EUROPEAN CENTRAL BANK

EUROSYSTEM

DG MARKET OPERATIONS

6 December 2023

ECB Money Market Contact Group

Tuesday, 5 December 2023, 09:00-13:00 CET, Frankfurt am Main, hybrid meeting,

Summary of discussion[1]

MMCG members reported a disconnect between market pricing, analysts' expectations, and the ECB's communication on the future path of its policy rates, with markets pricing in more frequent and earlier rate cuts in 2024. Members highlighted that this disconnect was fuelled partly by market participants' attempts to hedge against earlier rate cuts with the current pricing of overnight index swaps (OIS), while low liquidity in the OIS market and the closing out of earlier positions for higher rates amplified the latest moves. Some members also pointed to the ECB's mixed track record in following through with its previously provided orientation on the future path of interest rates.

Money market liquidity was concentrated mainly in shorter maturities. Shorter tenors were an attractive investment given the yield curve inversion, while longer-term investments carried greater uncertainty about the timing of interest rate cuts. Some members reported higher demand for floating rate instruments for longer-term investments – with banks' issuance adjusting accordingly – as investing in such instruments avoided the negative carry that fixed rate assets entail in an inverted yield curve environment.

Banks' funding plans were expected to be lighter in 2024 compared with 2023, owing partly to prefunding as the level of interest rates continued to benefit money market and fixed income investment overall, including in bank funding instruments. As a result, repayments of funds provided under the third series of targeted longer-term refinancing operations (TLTRO III) in 2024 were not expected to be a concern. This was also reflected in the spread between EURIBOR and OIS rates, which was not pricing in imminent liquidity or credit risks. Moreover, some members expected larger early repayments of TLTRO III funds in December 2023 given the degree of prefunding by banks. Banks' bond issuance met with sufficient demand but members were of the view that if signs of stress were to emerge, this favourable funding situation could quickly reverse, especially for smaller banks, as in spring 2023. Moreover, lower interest rates could reduce flows into money market funds and, in turn, dampen appetite for investing in bank funding instruments.

Members highlighted the impact on money markets of the change in the remuneration of minimum reserve requirements (MRR). In particular, unsecured overnight rates and volumes dropped on the last day of the month if that day was one of the eight MRR calculation dates in the year. Those unsecured deposits were partially placed in repo markets, causing

[1] Disclaimer: The views expressed in this summary are those of the MMCG members and do not necessarily reflect those of the ECB.

downward pressure on repo rates and the euro short-term rate (€STR) on the MRR reporting dates. Furthermore, an increase in overnight US dollar funding costs in the EUR/USD FX swap market was observed on MRR reporting dates, as banks tried to place their euro in the FX swap market against the US dollar. However, some members considered these market developments modest at the November month-end, while others pointed out that a potential increase in the MRR ratio would exacerbate them and lead banks to further exploit avoidance strategies.

The pricing of the year-end in money markets was seen as benign and substantially less expensive than last year in both FX swap and repo markets. Several reasons were mentioned, including better collateral availability and less restricted balance sheet capacity, owing also to lower Single Resolution Fund costs in 2023.

Members discussed the growing importance of non-bank financial institutions (NBFIs) in financial markets. Euro area banks relied increasingly on NBFIs for funding, in particular in longer maturities. In shorter tenors, banks were more restrictive in their acceptance of short-term deposits from NBFIs, especially around balance sheet reporting dates. However, NBFIs – in particular money market funds (MMFs) – had a preference for short-term investments owing to the current interest rate environment and credit spreads, as well as for regulatory reasons. While NBFIs were the main buyers of banks' issuances, members also referred to the comparative appeal of holding deposits rather than debt securities for NBFIs, as the former were not subject to valuation volatility. They discussed the implications of buy-back options for banks' commercial paper (CP) issuances. Views were mixed on the topic. Some members highlighted that buy-backs remained an option that offered advantages for issuers, giving them the possibility of replacing CP with a short remaining maturity with longer-dated CP. However, others mentioned that banks were expected to be able to buy back their issuances, which further increased banks' liquidity needs.

