Eurosystem’s monetary policy instruments and their application in Lithuania

On 1 January 2015, Lithuania joined the euro area and the Bank of Lithuania, accordingly, joined the Eurosystem, which primary objective is to maintain price stability in the euro area. This objective of the Eurosystem is forward-looking and in fact implies the management of mid-term inflation expectations to keep them close to the level defining the stability of prices.

This box provides an overview of monetary policy instruments, which are used by the Eurosystem in pursuit of its primary objective. It also describes cooperation between the ECB and NCBs in this context and specifies the Eurosystem’s instruments that are applied by the Bank of Lithuania. First, it presents the standard monetary policy measures, which the Eurosystem used to pursue its primary objective until 2007. In future, when the euro area’s economic growth returns to a sustainable path, these instruments may once again become the key or the only tools of monetary policy. Next, it discusses the Eurosystem’s non-standard monetary policy measures and the reasons behind their choice as well as the factors, which have led to the current combination of standard and non-standard tools. Finally, it reviews the use of the Eurosystem’s monetary policy instruments by the Bank of Lithuania.

Standard monetary policy measures

Until August 2007, the Eurosystem pursued its primary objective through the setting of interest rates on monetary policy operations and through the steering of short-term interest rates of the euro money market (see Chart A) and the management of liquidity of the banking system (i.e. credit institutions established in the euro area) by way of standard monetary policy instruments (see Table 1).

Standard monetary policy instruments used by the Eurosystem in the past and/or at present

<table>
<thead>
<tr>
<th>Monetary policy instrument</th>
<th>Maturity/frequency</th>
<th>Purpose</th>
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<tbody>
<tr>
<td>Main refinancing operations (MRO)</td>
<td>1 week/Weekly</td>
<td>The Eurosystem uses MROs to lend and refinance funds to the euro area’s credit institutions. The MRO interest rate is the key rate signalling the Eurosystem’s monetary policy stance. Until August 2007, MROs used to be the main monetary policy instrument and used to account for about two-thirds of the total volume of the full set of monetary policy operations.</td>
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<tr>
<td>Longer-term refinancing operations (LTRO)</td>
<td>3 months/Monthly</td>
<td>LTROs are used to provide credit institutions with necessary liquidity, which needs to be refinanced less frequently than MRO loans. Until August 2007, LTROs used to account for about one-third of the total volume of the full set of monetary policy operations.</td>
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<td>Fine-tuning operations</td>
<td>From 1 to several days/on demand</td>
<td>Fine-tuning operations are executed with the aim of eliminating or smoothing unexpected fluctuations in short-term interest rates, which may appear in periods between regular monetary policy operations. Fine-tuning operations are executed through quick tenders and may be used to either supply or absorb liquidity from the banking system. Fine-tuning operations were occasionally executed up till the end of 2010 and accounted for a minor share of the total set of monetary policy operations.</td>
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<tr>
<td>Standing facilities: overnight marginal lending facility and overnight deposit facility</td>
<td>Overnight/access at the discretion of credit institutions</td>
<td>Standing facilities are used to restrict short-term volatility of market interest rates within the interest rate corridor set by the ECB, which has the marginal lending interest rate as its ceiling and the deposit interest rate as its floor. Credit institutions have the discretion to decide when to borrow funds from, or to place funds with the NCB. Until 2008, recourse to the standing facilities was negligible; this was followed by a surge in deposits as the Eurosystem provided boost liquidity to the banking system’s.</td>
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<tr>
<td>Minimum reserve requirements</td>
<td>One month and a half</td>
<td>The purposes of minimum reserves are to stabilise money market interest rates in periods between regular monetary policy operations as well as to support or prop up the banking system’s demand for the Eurosystem’s refinancing operations and, thus, to enhance the Eurosystem’s ability to steer market interest rates. The minimum reserve maintenance period starts on the date of coming into force of a decision on the ECB’s interest rates adopted at a meeting of the Governing Council and ends on the date immediately prior to the coming into force of a decision adopted at the subsequent meeting of the Council. In this way, the ECB’s interest rates usually remain unchanged during the minimum reserve maintenance period.</td>
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Since 2012, the minimum reserve ratio has been 1 per cent (previously, 2%). The minimum reserve requirements are applied to deposits raised by the credit institutions operating in the euro area and to their debt securities issued with an original maturity of up to 2 years. These liabilities of credit institutions account for the bulk of the monetary aggregate M3, which is monitored by the Eurosystem because of its long-term link with inflation.

