EUR money market faces gradual tightening from ECB's shrinking balance sheet

The European Central Bank remains in rate-cutting mode and could take the policy rate just into accommodative territory. In the background, however, remains a structural tightening trend as the ECB shrinks its balance sheet and drains reserves. So far liquidity conditions are still ample and the impact has been mainly felt in repo markets

The European Central Bank in Frankfurt am Mainn, Germany

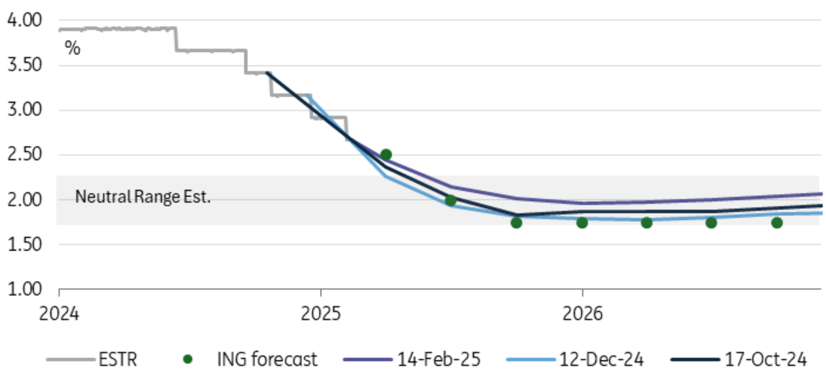
ECB to continue cutting rates, possibly more than markets are pricing

Our economists still think the European Central Bank (ECB) could end this cycle with a terminal rate at 1.75%, ending up in slightly accommodative territory compared to neutral interest rate estimates ranging mostly from 1.75% to 2.25%. We think that, in the near term, a combination of adverse headlines and data disappointments could push market pricing temporarily even closer to a terminal rate of 1.5%.

Markets are only now starting to lean in the direction of our economists' prediction given the growing list of downside risks to the economic outlook. Overall macro indicators continue to show weakness. January's composite PMI barely made it above the boom-or-bust level, while the manufacturing PMIs have remained mired in contractionary territory for more than two years now. The prospect for fiscal stimulus also looks distant. There might be some stimulus coming through out of Germany after the elections, but several countries are under excessive deficit procedures, forcing them to maintain tighter budgets. Our economists anticipate stagnation over the winter months, followed by a modest recovery, resulting in only 0.7% GDP growth in 2025.

At the same time, the ECB seems more confident of reaching its inflation goals in line with forecasts, even as monthly inflation prints are showing ticks higher for the fourth time since headline inflation normalised from record highs. We sense that a growing number of officials have become more geared towards supporting growth. Indeed we think the ECB will have to be more nimble amid the influence of policies abroad, which might leave it picking up the pieces as domestic politics remain largely incapacitated.

The ECB is in rate cutting mode



Source: Refinitiv, ING

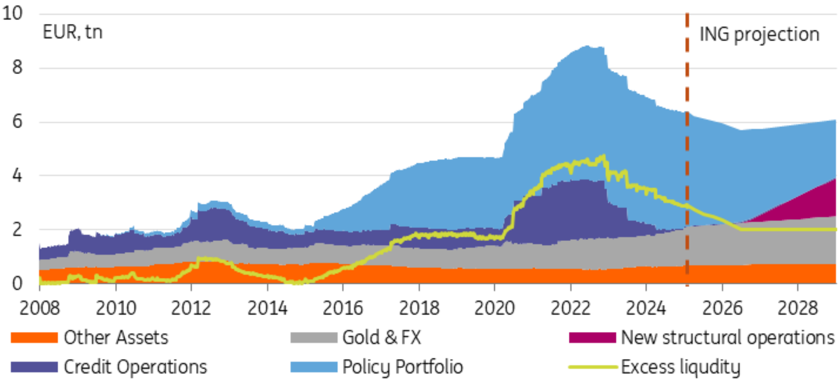
Excess liquidity will remain ample in 2025 despite the ECB's balance sheet unwind

Looking at the operational aspects of monetary policy implementation, one of the ECB's main goals at the moment is the normalisation of its balance sheet. The central bank wants to have less of a footprint in overall markets outside of setting interest rates. At least part of the reason for this is regaining policy space and "restocking" the tool box.

