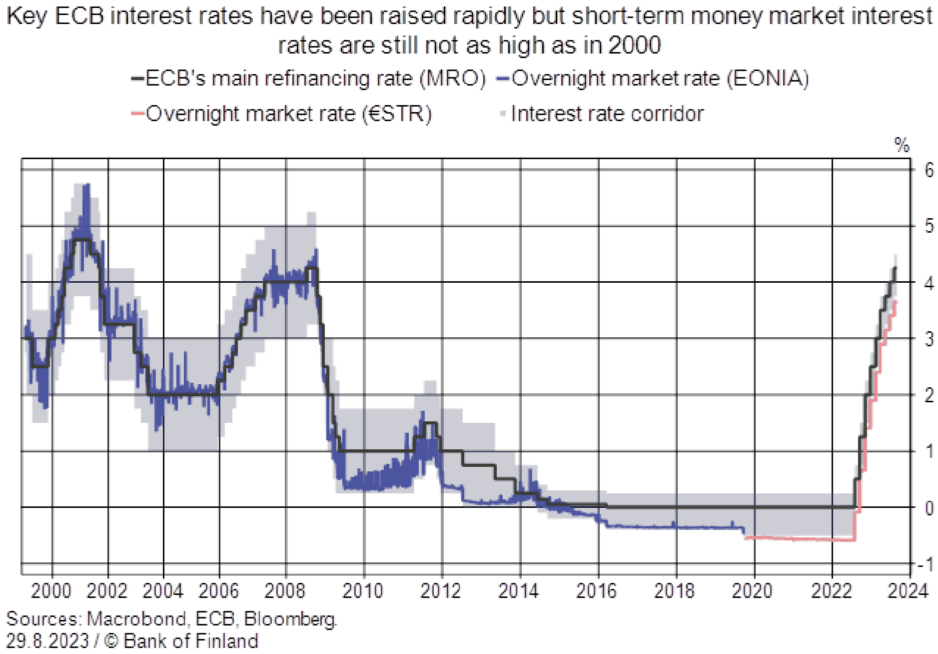
The ECB has three key interest rates: the marginal lending facility rate, the main refinancing operations rate and the deposit facility rate.

The marginal lending facility rate and the deposit facility rate form the upper and lower limits of the 'interest rate corridor' for the short-term money market rates. The marginal lending facility rate is paid by banks when they borrow from the central bank overnight, and the deposit facility rate is the rate received by banks when depositing money (reserves) with the central bank overnight. The main refinancing operations rate is the interest rate banks pay when borrowing from the central bank for one week.

Before the 2008 global financial crisis, the ECB restricted the supply of reserves and thus steered short-term money market interest rates towards the level of the main refinancing operations rate. Over the past 15 years, the euro area economy and the financial markets have faced a number of crises, including the euro area sovereign debt crisis and the COVID-19 pandemic. Inflation was low for a long time. To maintain price stability, the ECB reduced interest rates as much as possible, even to the point where they were in negative territory. This was not, by itself, sufficient, however. To further improve (i.e. loosen) financing conditions across the economy, the ECB purchased a substantial amount of bonds, especially those issued by national governments (sovereign bonds), and granted banks long-term loans on favourable terms. As a result, reserves held by banks grew considerably, and the banks then deposited excess reserves with the central bank. This led to a decrease in short-term money market interest rates from the level of the main refinancing operations rate to the ECB's deposit facility rate.

Since autumn 2021, inflation has been rising sharply, driven up by the pandemic recovery and Russia's war in Ukraine. The ECB has responded to this by rapidly raising its key interest rates. The most important of these, the deposit facility rate, is now at 3.75%, whereas in June 2022 it was still negative, at -0.5%. Nevertheless, short-term money market interest rates have still not reached their previous euro-era high. In 2000, short-term money market rates followed the main refinancing operations rate, which at that time was 4.75%. Now they follow the deposit facility rate.

Chart 1.