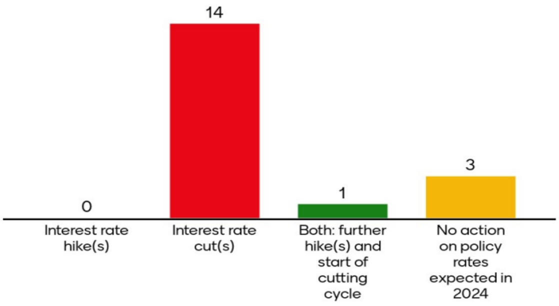
Regarding the ECB's operational framework review, the majority of members expected the ECB in the future to operate in a floor system with ample liquidity, a mix of credit operations and a structural bond portfolio. Members discussed various operational framework options, the corresponding necessary level of excess reserves and instruments, as well as the effectiveness of the different frameworks in steering short-term money market rates. For the supply-driven floor system, members highlighted the uneven distribution of reserves in the euro area which created uncertainty about accurately estimating the demand for reserves, creating the risk of local scarcity of reserves. For the demand-driven floor system, members stressed the importance of avoiding stigma in liquidity-providing operations. Negative side effects on banks' funding markets should be carefully considered in the operational framework review in terms of instruments and counterparty selection to not crowd out private sources. Members concluded that the liquidity needs of the banking system today were higher than before the global financial crisis, owing in part to regulation, in particular the liquidity coverage ratio (LCR). Both the LCR and the net stable funding ratio (NSFR) were expected be in focus in 2024, with retail banks having a stronger focus on the LCR and investment banks focusing more on the NSFR. Moreover, members discussed their thoughts on potential changes to the ECB's collateral and counterparty frameworks.

Members viewed the prospects of a revival of the unsecured interbank market as limited. Reduced unsecured counterparty limits and the impact on risk-weighted assets (RWA) and LCR disincentivised banks to lend out unsecured in sufficient amounts.

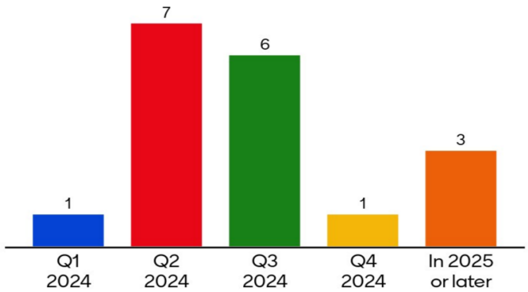
Investments by NBFIs in bank products were not seen as a sufficient alternative to the interbank market as a liquidity distribution channel, as a result of regulatory restrictions and preferences to invest in certain countries and institutions only. Members agreed that the repo market had a liquidity-distributing role across euro area banks, despite the fact that cross-border lending was still judged to be limited by some members owing to the lower appetite for risk of central counterparties (CCPs) in accepting all euro area collateral and overall insufficient cross-border credit lines for the time being.

Survey of MMCG members (18 replies, conducted 1-4 December 2023)

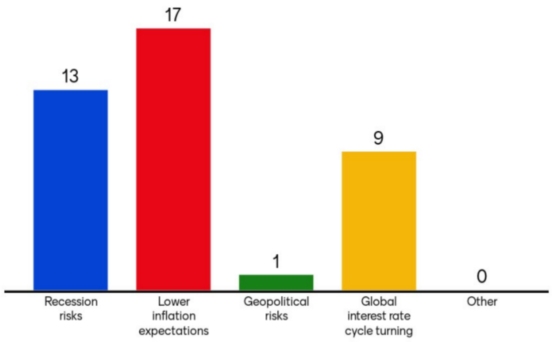
Which policy rate actions do you expect from the ECB in 2024?