By now, all targeted liquidity refinancing operations (TLTROs) are matured, but the ECB's asset portfolio still holds €4.3tr in bonds, contributing to around €3tr of excess reserves in the banking system. €510bn will roll off over the course of 2025 and will – all else equal – reduce excess liquidity by the same amount.

The overall sense is that the banking system is still operating at levels of excess reserves well above those that would trigger a stronger rise in money market rates and spreads. That level, depending on literature, is estimated to be around €1.5tr to €2tr. Approaching that level, the expectation is that the system will then start to rely more on the ECB again as a provider of liquidity via its open market operations, offsetting the impact of quantitative tightening and stabilising the overall level of reserves in the system.

ECB balance sheet is still to decline over the next years



Source: ECB, ING

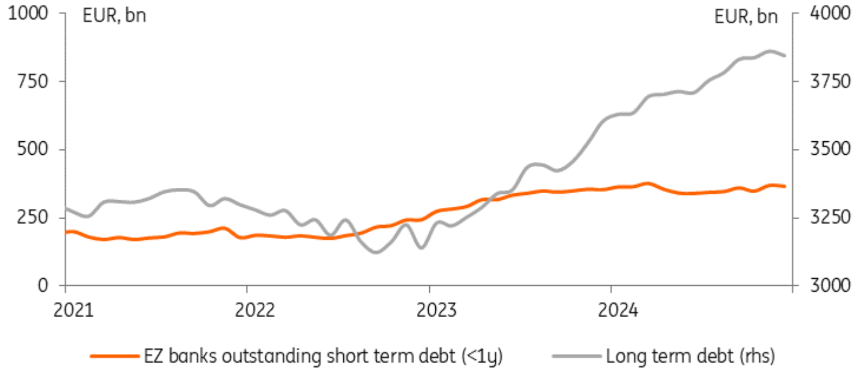
Banks' demand for reserves will determine when the point of market tightness is reached

By the end of the year, excess reserves in the banking system are expected to have reached a level of around €2.5tr. The exact level from where on money market conditions would start to tighten and impact spreads to a greater degree, will largely depend on the desired level of cash reserves banks want to operate with.

Liquidity is not only needed to fulfil the minimum reserve requirement set by the ECB – by definition NOT as part of the excess reserves – but beyond that, demand is also determined by operational needs and buffers, e.g., anticipated cash flow settlements. Another important role is played by regulatory requirements where cash reserves can form part of the high quality liquid assets (HQLA) portfolio to meet the liquidity coverage ratio (LCR, which requires banks to hold a sufficient stock of high-quality liquid assets, HQLA, that can be converted into cash easily and immediately to survive a period of significant liquidity stress lasting 30 calendar days).

Banks' LCR ratios remain relatively high overall all at 159% in third quarter 2024, according to ECB data for the weighted average of “significant institutions”. Any reduction of this ratio is likely to be only very gradual, not least due to the signalling effect and peer pressure. For now, banks have also been able to cover the need for cash reserves with other sources of market funding, also via unsecured commercial paper, bond or covered bond issuance.

Banks have already increased their market funding as the ECB withdraws

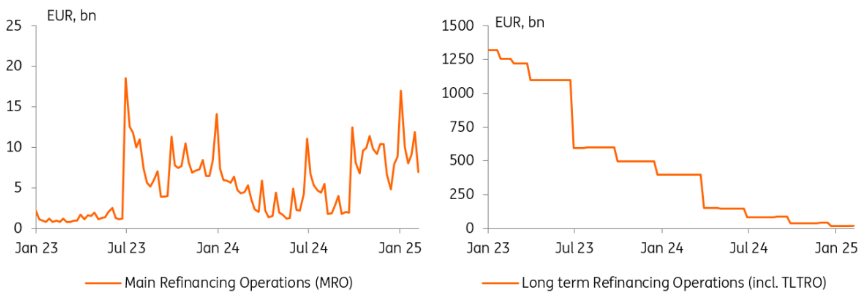


Source: ECB, ING

This implies HQLA portfolios are remaining larger for now, but within those portfolios banks can, of course, substitute declining reserves with high quality bonds. And they have indeed done so when the TLTROs matured and excess liquidity levels declined, the added incentive now being that bonds have a higher return. With (ASW) curves steepening, bonds could become even more attractive in relative terms. But then also credit risks and limits to the amount, for example, of sovereign bonds a bank may hold have to be kept in mind.