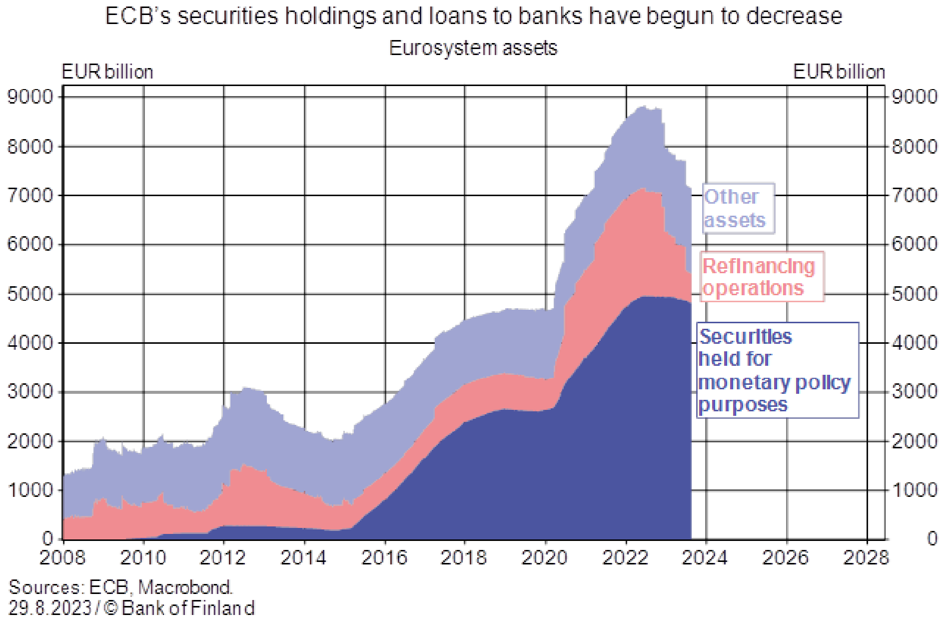


Besides raising its key interest rates, the ECB has also reduced its securities holdings and its lending to banks over the past year. Securities holdings maturing from the asset purchase programme (APP) are no longer reinvested in the market. Furthermore, most of the favourable long-term loans granted to banks (targeted longer-term refinancing operations, TLTROs) have already matured or have been repaid early. The intention is to continue with the reinvestment of maturing principal payments from securities purchased under the pandemic emergency purchase programme (PEPP) until at least the end of 2024.

The ECB stands ready to respond to harmful tensions arising on the sovereign bond market or money market. However, so far, monetary policy tightening has proceeded smoothly on the financial markets. The Bank of Finland's securities holdings, which focus strongly on Finnish government bonds, and its lending to Finnish banks have also been reduced.

With the decrease in the Eurosystem's securities holdings and loans to banks, there is a decline in the volume of banks' deposits with the central bank. When deposits have decreased sufficiently, short-term money market interest rates will begin to rise from the deposit facility rate towards the main refinancing operations rate. Before this, however, the ECB is reviewing how it will control interest rates in the future.

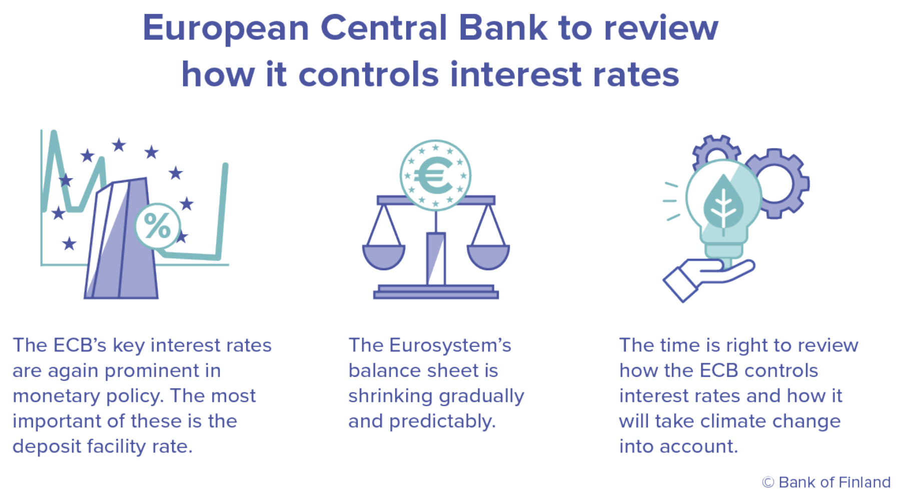
Chart 2.



Each country has its own practices for controlling short-term money market interest rates. The ECB is examining which practices are best suited to the euro area in view of its specific characteristics. These characteristics include a bank-centric financial system and the euro area's vulnerability to interest rate differentiation between member countries.

The choice of how to control interest rates will affect the volume and composition of the Eurosystem's assets and liabilities. In any event, the Eurosystem balance sheet will be significantly larger than before the global financial crisis, as the amount of banknotes in circulation and other liabilities have grown. For this reason, the ECB should consider establishing a structural securities portfolio. The composition of this portfolio could also reflect the ECB's climate strategy objectives.

Chart 3.



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