R.I.P. TLTROs, long live green dual rates

Open letter to the European Central Bank's Governing Council

1st June 2022

When tightening its monetary policy, the European Central Bank should continue to make use of the innovative "dual rate" embedded in its Targeted Longer-Term Refinancing Operations programme (TLTROs).

In the world of modern central banking, the most genuine innovations often hide behind obfuscated acronyms, convoluted guidelines and template spreadsheets. Such is the case of the ECB's targeted longer-term refinancing operations.

The genuine innovation in the TLTRO's bottle lies in the fact that it created a "dual rate" system where banks were rewarded with a discount rate if they effectively contributed to the transmission of the ECB's monetary policy into the real economy.

In practice, while the ECB's key rate stood at -0.5%, banks could borrow at -1% under TLTROs, if they achieved a certain "lending performance threshold" in terms of loans to the real economy. During the pandemic, this threshold was lower to 0% of lending volume growth, meaning that banks could receive the subsidised rate as long as they didn't decrease their lending to the economy.

And it was a success. The TLTROs were massively taken up by banks, with 2.2 trillions of outstanding lending at the current peak. Despite the fact that banks received 12 billions from the ECB from by borrowing money at a negative rate, it is intriguingly remarkable how little controversy nor court litigations had been triggered by the TLTROs. In the peculiar world of Eurozone's central banking, this is a victory in itself.

The ECB invented the TLTROs at times when its priority was to stimulate aggregate demand in order to cope with frustratingly low inflation levels.

Today, the ECB is facing the opposite problem, with inflation hitting record high levels since the creation of the Eurozone, as a consequence of tensions on food and energy markets due to the War in Ukraine, weather events and the still ongoing pandemic crisis. The current inflationary pressures are clearly not stemming from monetary phenomena, but from one very material problem: the excessive reliance of the European economy on fossil fuels energy. What Isabel Schnabel called "fossilflation".[1]

Combatting fossilflation

Understandably, the ECB is now revisiting its monetary stance and the future design of refinancing instruments. However, the complexity of this new conjuncture requires a more sophisticated response than simply raising interest rates across the board. High inflation triggered mainly by a supply side shock should not exclusively be tackled by 'only' weakening the demand side. Particularly not when the eurozone economy is in desperate need of investments to manage the green transition but also to improve its digital and conventional infrastructure.

While the TLTROs programme should probably be phased out, the benefits of prolonging the ECB's discount rate policy within the refinancing operations should be properly evaluated by the ECB ahead of the next Governing council meeting of June 9th and July 21st.

The advantages of a dual rate strategy go well beyond the case for a more accommodative monetary policy. As a matter of fact, the ECB could perfectly raise the key interest rate by 50 basis points while keeping the discount rate on TLTROs at its current level, or commit to keep the discount rate at 50bps below the key interest rate. Thus, dual rates can work at any point of the economic cycle.

[1] "A new age of energy inflation: climateflation, fossilflation and greenflation", speech by Isabel Schnabel at The ECB and its Watchers XXII Conference, 17 March 2022

But for what purpose the ECB should continue offering a discount rate today? Answering this question requires thinking about how bank lending should be incentivized in order to optimise the transmission of monetary policy.

The case for green dual rates

Given that the current inflationary pressures are clearly not stemming from monetary phenomena, but from one very material problem: the excessive reliance of the European economy on fossil fuels energy. What Isabel Schnabel called "fossilflation". The most obvious response to fossilflation is to accelerate the pace of the green transition, by doubling down the amount of investments towards energy efficiency and renewables, as outlined in the European Commission's REPowerEU' strategy.

As the ECB recognised during its recent strategy review[1], a slow and disorderly transition will multiply the risks of further energy price shocks in the coming decades, making the ECB's price stability mandate even harder to deliver. The ECB has everything to gain from a successful transition towards a greener energy mix.

Enters the "green dual rate" proposal: the ECB could introduce a green discount interest rate on future refinancing operations, but this time designed to incentivize banks to increase their lending towards areas of the supply side where shortages are currently sources of inflationary pressure: clean energy production and energy efficiency renovations. Cheaper capital costs for these investments would stimulate the supply of green domestic energy, while also directly supporting households navigate throughout the cost of living crisis, by reducing energy consumption and bills.

Isabel Schnabel rightly pointed out the technical difficulties of asking banks to categorise their loan book. This is no small challenge, but one that the EU is already tackling. Under the EU taxonomy, banks will start collecting data on energy performance on their mortgage portfolios and renovation loans as soon as 2023.

"Never let a good crisis go to waste," Churchill famously said. By reinventing its dual rate strategy, the ECB has the opportunity to ensure it keeps one of the best innovations of the last crisis while improving its ability to navigate the new and future energy crisis.

1 "Climate change and monetary policy in the euro area," Occasional Paper Series 271, European Central Bank.

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