In theory these bond holdings can also always serve as collateral to be used in the collateralised ECB liquidity operations (the weekly MRO and three-month LTROs) to convert them to cash reserves, especially when the price differential between market repo and the MRO rate is very small. The ECB had lowered the MRO rate to 15bp above the deposit facility rate last December to make the ECB's operations more attractive and, in turn, also a more effective back-stop for the money market in general.

Banks' recourse to ECB liquidity operations remains relatively low

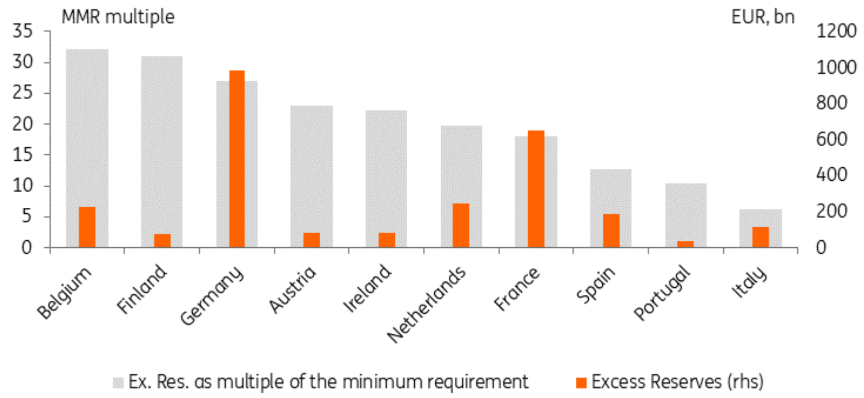


Source: ECB, ING

But a lingering stigma effect appears to still surround the ECB operations. No bank would want to be seen as having to resort to these operations in larger size. It could be interpreted as not having access to regular market funding to cover cash needs. The relative attractiveness to market rates will likely have to grow in order to draw in wider participation to overcome the perceived "firstmover disadvantage".

For now, banks' liquidity take-up in the ECB's MROs has been muted and is mainly attributable to banks in Italy, and to a lesser degree (likely smaller) banks in Germany and Greece. More generally, one would expect to witness a more noticeable pickup first in jurisdictions where the excess reserves cushion above the minimum requirement is relatively low.

Excess liquidity is not distributed evenly in the banking system



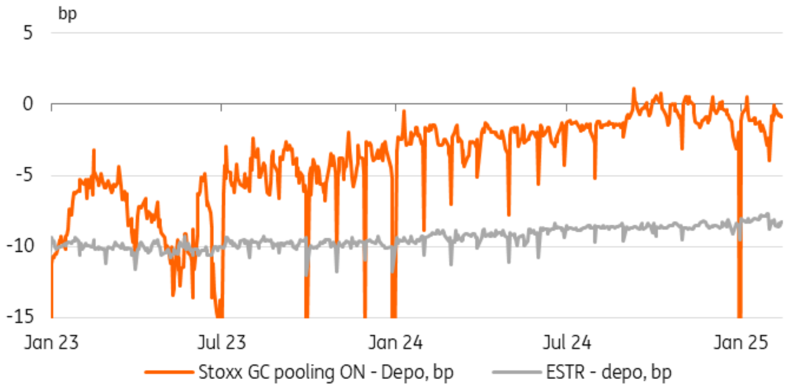
Source: ECB, ING

Market segmentation contributes to unsecured rates staying below secured rates

For now, the impact on spreads stemming from the ECB's shrinking balance sheet has been mainly felt in the realm of secured transactions. Rates on repurchase agreements ('repo') were feeling the largest impact and have risen versus €STR and OIS, mainly as collateral has become more abundant – not just as ECB holdings roll off, but also as the net funding needs of issuers remain at elevated levels.

