

Money markets at the crossroads

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* The views expressed in this presentation are those of the presenter and not necessarily those of the ECB.

Central banks around the world face a challenging environment



Central bank operations (as share of GDP)

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Source: ECB SDW, IMF, BOJ, FED, Bloomberg

A triangle of challenges

- 1 Large(r) central bank balance sheets
- 2 Low(er) for long(er) and negative policy interest rates
- **3** Operational frameworks in the long-term

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Large central bank balance sheets

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Asset purchases and lending operations drove the ECB balance sheet and bank excess liquidity holdings to unprecedented levels



Source: ECB. Last observation: 30 July 2021.

Notes: standard operations such as the main refinancing operation and the three-month LTROs are excluded. Standard operations make up for less than 1% of the liquidity provision.

Effect 1: high and persistent levels of excess liquidity weigh on unsecured interbank activity, while EONIA decline to the deposit facility rate

Unsecured interbank volume as a function of excess liquidity



Notes: Y-axes show the total quarterly unsecured transaction amount for the overlapping sample of the 38 reporting agents that took part in the EMMS study and MMSR (LHS) and the EONIA volume on the last day of each quarter (RHS) for every Q2 starting from 2003. X-axis shows the quarterly average euro excess liquidity, for every Q2 starting from 2003 until 2021. Source: EMMS, MMSR, ECB.



Notes: Y-axis shows the quarterly average of the ratio of the spread of EONIA to the DFR and the spread of the MRO to the DFR. X-axis shows the quarterly average euro excess liquidity for the period 2008-2021 Q2. Source: EMMI, ECB.

EONIA as a function of excess liquidity

Effect 1: non-bank financial institutions (NBFI) activity becomes a major driver of money market volumes and rates



Notes: 1-m Bubill rate is the 10-day moving average and rate on repo with NBFIs is based on MMSR transactions. Source: ECB, Bloomberg, MMSR, EMMI.

Effect 2: the Eurosystem's footprint (as an intermediary) has grown, but without significantly displacing private market participants

Central government bonds held by the Eurosystem and by market participants (EUR tn, share of total outstanding)



Source: ECB, EADB, CSDB

Effect 2: Eurosystem securities lending facilities help to alleviate the scarcity effect on collateral and securities markets



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Source: MTS, BrokerTec Note: Chart truncated at -1% for readability

Effect 3: high reliance on attractive refinancing operations also impacts money market conditions



Source: ECB.

Source: Bloomberg.

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Low for long and negative policy rates

Smooth transmission of negative policy rate to money market rates, bringing the effective lower bound below zero



Note: Solid bars show the decline in rates in the first maintenance period (MP) after the rate cut. Dashed bars show the decline in market rates from the second MP after the rate cut until the next rate cut. All data based on MP averages. Source: EMMI, Bloomberg, ECB.

Notes: Forward OIS curves on selected dates: before negative rates (March 2014) and after three of five 10-bp deposit facility rate cuts from 0% to -0.5%. Source: Refinitiv, ECB estimations.

Money markets remain active below zero

Trading volume per money market segment (bank and CCP counterparties) (EUR tn)



Active transmission of negative policy rates to interest rates on deposits

Share of deposits with negative rates (%)



Sources: ECB (iMIR, iBSI) and ECB calculations. Latest observation: March 2021.



Operational frameworks in the long-term

Three main discussion points

- 1. Is it desirable to maintain a regime of ample reserves?
- 2. Is it feasible to operate a regime of scarce(r) reserves?
- 3. What is a desirable and feasible intermediary function towards money markets, given the role of non-banks?

1. Is it desirable to maintain a regime of ample reserves?

Excess liquidity is expected to remain high



Source: ECB calculations.

Notes: The range captures the scenarios of 0% and 100% repayment of TLTROs and the take-up in further operations and the duration of asset purchases correspond to the expectations expressed in the survey of monetary analysts.

2. Is it feasible to operate a regime of scarce(r) reserves?



EONIA to excess liquidity relation

Note: Y-axis shows the normalised EONIA = EONIA to DFR spread / MRO to DFR spread, which is subsequently projected onto the current MRO to DFR spread of 0.5pp with DFR=-0.5%. The observations in blue reflect a period when regulatory

demand is expected to have become important. The observations in red reflect the period since the introduction of the two-tier system which exempted part of the excess liquidity holdings from the negative DFR. Source: EMMI, ECB.

Banks may have a higher and less predictable demand for reserves

Factors (beyond the MRR) which may be driving the demand for central bank reserves are:

- 1. Payment needs are to a large extent facilitated by broad access to (intraday) credit
- 2. Liquidity regulation may incentivize banks to hold reserves, although it does not prescribe a minimum of reserves and acknowledges banks ability to monetize eligible collateral
- 3. Heterogeneity in euro area government bonds yields and European banking sector may result in a higher demand for reserves
- 4. Banks' business models may have been adjusted to the environment of broadly available reserves

2. Is it feasible to operate a regime of scarce(r) reserves?

Intraday credit usage remains fairly common among euro area market participants



Source: ECB Economic Bulletin Issue 5/2020. Note: Data covers the period from June 2008 to December 2019.



Reserve holdings are fairly concentrated

in the euro area, but less than in the US

Source: ECB and the FFIED. Notes: Banks' excess liquidity holdings in the euro area

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3. What is a desirable and feasible intermediary function towards money markets? Liquidity providing operations

Through banks

Existing lending operations

Standing repo facility / ECB MLF

Fixed Rate Full Allotment

Purchase programmes

Direct with non-banks

Ease funding costs for non-banks Addressing market dysfunction Financial stability: Avoid fire sales

> New territory Operational challenging Moral hazard

3. What is a desirable and feasible intermediary function towards money markets? Access to central bank deposit / account - liquidity absorbing operations

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Sources: MMSR, ECB.

Notes: DF stands for Eurosystem deposit facility. Shown is borrowing activity of MMSR reporting banks via deposits from financial counterparties at all maturities.

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Concluding

- Money markets dynamics have changed due to the increasing balance sheet of the Eurosystem
- Money markets remained active and functioning and have proven to be robust to negative interest rates
- The ECB's policies and the outcome of its <u>strategy review</u> will be important drivers for euro area money markets in the future