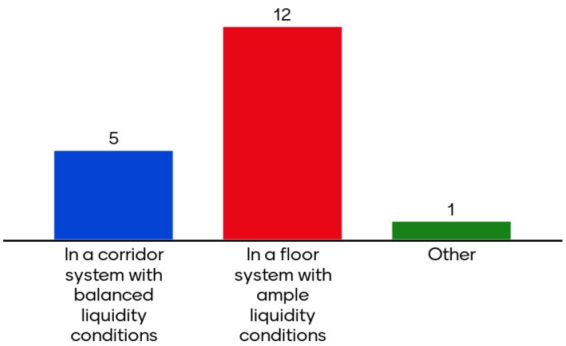
When do you expect the first ECB policy rate cut?



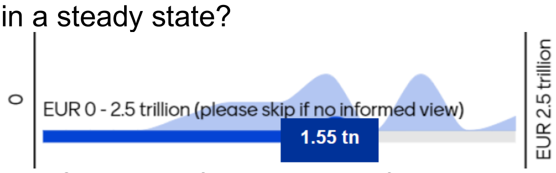
What is driving your expectations for rate cuts in the euro area?



How do you expect the ECB to steer short-term rates in the future?

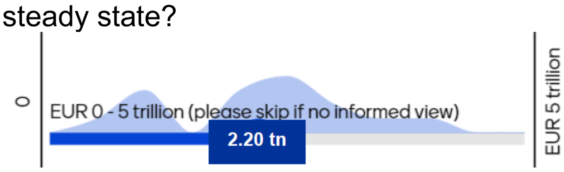


What level of reserves do you deem necessary for balanced liquidity conditions in a steady state?



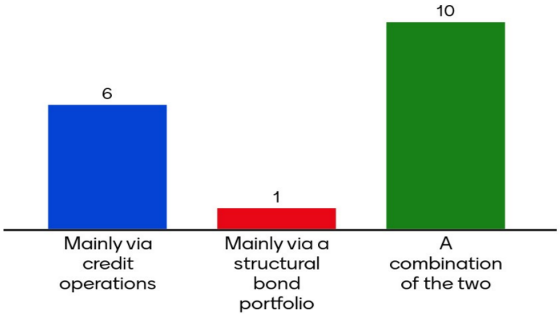
Note: €1.55 trillion reflects the average of survey replies.

What level of reserves do you deem necessary for ample liquidity conditions in a steady state?



Note: €2.20 trillion reflects the average of survey replies.

How do you expect the ECB to provide reserves in a new steady state?



Participant’s organisation	Name of participant	
Banco Santander	Luis Barrigon Rodriguez	
Barclays	Bineet Shah	
Belfius Bank	Werner Driscart	
BNP Paribas	Patrick Chauvet	Remote participation
BPCE/Natixis	Olivier Hubert	
CaixaBank	Xavier Combis	
Commerzbank AG	Andreas Biewald	
Crédit Agricole/CACIB-CASA	Pierre Le Veziel	Remote participation
Deutsche Bank AG	Jürgen Sklarczyk	
DZ Bank AG	Oliver Deutscher	
Erste Bank	René Brunner	
EUREX	Frank Odendall	
HSBC CE	Pierre Bouvy	
ING Bank	Jaap Kes	
Intesa Sanpaolo	Maria Cristina Lege	
JP Morgan Asset Management	Olivia Maguire	
Coöperatieve Rabobank	Eric Scotto di Rinaldi	Remote participation
Société Générale	Ileana Pietraru	
Unicredit	Harald Bänsch	
European Central Bank	Thomas Vlassopoulos	Chair
European Central Bank	Pamina Karl	Secretary
European Central Bank	Helmut Wacket	
European Central Bank	Julija Jakovicka	Remote participation
European Central Bank	Marta Skrzypińska	
European Central Bank	Sofia Delgado	
European Central Bank	Raúl Novelle Araújo	