The width of the ECB's Monetary Policy Corridor

Implications for the EONIA Rate and Money Market Activity

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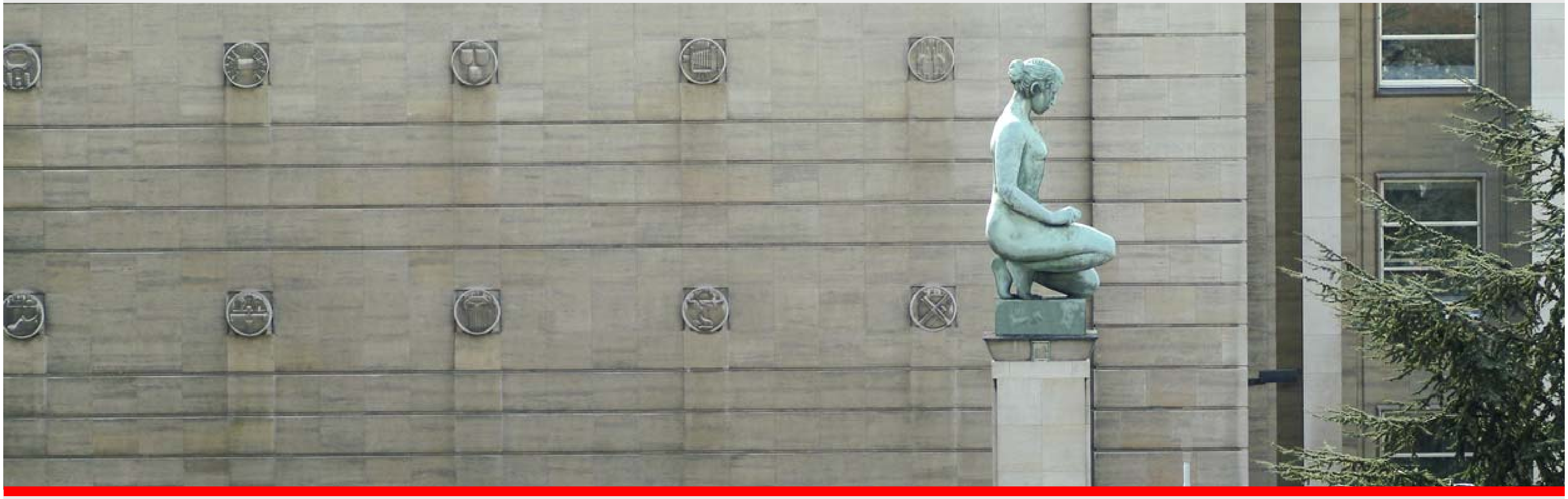

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Brief overview of the study

- What?
  - Analysis of the impact of the witdth of the monetary policy rate on MM in the euro area, looking at 4 channels:
    - Level
    - Volatility
    - Term structure of MM rates
    - O/N market transactions
- How?
  - Qualitative review of different episodes of the ECB's monetary policy corridor
  - Quantitative analysis (GARCH model for the level and the volatility of the EONIA rate; simulation exercise to analyse the effect of the corridor width on MM activity)
- Results
  - The width of the corridor has no effect on the level of the EONIA rate
  - The width of the corridor limits interbank rate volatility, but also other factors play a role
  - Findings for the volatility of the O/N interest rate have an implication for LT rates
  - A narrow corridor can sometimes limit MM activity
  - In the current environment with excess liquidity, the narrow width of the corridor does not limit interbank lending

