

EUR Money Markets: Gradually less comfortable

The European Central Bank's 'good place' is looking less comfortable as FX dynamics pressure the inflation outlook, although the baseline remains no policy change for the foreseeable future. The money market impact of declining reserve levels is visible but remains gradual. Nonetheless, some scenarios see levels becoming tight already this year



Geopolitics and a stronger euro have markets pricing a 20–25% chance of a year-end rate cut

ECB looks a little less comfortable in its 'good place'

The ECB still finds itself in a 'good place' after having lowered rates to 2% in June last year. Risks and uncertainties around the outlook are still substantial, and explain why under the surface there is still divergence within the ECB Governing Council around the nature of inflation risks in particular.

Market expectations are largely aligned with the view that the ECB will very likely not change policy rates this year and will probably remain on hold next year as well. This is also our economists' baseline scenario. Only on the back of recent geopolitical turmoil and then the strengthening of the EUR exchange rate has market pricing turned towards further cuts again, pricing in a 20% to 25% probability for another rate cut by year-end.

At least for the coming months, we would also subscribe to the view that the balance of risks is tilted towards more easing from the ECB. But we think that the balance will shift in the other direction when the effects of the planned fiscal stimulus out of Germany, in particular, start to show in the second half of the year.

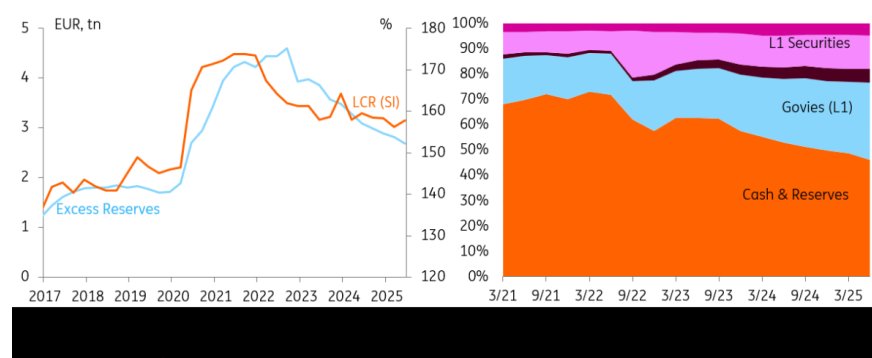
Liquidity still well above banks' desired level

The level of reserves in the banking system remains on a declining trajectory as the bonds mature from the ECB's policy portfolios. This is a process that Isabel Schnabel coined as 'quantitative normalisation' in a speech last November, rather than the commonly used term of 'tightening' for the shrinking of the balance sheet.

It perhaps better captures automatism as the ECB slowly transitions to its new ways of implementing monetary policy. Recall, the new operational framework was initially revealed in 2024, with implementation focusing more again on the ECB's lending operations but also acknowledging the changed role that central bank reserves are playing in the financial system – the ECB's balance sheet is set to become more responsive to banks' liquidity demand.

The duration of the transition crucially depends on the level of reserves that the banks demand on top of their minimum reserve requirement and the liquidity needed to cover for the so-called autonomous factors – mainly banknotes in circulation. That level is commonly estimated to lie around €1.5tn, but as we already outlined in our last publication, the range is quite wide. In her speech, Schnabel also provided scenarios developed by ECB staff, which they make dependent on banks' choices for their Liquidity Coverage Ratio (LCR) and for the share of reserves in the High Quality Liquid Assets (HQLA) portfolios underpinning this ratio.

Banks choose stable liquidity ratios, replacing reserves with other liquid assets



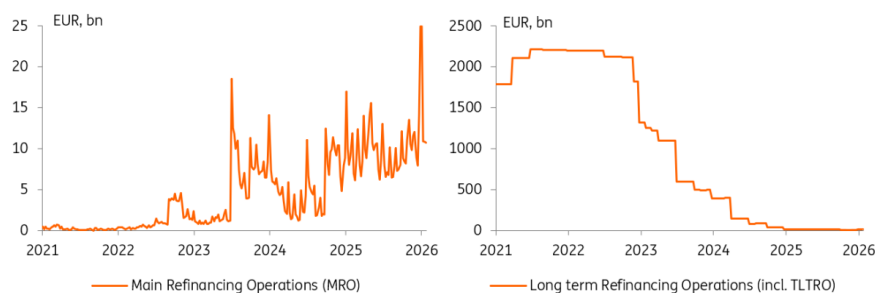
Source: ECB, ING

The ECB staff scenarios range from a level of €600bn to €2.2tr, and these levels would mark the point when banks' would need to obtain liquidity via the ECB's lending operations to maintain them. Extrapolating the trajectory from a current level of around €2.5tn with €501bn maturing this year, this could happen as early as mid-2026 or as late as 2029. Currently, it appears that banks are keen to maintain their higher LCR levels, but we do not know to what extent they will continue to replace declining reserves with government bonds in their portfolios.

