ECB Money Market Contact Group

Developments in the euro money market and monetary policy expectations

16th June 2021

Classification: Red
USD Swap Facility

Impact on EUR/USD OIS Basis

Source: Bloomberg 09/06/2021
OIS Trading Volumes

Switch from Eonia to €STR

- The transition from Eonia to €STR in interest rate derivatives continues, with traded notional increasing further in May, albeit at a slow place.
- In short tenors, liquidity in the €STR market is on a par with Eonia. However, in tenors beyond 2yr, €STR liquidity hasn’t developed sufficiently yet.
- Euribor/€STR is becoming the primary Euro In-CCY basis market.
- €STR is now also regularly referenced in the XCCY basis market.

Source: PWC Libor Transition Market Update May 16-31, 2021
Decline in Euribor Rates Below DFR

Weight of Excess Liquidity

• There has been a material decline in Euribor rates to levels below the DFR since Q3 2020
• This has been driven primarily by the significant volume of excess liquidity
• Excess liquidity estimated to peak at close to €5tn in H1 2022 as further PEPP, QE and TLTRO funding takes effect

Source: Bloomberg 08/06/2021
Increase In Inflation Expectations

5Y5Y Euro Inflation Swap

- Strong pick-up from Q1 2020 lows
- 25bp above pre-Covid level
- Close to 5yr highs
- Circa 20bp away from ECB target of below but close to 2%

Source: Bloomberg 08/06/2021
ECB Rate Pricing

Jan-20 Pricing v Current Pricing

- ECB rate hike expectations have increased significantly since the turn of the year
- Pricing of first ECB DFR hike now 18mths earlier at Q2 2023
- Room for that to come 6-9mth closer if inflation expectations continue on their current trajectory
- Beyond that, sequencing presents a barrier to earlier rate hikes

Source: Bloomberg 08/06/2021
ECB Sequencing

1) PEPP guidance
   - Runs ‘at least until the end of March 2022’

2) APP (market expectations)
   - Expect APP to increase for a period to avoid a cliff
effect on QE purchases

3) Forward guidance on APP
   - ‘For as long as necessary to reinforce the
   accommodative impact of the policy rates’
   - APP to end ‘shortly’ before the first rate hike

4) Forward guidance on rates
   - Period long enough for the ECB to have ‘seen the
   inflation outlook robustly converge to a level
   sufficiently close to, but below 2% within its
   projection horizon, and such convergence has been
   consistently reflected in underlying inflation
dynamics’

   This limits the potential impact of increasing inflation
   expectations on the pricing of ECB DFR hikes

Other potential effects on monetary policy decisions

PEPP – taper pace of monthly purchases and don’t use
the full €1.85tn envelope?

APP – purchase a smaller monthly amount beyond the
end of PEPP than would otherwise have been the case if
inflation expectations were lower?

TLTRO – need to extend the special rate beyond June
2022 or introduce further operations to smooth the
potential cliff effects from early repayments?

And if inflation expectations reverse lower from here?