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Eurozone Money Markets: Shifts beneath the surface

On an aggregate level, excess reserves remain ample, limiting banks' reliance on ECB liquidity operations, as they opt for cheaper, market-based funding. In longer unsecured tenors, rates have pushed beyond the ECB funding costs. This is partly due to recent turmoil and market structure, but can also point to a persistent ECB funding "stigma"

More ECB cuts expected, but pricing increasingly driven by global sentiment

The recent de-escalation on the global trade front has pushed money market rates significantly higher again. If we look at the range of the market's 2025 year-end European Central Bank discount, which has spanned from 1.5% to 2%, the current discount still leans slightly dovish. Markets are firmly eyeing a 1.75% rate for the deposit rate by the end of the year (currently 2.25%). This is in line with our economist's view, who also thinks that the ECB will cut twice more this year, leaving the depo rate at 1.75% for the foreseeable future.

Ahead of the latest tariff headlines, markets were eyeing ECB rates going as low as 1.5% by year-end. But such levels did mark the bottom. The German fiscal plans have helped to limit the downside and even introduce some upward slope beyond a trough in the forwards strip around early 2026. It was also on the back of the fiscal plans that we saw the last peaks in the market discount in the 2% area early in March.

However, fiscal spending and investment plans remain vague and are still subject to implementation risks, as the rocky start to Germany's new government hinted at. It might not take much in terms of headlines or softer data to get back to more dovish ECB pricing, especially as EU trade negotiations with the US could prove more tricky.

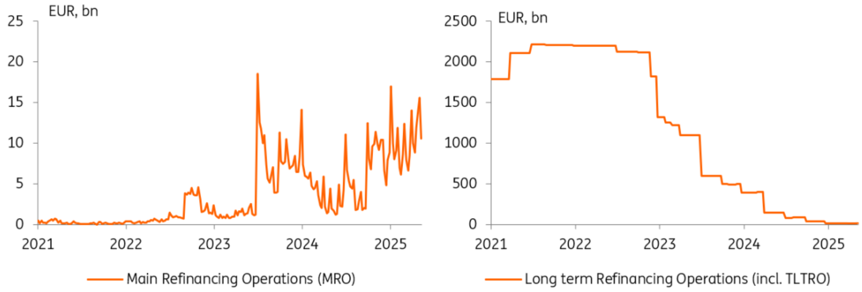
Excess reserves continue to decline, but no pressure on ECB liquidity facilities

Excess reserves in the banking system have declined from €2.9tn at the start of the year to €2.77tn, driven by the gradual reduction in the ECB's bond holdings following the end of reinvestments under the Asset Purchase Programme and Public Sector Purchase Programme.

On aggregate, reserve levels are still ample. However, an ECB survey among bank treasurers published in a recent blog post revealed that "40% of them are already operating close to their internal liquidity coverage ratio (LCR) and net stable funding ratio (NSFR) targets", while a little less than 20% are "close to desired target".

Still, there has been no real increase in the recourse to ECB liquidity operations. The take-up in the weekly liquidity operation is around €10bn and in the three-month operations together, around €14bn. Borrowing in the market still remains more attractive where banks find rates below the deposit facility rate in both the repo and the (short-term) unsecured markets.

Banks' funding via the ECB remains low amid still high excess reserves



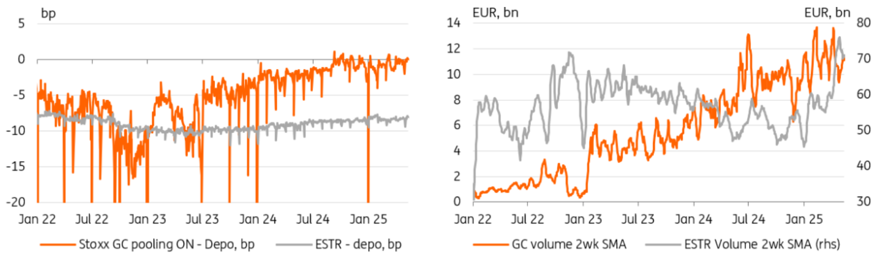
Source: ECB, ING

In its latest money market study, the ECB explains that banks still have a preference to use the secured market, which reduces leverage ratio costs, especially when centrally cleared for balance sheet netting purposes. There are also market structural factors that keep unsecured rates relatively higher. But the ECB pointed out that the portion of repo transactions motivated by liquidity needs remained limited - "most of the €1 trillion of trading volume comes from banks with reserves well above their internal desired reserve levels."

This also suggests that the longer-running upward trend in the repo funding rates is more a reflection of rising intermediation costs. Dealers are facing increasing intermediation demand as collateral supply rises on the back of higher net issuance and quantitative tightening.

ECB liquidity operations, in turn, still face a “stigma” effect where, amid high levels of excess reserves in the system, recourse to ECB operations by an individual bank could be interpreted, e.g. as signalling difficulties to access the market. The ECB itself wants its operations to be an “integral part of [banks] day-to-day liquidity management”, but for take-up to increase, aggregate levels of excess reserves will likely have to fall further and market-based funding to become comparably less attractive.