When using standard and non-standard monetary policy measures, the Eurosystem combines centralised decision-making and coordination with decentralised implementation. Decisions on the features of instruments and their combination as well as on the interest rates are drafted by the ECB in cooperation with NCBs through various committees and working groups. They are adopted by the Governing Council, which comprises the members of the ECB’s Executive Board and the governors of the euro area’s NCBs. The Governing Council also sets the minimum reserve requirements and each NCB supervises credit institutions established in its respective country for compliance with these requirements. The Eurosystem’s lending to credit institutions shall be fully covered by eligible collateral, which shall comply with the general criteria adopted by the Governing Council. The ECB sets the volumes of particular open market operations (MROs, LTROs and fine-tuning operations) for the entire euro area, which are then allotted to credit institutions that choose to participate in centralised tenders. Open market operations are executed by NCBs, which enter into transactions with the domestic credit institutions that are deemed the winning bidders. The volume of standing facilities is not restricted at the central level, however, in a normal context, their use by credit institutions is very limited as a result of interest rates set by the Governing Council: to have access to these facilities, they enter into transactions with the NCB of their home country. Decentralised execution of the Eurosystem’s monetary policy operations makes them available to credit institutions in each euro area country, which became especially relevant after the big shock, which the euro area’s interbank market suffered back in 2008 and has not fully overcome ever since.

**Chart A. ECB interest rates and 3-month EURIBOR**

**Chart B. ECB’s key (MRO) interest rate and inflation**

Non-standard monetary policy measures used by the Eurosystem until 2015

Since 2007, a period of tensions in the financial sector, the Eurosystem has been coupling its conventional monetary policy instruments with non-standard measures, which acquired prime importance soon. The Eurosystem played a vital role in stabilising the financial markets and the economy of the euro area in this period full of challenges for the central banks. It gave market participants and public authorities the necessary time to shore up the banking system and allowed time for governments to embark on the required structural reforms and consolidation of public finances.

The Eurosystem, in tandem with other major global central banks, rolled out non-standard monetary policy measures in August 2007, to counter the rise of tensions in the global financial markets and the spread of subprime crisis. As mutual confidence among credit institutions started crumbling, the central banks, first and foremost, moved to enhance lending to credit institutions, to lengthen the maturity of loans and to provide access to funding in major foreign currencies so as to offset the collapse of the interbank market. The Eurosystem, in its turn, increased the volume of LTROs (which became predominant) and opened up access to borrowing in US dollars to the euro area’s credit institutions. Despite the provision of enhanced liquidity support to the banking system, the Eurosystem continued its interest tightening cycle until July 2008 as it sought to harness inflation that shot above the 2 per cent threshold (see Chart B).
The use of non-standard monetary policy measures by the Eurosystem was further intensified in September 2008, when the period of tensions in the financial sector turned into a banking crisis, sparked by the collapse of Lehman Brothers, an international investment bank headquartered in the United States. The crisis in the banking sector eventually led to a severe recession, which erupted in 2009. The first necessary step towards restarting the economy was to restore confidence in the banking system, which plays a vital (and pivotal in the euro area) role in transmitting accommodative monetary policy signals to the economy. The Eurosystem responded with a standard measures, which involved rapid lowering of its benchmark interest rates, as well as with a package of unconventional instruments. In particular, it stopped limiting liquidity provision via MROs and LTROs, introduced a full allotment at a fixed rate and additional longer-term (6–12 months) LTROs, which quickly became the dominant instrument, and expanded the range of foreign currencies, provided through loans or swaps, to include Swiss francs, Danish kroner and Swedish kronas as well as British pounds sterling, in addition to US dollars. Between July 2009 and June 2010, the Eurosystem implemented its first (albeit limited in scale) securities purchase programme, which involved purchasing of covered bonds issued by credit institutions, as it sought to shore up the supply of credit to the economy. In the first half of 2010, the banking crisis abated leading to a temporary respite in demand for non-standard measures. However, the Eurosystem kept the full allotment via MROs and LTROs as the interbank market remained shallow and fragmented (this instrument is necessary until now).