Remarks/questions w.r.t. the paper

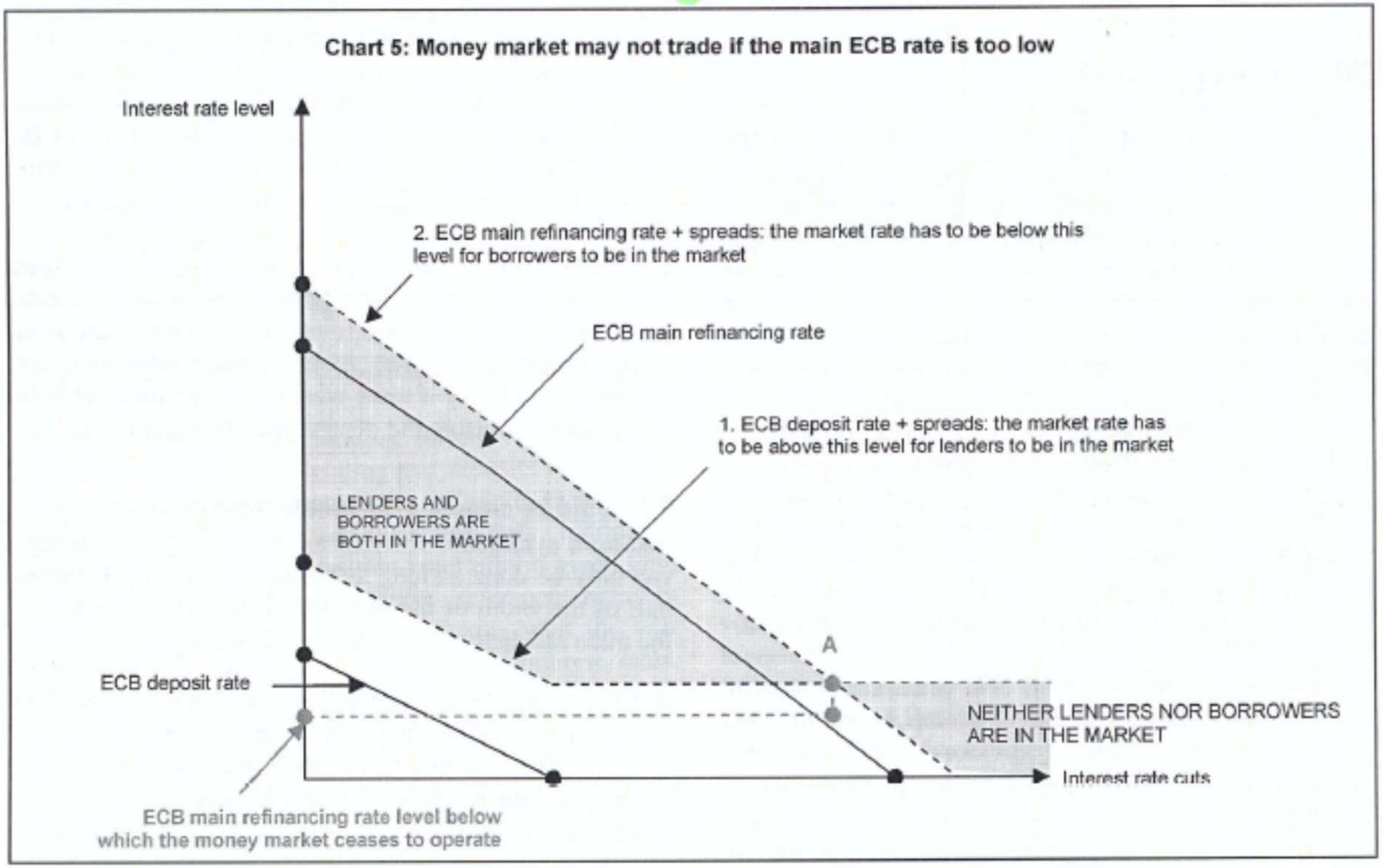
- Indicators (level/vol/term/volumes) used in the study are valuable. However, the width of the corridor is only one parameter. Other parameters could be investigated in future research.
  - E.g. The EONIA spread before and during the crisis of 2007-2009: The role of liquidity and credit risk (Beirne, 2012)
    - Paper provides an overview of the drivers of the EONIA spread across non-crisis and crisis regimes

- The episodes-section: valuable. (An overview table could be added)
- Calendar effects (end of reserve maintenance periods) may be given more prominent attention (maybe the width does matter for the level of eonia on the last day of the MP?)
- Elaborate some more on why EONIA moved towards the DF since fixed rate full allotment