Secured overnight funding rates have so far faced the brunt of the upward pressure

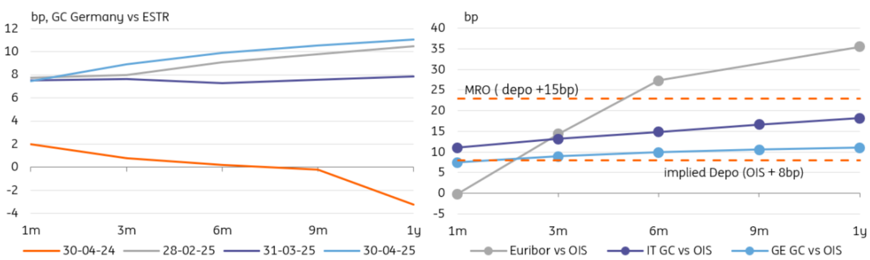


Source: Refinitiv, ING

Repo market: Banks preferred funding source still cheaper than ECB facilities

Overnight secured funding rates against wider general collateral (GC) but also German GC have bumped up against the ECB deposit facility rate, but have since remained capped at these levels. If we look at the term structure of the German GC spread curve against OIS, we do note that at the end of April, the 1m to 1y was at its steepest this cycle at 3.5bp since the disinversion began in the last quarters of last year. That leaves the unsecured term rates slightly above the forward implied deposit facility rate but still below the main refinancing operations.

Funding terms structure at the end of April in relation to ECB and unsecured funding



Source: ING

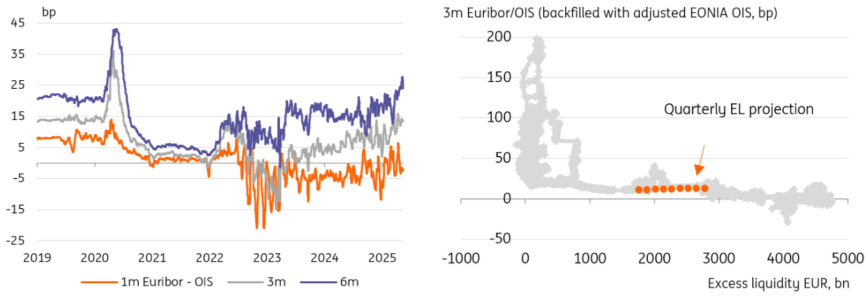
Unsecured funding: Term rates push above the implied MRO rate

In unsecured funding markets, the 3m Euribor spread over OIS has widened towards 14bp with spikes in volatile markets to as high as 20bp. But this is in part due to the lagging nature of the fixing, with a large share of “level 2.3” methodology employed based on contributions from prior fixing dates, even as they are adjusted for interest rate and credit risk changes.

Spreads over OIS derived from 3m Euribor futures had nudged higher by at most 3bp on the back of “Liberation Day” turmoil, with the front month spread as high as 15bp. But they have eased back since then. The futures strip even implies further tightening expectations from the current 13bp towards 12bp. We would note, though, that levels around 13bp constitute pre-2020 levels when excess reserves in the banking system averaged around €1.7trn. Plotting the futures-implied path into the historical relationship between 3m Euribor/OIS and excess reserves shows it is not out of line, as the upward pressure from declining excess reserves could be expected to remain limited in this tenor for the foreseeable future.

In the 6m Euribor, tenor spreads vs OIS have widened more noticeably from well below 20bp early this year to now around 24bp - still slightly above the implied MRO rate of 23bp above ESTR. The dynamic has looked more structural than merely a technical lag, although forward spreads here indicate the expectation of some minor retightening. If we look at the 2y IRS/OIS basis, it is back to the area just below 25bp, which was prevalent in 2022 through 2023 – a level around the implied MRO rate, if not slightly above.

Euribor-OIS spreads and their relation to the level of excess reserves

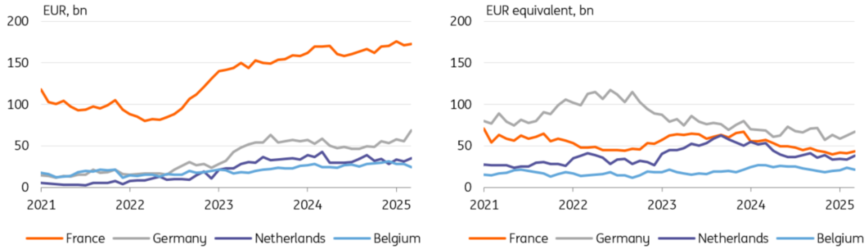


Source: Refinitiv, ING

ECB data indicates that short-term debt issuance has been on an upward trend since mid-2022, as banks sought replacements for declining ECB reserves. French banks were the most active in these markets, followed by German banks, which even saw another noticeable rise over March. The main counterpart to banks’ issuance in this segment is money market funds, which, on aggregate, had seen inflows at the beginning of April and again early in May, according to weekly EPFR data.

Still, the uncertainty around trade and recent market turmoil will have led to tactical shifts, where typically things like preferred maturities usually start to diverge more noticeably between issuers, asset managers and investors. This might explain some of the upward pressures on the Euribor rates, but the fact that we have seen them rising more noticeably and structurally even above the implied MRO rate in the longer tenors might also point to the price of ECB funding "stigma”.

Banks' funding via short term debt, in EUR (left) and foreign currencies (right)



Source: ECB, ING

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