In May 2010, the Eurosystem had to further broaden the scope of its non-standard measures in response to a sovereign debt crisis which hit certain euro area countries. The Eurosystem resumed purchase of covered bonds and initiated limited purchase of government securities of distressed member states in the secondary market through the Securities Markets Programme in response to an increase in yield spreads for government securities of those crisis-hit euro area countries relative to respective Germany’s papers and to disruptions in the single monetary policy transmission mechanism. Based on volumes, the key operations of the Eurosystem in that period included 3-year LTROs conducted in December 2011 and February 2012, which saw active participation from credit institutions and fully met their total demand of slightly more than EUR 1 trillion. This helped mitigate the crisis, yet the actual breakthrough came in July 2012 with the announcement of outright monetary transactions programme by the ECB President. Those transactions were to involve unlimited purchases of government securities of crisis-hit euro area’s countries by the Eurosystem on condition that those countries undertook to implement an economic adjustment programme agreed with the European Stability Mechanism. Tensions in markets for government securities abated before entering into any outright monetary transactions and the Eurosystem wrapped up its purchases of covered bonds and government securities. The outstanding volume of 3-year LTROs started to decrease rapidly (it fell by 60% by mid-2014) as credit institutions exercised the option to repay, starting from 2013 and before LTRO maturity, any portions of the amounts obtained through these operations.

In 2013, as the euro area’s economy continued to contract and actual inflation fell below the target, the Eurosystem stepped up its forward guidance in July. This instrument is used to convey a message to the market that the ECB intends to keep its interest rates at an unusually low level for an extended period of time, given the subdued outlook for inflation extending into the medium term and economic slowdown.

After cutting its interest rates to record lows, the Eurosystem introduced a new package of non-standard measures in the second half of 2014, as both the annual inflation in the euro area and its medium-term expectations fell below the Eurosystem’s primary objective. The decline in inflation and its shift towards the negative territory was driven by the slump in oil prices, the euro’s appreciation in 2013 and the first half of 2014 and sluggish recovery of the euro area’s economy. Although cheaper energy resources brought down production costs and encouraged consumption, they also ratcheted up fears of negative side-effects of low inflation as higher real interest rates (in particular in the euro area’s periphery countries) and weaker chances for the public and private sectors to reduce their debt burden undermined expectations for growth of the economy and demand and depressed investment.

In 2014, the Eurosystem cut its interest rates by two steps (in June and October), bringing them down to the levels described as a technical floor. The interest rate on MROs was reduced to 0.05 per cent, and the interest rate on the marginal lending facility — to 0.30 per cent. The interest rate on the deposit facility was taken into the unconventional, i.e. negative, territory as it was cut to minus 0.10 per cent in June and brought further down to minus 0.20 per cent in October. The negative interest rate was charged on both overnight deposits made by credit institutions with NCBs and on the entire excess reserves held by credit institutions on settlement accounts with NCBs (i.e. the reserves in excess of minimum reserve requirements).

The Eurosystem established the negative deposit facility interest rate in order to maintain a fairly wide (0.50 p.p.) interest rate corridor of its standing facilities to support the cross-border euro interbank market. Moreover, it was a tool to reduce fragmentation of this market, which developed after the banking and sovereign debt crises, as it encouraged credit institutions from Germany and other euro area “safe havens” to step up lending and investing of their existing excess reserves, inter alia, in other euro area countries, and, therefore, to narrow interest spreads between the euro area’s periphery and its core. Although the exchange rate of the euro is not regulated by the Eurosystem, the exchange rate of the single currency started a downward slide in the second half of 2014 as a result of divergence in the monetary policy cycles of the euro area and the United States and increasing spreads between rates of interest on respective financial instruments denominated in US dollars and euros.
After cutting its interest rates to the technical floor, in 2014 the Eurosystem deployed additional non-standard measures, which included targeted LTROs (TLTROs), a new (the third) covered bond purchase programme and the first asset-backed securities purchase programme.

