

16 September 2021

Video conference of the ECB's Bond Market Contact Group

15 September 2021

Summary of the discussion

Welcome remarks by ECB Executive Board member Isabel Schnabel

ECB Executive Board member Isabel Schnabel opened the meeting and provided her views on the most recent bond market developments: [The monetary policy non-puzzle in bond markets](#).

1) Review of bond market developments

Christoph Rieger (Commerzbank) reviewed the main bond market developments since the last meeting on 27 May 2021. The discussion focused on the downward trend in euro area bond yields over the summer and the question of how financial markets would react to the end of the coronavirus (COVID-19) emergency state phase, based on current knowledge.

There was consensus that the decline of euro area bond yields over the summer was driven by a combination of technical factors: low primary market supply, implementation of the asset purchase programme (APP) and the pandemic emergency purchase programme (PEPP), and one-sided speculative positioning in the market. There were diverging views on the extent to which real yields matter in bond market trading. The majority of members were of the view that real interest rates matter economically and for equity and housing markets, but that from a bond market perspective they can be considered residual as most of the trading volumes are in nominal bond and inflation swap markets. Some members raised concerns that if the most recent increase in inflation rates proves to be only temporary, real interest rates might face considerable upward pressure in 2022.

With regard to the future design of monetary policy purchases and their pace, several members highlighted the importance of a flexible backstop for bond markets. Even though it was widely acknowledged that the PEPP has not recently made excessive use of its flexibility to deviate in purchases from the ECB's capital key, it was stressed that an extension of the PEPP due to its flexibility beyond March 2022 would provide more comfort to bond markets than adjustments to the

APP, regardless of the actual purchase pace. One member highlighted that there were some signs of dislocation in the ultra-long bond market segment during summer, as the segment is currently not eligible for APP purchases. A few members would welcome an increase of the share of supranational bonds under the APP in order to reflect the growing size of this segment.

On the market reaction to a slowdown of PEPP purchases, one member expressed the view that the impact on intra-euro area sovereign yield spreads will be limited, as long as financing conditions remain benign and economic growth prospects improve. Another member highlighted that in search for yield, investors have turned to the euro area high-yield corporate bond segment which might become a cause of concern once monetary policy accommodation is scaled back and corporate default rates potentially increase.

2) Developments in ESG bond markets and the role of NGEU

Christian Kopf (Union Investment) provided an update on the developments in environmental, social and governance (ESG) bond markets and the role of NextGenerationEU (NGEU). The discussion concentrated on the challenges that come with the rapid increase in market size of green and sustainability-linked bonds and the simultaneous developments of common standards and principles.

Members raised concerns about the complexity of the EU taxonomy for the bond issuers but at the same time highlighted some very useful aspects, such as the external reviewer role for European Green Bonds given to the European Securities and Markets Authority (ESMA) to provide market integrity and ensure the high quality and reliability of the reviewer's services.

Criticism focused on the fact that the taxonomy lacks the necessary flexibility to ensure that outstanding green bonds issued under the current market principles and standards do not lose their green status. Members stressed the importance of taking into account the peculiarities of certain issuer categories. Sovereign green bonds normally finance a large variety of projects and their implementation is sometimes challenging to control, while it is also difficult to ensure that the issuer sticks to the commitments.

There was a broad consensus that one of the major challenges ahead is the financing of the transition to a sustainable economy. In this regard, transition efforts should be supported on a broader scale and financing should not be channelled only to best-in-class companies.

3) The impact of bond ETF growth on cash market liquidity

Enrico Bruni (Tradeweb) reviewed the growing role of bond exchange-traded funds (ETFs) and their use during the COVID-19 pandemic. Members agreed that ETFs provided liquidity and

showed a high degree of robustness during the most recent episodes of market stress and enabled investors to adjust their portfolios smoothly in certain situations.

Members related that they use ETFs most often to rebalance or reallocate their portfolios, which can be more convenient and provide efficiency gains through the portfolio trading feature. At the same time one member voiced concerns over a liquidity illusion.