By design, as one approaches the threshold liquidity levels, one would observe market repo rates

approaching the main refinancing operations (MRO) rate. Once reached, the relative attractiveness of the ECB's lending rates would see demand in the central bank's operations start to increase. The ECB encourages the use of its operations as an integral part of banks' day-to-day liquidity management and Schnabel even argues that usage should also extend to funding banks' repo desks. At the end of last year, the ECB 'invited' banks last year to regularly access the lending operations to test operational readiness. It is likely also a means to ease any remaining 'stigma' attached to the operations. In any case, the number of participants – not so much the volume if bid amounts remain symbolic – could start to rise more noticeably from an average of around 50 participants if banks follow suit.

ECB seeks more MRO/LTRO participation, but banks see little need for now



Source: ECB, ING

Apart from a spike over year-end, weekly MRO participation remains at volumes just above €10bn. The median expectation reflected in the ECB's survey of monetary analysts from December – a survey conducted with bank treasuries ahead of every ECB meeting – sees take-up volumes double by the end of the year to €20bn and another doubling only by 2028. Similarly, the aggregate 3m LTRO volume is expected to grow from currently around €12bn to €30bn by end of the year and €50bn by 2028.

Upward pressure on market rates remains very gradual

For now, repo rates remain more closely aligned to the ECB deposit facility rate, reflecting the still high level of excess reserves in the system of around €2.5tn. But in December we have already seen episodes where the GC pooling rate, for instance, has ventured more noticeably above the depo rates by up to 4bp amid elevated market volumes. German CG term repo rates remain close to the deposit facility rate but over the course of the past year the term premium has continued to rise gradually, although we have seen spreads tighten since the start of the year.

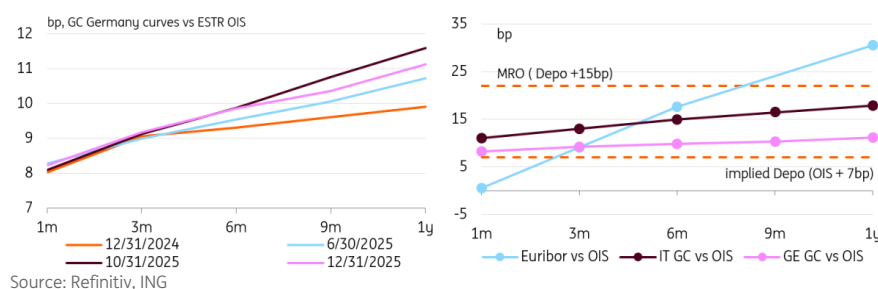
The unsecured overnight ESTR is also experiencing gradual upward pressure, fixing on average a little less than 7bp below the depo rate so far this year. We do believe it should stay below the deposit facility rate given the charges that banks apply for their intermediation with sectors that do not have access to the ECB facilities.

Spreads of unsecured term funding rates over ESTR OIS have been relatively stable within their ranges. Still, with the 6m Euribor having inched up to 23bp above OIS in the early weeks of 2026, it does sit at the upper end of what we have seen over the past half year or so, but there hasn't been any real trend over that period. That said, the basis of 2y swap rates (vs Euribor) over OIS points to

some widening expectation – it is now close to 26bp and has been trending gradually wider since October last year.

Note that this year the ECB is set to review the operational framework. Given the range of scenarios as outlined previously, providing more clarity about the design – size, pricing etc. – of the structural liquidity operations it intends to offer, should not only help guide the dynamics of term-premia in money markets, but could also help alleviate the stigma of the ECB operations itself.

Year-end money market snapshot: term premia still have upside as liquidity is gradually withdrawn



Author

Benjamin Schroeder
 Senior Rates Strategist
benjamin.schroeder@ing.com

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