TLTROs, as the key tool of the 2014 package, are intended to support lending to the real economy. The covered bond and asset-backed securities purchase programmes are aimed at enhancing the effect of TLTROs and supporting the growth of markets for these securities. However, these programmes are just auxiliary tools, given the limited scale of these markets and their role in lending in the euro area. The Eurosystem provided credit institutions with access to TLTROs, which came with an attractive fixed interest rate and were subject to borrowing limits based on the portfolios of loans issued by credit institutions to non-financial corporations and households (excluding loans to households for house purchase) and outstanding as of April 2014 as well as on the trends displayed by those portfolio in the twelve months to April 2014 and on their future developments. The Eurosystem plans to conduct eight TLTROs on a quarterly basis from September 2014 to June 2016. The TLTRO programme will end in September 2018. However, credit institutions will have to repay the funds raised through these operations under the mandatory early repayment procedure if they fail to reach the loan portfolio target. The Eurosystem has already conducted the first three TLTROs, worth a total of EUR 310 billion. In late March 2015, this amount accounted for one-third of the total balance of all liquidity-providing monetary policy operations conducted by the Eurosystem.

Expanded asset purchase programme (2015)

In January 2015, the Governing Council announced an expanded asset purchase programme (EAPP) as it sought to reinforce the existing kit of stimulus tools. This programme was introduced in response to the results of the final quarter of 2014 and forecasts, which showed that the effects generated by the existing package of non-standard measures would be insufficient to reach the turning point for inflation and its expectations. As participation in the first TLTROs by credit institutions was rather low, the Governing Council decided to choose pro-active interventions in debt securities markets as the dominant instrument. The Eurosystem launched purchases of the euro area's public sector bonds in the secondary market under the Public Sector Purchase Programme (PSPP) as it sought to enhance the extent of this tool. The outstanding volumes of these bonds in the market way exceed the respective volumes for covered bonds or asset-backed securities. The EAPP added the purchase programme for public sector bonds to the existing purchase programmes for covered bonds and asset-backed securities of the private sector. The EAPP is often referred to as quantitative easing of the Eurosystem. On top of that, the Eurosystem continues to conduct TLTROs, which are regarded as a good alternative for credit institutions to raise long-term credit resources.

The securities eligible for the public sector purchase programme include euro-denominated bonds issued by the euro area's governments, certain agencies and European institutions and having the residual maturity of 2 to 30 years. Sovereign bonds issued by Greece and Cyprus will remain non-eligible for the EAPP until the countries get positive assessments for their macroeconomic stabilisation programmes from the institutional providers of international financial aid. The Eurosystem will limit its purchases to 25 per cent of any single eligible issue of public sector bond, which will help it avoid obtaining a blocking minority, and to 33 per cent of an issuer’s outstanding securities (this limit applies to the combined holdings of bonds purchased for monetary policy or investment purposes) in order to avoid dominance in the market.

The ECB announced that, together with the NCBs participating in the Eurosystem, it intends to purchase EUR 60 billion a month of securities under the EAPP until September 2016 or beyond that if needed. The end date of the EAPP will depend on success in achieving the goal of this instrument, which is to get inflation back on a sustainable path consistent with the primary monetary policy objective. The total scale of the EAPP over the specified period of 19 months will amount to EUR 1.14 trillion, which would swell the Eurosystem’s balance sheet by approximately 50 per cent.