Market views on corridor width

- Goldman Sachs (April 2009)
  - The exact corridor width has to balance two aims:
    - It should be narrow enough to stabilise short-term interest rates (ie cap their volatility)
    - It should be wide enough to avoid ECB operations fully crowding out of MM activity
  - GS states that narrowing the rate corridor led to an unsatisfactorily high use of the DF
  - GS looks at *the level of monetary policy rate* where markets will cease to be active:
    - The level of the MRO rate at which MM cease to operate is strictly positive, but that does not preclude the deposit rate being at zero
    - Markets will not operate if the MRO rate reaches zero unless there is no strictly positive ‘natural’ spread of market rates over the deposit facility

Market views on corridor width (2)



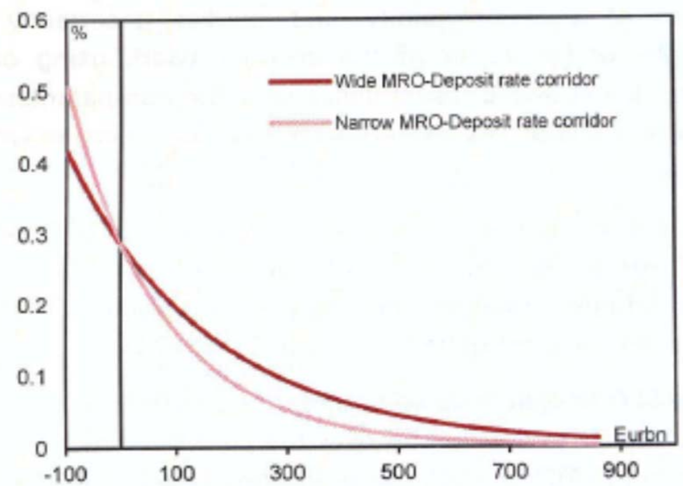
Source: GS.

Market views on corridor width (3)

- Goldman Sachs (April 2014)
  - GS estimated the EONIA/excess liquidity relationship (non-linear ‘L-shaped’ relationship in ‘normal times’)
  - GS obtains a positive and significant coefficient for the excess liquidity interaction term with the ECB corridor width: a wider corridor results in a higher EONIA for a given amount of excess liquidity and market uncertainty/fragmentation). A wider corridor is associated with an outward shift in the L-curve.

Exhibit 11: Wider ECB interest corridor pushes up Eonia / excess liquidity curve

Eonia - deposit rate vs. Excess liquidity



*Source: Goldman Sachs Global Investment Research *Wide MRO – Deposit rate corridor: 100bp, Narrow Corridor: 25bp. Coefficients obtained from base-case specification of regression the log Eonia / Deposit rate spread of excess liquidity w. interactions terms, chg. in aut. factors and calendar effects.*

Market views on corridor width (4)

- RBS (March 2014)
  - GC member Knot is an advocate of the view that the corridor should not be narrowed any further, because this would make market functioning more difficult
  - Conventional argument for not compressing the corridor any further:
    - It would increase the tendency for the Eurosystem balance sheet supplant the short-term MM, which in turn implies the loss of valuable information and incentives embedded in observed market rates
  - RBS states 3 arguments to justify a cyclical (temporary) compression of the corridor
    - RBS finds it hard to believe that members of the GC can be too dogmatic about the width of the corridor so long as the ECB remains in fixed rate full allotment mode
    - The strongest case for a steady state compression in the corridor is that the market for O/N money serves no real purpose. Markets cannot discover the price of central bank money: central banks are the monopoly providers and policy committees decide the optimal price
    - If the volatility is hard to rationalize and of little obvious benefit and potentially some cost to the wider economy, and the ECB is already in FRFA, why resist the natural remedy to this situation? Narrow the corridor.

Market views on corridor width (5)

- Nomura (November 2013)
  - Pro narrowing the corridor:
    - Would help protect euro area rates from Fed tapering
    - Would reduce EONIA volatility
    - This view was also articulated by Belgian Central Bank Governor Coene: a further fall in inflation could warrant ECB action and a narrowing of the corridor could reduce volatility in short-term rates