THE TRANSMISSION OF ECB RATE HIKES TO MONEY MARKETS IN THE EUROZONE: WHAT CAN WE EXPECT WHEN RATES WILL RISE IN POSITIVE TERRITORY?

PRESENTATION TO THE ECB MONEY MARKET CONTACT GROUP

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HISTORICAL DATA SHOWS EVIDENCE OF HOMOGENEOUS RATE MOVES ACROSS INSTRUMENTS FOR THE PAST DECADE

- REPO GC RATES AND ESTR MOVED CONSISTENTLY WITH DFR

- DUE TO INCREASES IN ECB’S BALANCE SHEET SINCE 2016, WE HAVE WITNESSED SOME VOLATILITY ON REPO RATES AND A DECREASE OF ESTR COMPARED TO DFR
INFLATION PATH IN THE EUROZONE MAY CALL FOR MORE RATE HIKES THAN WHAT IS PRICED TODAY

➢ LEVEL OF INFLATION PEAK MAY PROVE HIGHER, DECREASE TOWARDS THE 2% TARGET SLOWER THAN ANTICIPATED

➢ THE MAGNITUDE AND TIMING OF THE PRESENT CYCLE MAY PROVE UNPRECEDENTED
SIGNS OF BROKEN TRANSMISSION OF MONETARY POLICY TO MARKETS? THE UNSECURED FUNDING SEGMENT

➢ THE ESTR/DFR SPREAD MAY WIDEN AND BECOME MORE VOLATILE

➢ WHILE THIS VOLATILITY SPREADS TO UNSECURED FUNDING AND TO DERIVATIVES
SIGNS OF BROKEN TRANSMISSION OF MONETARY POLICY TO MARKETS? CORE COUNTRIES GOVERNMENT SHORT TERM DEBT YIELDS UNDER DOWNWARD PRESSURE

- DISRUPTIONS SEEM TO APPEAR AS SHORT-TERM INTEREST RATES ENTER POSITIVE TERRITORY, AS SHOWN BY THE RECENT DIVERGENCE BETWEEN CORE COUNTRY BILL YIELDS AND INTEREST RATE SWAPS

- 2Y EURO ASSET SWAP REACHED EXTREME 2008 AND EVEN 2011 LEVELS, ALTHOUGH ABSOLUTE RATES AND LIQUIDITY CONDITIONS ARE DIFFERENT TODAY
SIGNS OF BROKEN TRANSMISSION OF MONETARY POLICY TO MARKETS?
LOW PASSTHROUGH OF RATE HIKES TO REPO RATES

➢ ECB WORKING PAPER PUBLISHED AUG 11: "MONETARY TRANSMISSION IN SEGMENTED MARKETS" POINTS TO INEFFECTIVE AND UNEQUAL PASSTHROUGH OF ECB'S POLICY RATE IN REPO MARKETS

➢ GERMAN REPO SHOULD MOVE BY 15 BP LESS THAN THE DFR IN CASE OF A 75 BP RATE HIKE DECISION ON SEPTEMBER 8TH (PASSTHROUGH RATE OF 80%)
FIXING THE LOW PASSTHROUGH OF RATE HIKES TO REPO RATES?

➢ A NEW OVERNIGHT REVERSE REPURCHASE AGREEMENT FACILITY TOOL SIMILAR TO THE FED’S RRP MAY BE REQUIRED. THIS FACILITY COULD HAVE THREE PURPOSES:

• KEEP REPO RATES IN LINE WITH DFR
• ALLEVIATE SOME COLLATERAL SCARCITY ISSUES, BY INCREASING THE OFFER OF COLLATERAL FROM THE EUROSYSTEM
• DECREASE THE EXCESS LIQUIDITY, DEFINED AS THE BANKS' EXCESS RESERVE HOLDINGS AT CURRENT ACCOUNTS AND THEIR USAGE OF THE DEPOSIT FACILITY

➢ HOWEVER, THIS COULD PROVE OPERATIONALLY COMPLICATED AND MAY NOT FIX THE STRONG DEMAND FOR CORE COLLATERAL AND THE MARKET FRAGMENTATION
GOING FORWARD IN UNCHARTERED ENVIRONMENT: WHAT RISKS DO WE FACE? 1/2

➢ Risk of higher volatility and therefore higher disruption, could impair the analysis of the effects of monetary policy on money markets

➢ Rates increasing may have different effect than what we experienced in the past due to a totally new environment

➢ Possible reliance of banks’ funding and ratios on TLTRO III or in case of carry trades, reliance of government debt on banks’ purchasing

➢ Real economy and final corporate clients are hit by inflation, disruptions and volatility in energy prices a situation that reminds us on the hit suffered during the Covid crisis early 2020

➢ Large amounts of liquidity are sterilized as all financial actors increase liquidity buffers due to higher volatility: banks, MMFs, CCPs etc

➢ In the particular case of the CCPs, where 85% of Variation Margins consist of cash, the larger margin requirements operate a transfer of liquidity from unsecured to secured markets and amplify the need for collateral
➢ OTHER ISSUES THAT MAY IMPACT THE TRANSMISSION OF ECB RATE POLICY

➢ The change in Fiscal situation of European States may be a key element in case of large variations of the stimulus. The impact of budget deficits may require different neutral rates than otherwise anticipated

➢ EUR/USD FX downward trend

Figures as of end 2019