Purchases under the EAPP will be split between the NCBs and the ECB. The ECB will buy 8 per cent of the public sector bond while the remaining 92 per cent will be purchased by the NCBs. Each NCB will purchase bonds issued by its respective domestic public sector. Purchases of securities by the NCBs will be divided on the basis of the NCBs’ capital key in the Eurosystem’s paid ECB’s capital (the capital key of the Bank of Lithuania is 0.587%). Moreover, 80 per cent of the total purchases which will be conducted by NCBs under the EAPP will be allocated to bonds issued by central governments and national agencies and the remaining 12 per cent — to bonds issued by European institutions, which will be purchased by NCBs and ECB. If the market is in short supply of bonds issued by the national government and agencies as a result of abovementioned issue and issuer limits, the respective NCB will have to attain its target defined by the capital key through the purchase of bonds issued by European institutions. Purchases of covered bonds and asset-backed securities are split between the members of the Eurosystem based on the scale of the markets for these securities in individual countries and the NCBs’ competence therein.
As laid down in Article 127 of the Treaty on the Functioning of the European Union and in Article 2 of the Protocol No 4 to the TFEU on the Statute of the European System of Central Banks and of the ECB, the primary objective of the ECB and the NCBs of the EU is to maintain price stability. The Eurosystem is made up of the ECB and the NCBs of the EU Member States whose currency is the euro. On 8 May 2003, the Governing Council of the ECB refined the definition of the price stability objective pursued by the Eurosystem as “an annual increase in the HICP for the euro area of close to but below 2 per cent in the medium term”.

In macroeconomics, “medium term” defines a period, which it takes for production and employment as well as prices to respond to changes and which is insufficient for the level of investment and labour to reach new equilibrium (which is a feature of “long term”). The medium term usually means three to five years.

The European Stability Mechanism is an intergovernmental institution established in 2012 by the euro area countries as a permanent euro area crisis management mechanism for the provision of financial assistance to the euro area countries.

The interest rate on TLTROs conducted in September and December 2014 equalled the interest rate on MROs plus 0.10 p. p. The Governing Council of the ECB reduced the interest rate on subsequent TLTROs to match the level of MRO interest rate.

Purchases under the EAPP were launched on 9 March 2015. Public sector bonds purchased in March and April 2015 accounted for 78 per cent of the total amount of EUR 121 billion, covered bonds — for 20 per cent, and asset-backed securities — for 2 per cent.

The effects of the EAPP became evident as early as in November 2014 with a considerable build-up of market expectations related to this programme. They further intensified in January 2015 with the adoption of the programme’s guidelines by the Governing Council. Those effects included a substantial decrease in yields on public and private sector’s bonds, in particular long-term, improved access to bank loans and their demand as well as a decrease in costs involved in tapping other financial resources. Inflation expectations started to increase after bottoming out in January 2015. Meanwhile, professional forecasters from public authorities and the private sector moved to revise up substantially their forecasts for the growth of the euro area’s economy.

Europystem’s monetary policy instruments applied by the Bank of Lithuania

The Bank of Lithuania, which has been part of the Eurosystem since early 2015, is implementing both standard and non-standard monetary policy instruments. Starting from early January, the Bank of Lithuania enforces the minimum reserve requirement of the ECB, which the credit institutions operating in the country must comply with. It also offers access to MROs, LTROs, TLTROs and standing facilities. Lithuania has no markets for asset-backed securities or covered bonds hence the Bank of Lithuania is not involved in these securities purchase programmes. However, it has joined the Public sector purchase programme. Based on current estimates, the Bank of Lithuania will purchase EUR 1.2 billion worth of the Republic of Lithuania government securities within the framework of this programme. As the market for the Republic of Lithuania government securities is too shallow for the Bank of Lithuania to be able to purchase the entire volume assigned by the capital key rule, it also purchases the EAPP-compliant bonds issued by European institutions.

The EAPP has both direct and indirect effects on the Lithuanian economy and its full effect will unravel in the longer term during its implementation and some time thereafter. Direct effects feed through to the economy via low interest rates and the weakening of the euro, while indirect effects, as expected, manifest themselves through the economic uptick in the euro area countries, which are Lithuania’s main export markets. With the EAPP still being in its initial implementation stages, it will take time before it becomes possible to measure more precisely the total impact of the programme on the economy of Lithuania and the entire euro area.

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