We are at a point where the ECB facilities are starting to cap or at least noticeably slow the dynamics. Repo rates are now in the range of just 1bp below (German collateral) to 2bp above (Italian collateral) the ECB's deposit facility rate. The intuition is that at repo rates above the deposit facility rate banks should start shifting out of ECB deposits and place cash into market reverse repos, earning the additional interest.

Repo rates have moved towards the ECB's depo rate, but €STR lags noticeably



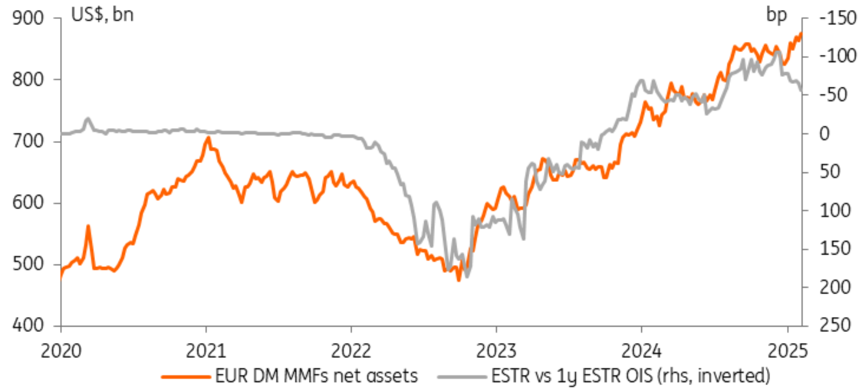
Source: Refinitiv, ING

In theory, non-banks could also shift out of bank deposits into repos. Ultimately it could be one channel to cheapen also the unsecured overnight rate (€STR) relative to the deposit facility rate. However, €STR has remained more anchored and still sits around 8bp below the deposit facility rate, having moved upwards only very marginally. Counterintuitively, that means the *unsecured* rate is well below the *secured* rate. The ECB's Isabel Schnabel has discussed several factors contributing to this effect:

For one, the short-term funding market is still very segmented. On the lending side many participants are only active in either one of the markets, repo or €STR, and very few are present in both. The hurdles to participating in the (cleared) repo market remain especially high. For banks themselves, though, repo markets are more attractive due to regulatory reasons where secured lending is treated preferentially. Also on the borrowing side, central clearing of repos allows for the netting of borrowing and lending which can also reduce regulatory/balance sheet cost.

The result is that the unsecured market is mainly used to channel excess liquidity from non-bank(s) to the ECB via the banks that have access to the central bank facilities – with banks applying the charges for the balance sheet costs in the form of a negative depo spread.

Money market funds have seen inflows alongside inverted rate curves

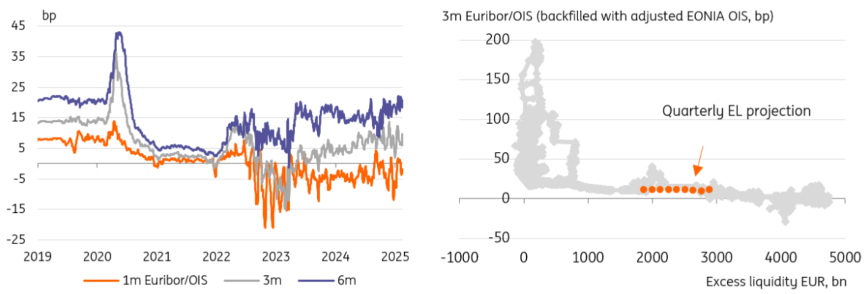


Source: EPFR, Refinitiv, ING

For now, there is no end in sight for non-banks needing to place cash in the deposit market, from money market funds, for instance, that only make use of repos to some extent due to intra-day liquidity needs. The interest rate curve is likely to stay inverted, directing flows towards money market funds – that is at least until summer when the ECB comes close to the end of its cutting cycle. But even thereafter, a notable resteepening is not ensured. At the same time that also means even smaller banks without repo access do not feel a greater need to borrow with liquidity conditions still comfortable.

The upward pressure on unsecured rates may remain muted in the near term. If it were to rise then it should likely be felt in rising Euribor-OIS spreads first, i.e., in the terms beyond one month that have more regulatory value for banks.

Unsecured rates have yet to feel more upside pressure



Source: Refinitiv, ECB, ING

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