Developments ECB framework for steering short-term interest rates: potential changes

Presentation to the ECB MONEY MARKET CONTACT GROUP
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Excess liquidity and collateral scarcity

These are some of the main challenges in steering short-term interest rates post QE

Excess liquidity in the Eurosystem

RepoFundsRate, spread over €STR

Source: ECB, RaboResearch

Source: RepoFundsRate
Excess liquidity and collateral scarcity

These will be structural, the “right” level of excess liquidity may support financial stability

Source: Research paper NY Fed
A lesson from the 2019 SOFR spike

An ECB equivalent of the Fed Standing Repo Facility (SRF) to introduce structural support?

The limits of the repo market microstructure were tested

Source: NY Fed
Collateral scarcity: an alternative is required

An ECB equivalent of the Fed Reverse Repo (RRP) facility?

“Granting OTC customers access to interdealer repo markets would decrease dealer market power and improve the pass-through of the policy rate.

Moreover, if the central bank gave OTC customers access to a secured deposit facility, like the Federal Reserve’s RRP, policy rate pass-through to non-dealer banks and nonbanks could be further enhanced. Notably, the RRP can improve pass-through even without an actual take-up of the facility in equilibrium.” (ECB working paper)

Not so fast:

• Dealers face high balance sheet costs (e.g. regulatory), netting bilaterally is difficult
• Implementation may take a long time due to operational considerations
• Requires careful balance in regulatory context, eligibility, limits and pricing
• Could create concentration risks and reduce volumes in other parts of money markets.

The example of the Fed RRP – peaks on reporting dates are clearly visible

Source: NYFed RRP
Collateral scarcity: an alternative is required

A new deposit facility for NBFIs and government deposits?

An alternative route to place excess cash and put a floor under short-term assets

- Legally challenging but not insurmountable
- Balance sheet neutral for the ECB
- Pricing must be tailored to maintain level playing field with MFIs
- Introduces a soft floor and therefore anchors short-term bond yields
- Supports more efficient monetary police stance transmission in repo
- May tighten ESTR-DFR spread

Source: RaboResearch
**Excess liquidity and collateral scarcity: killing two birds with one stone?**

ECB Bills to absorb liquidity on term and create a deep pool of a new high quality tradeable asset

**General impact**

- Liquidity draining to be more orderly than active selling of bond holdings following capital key
- Potential crowding and rebalancing effects due to supply of a new high quality collateral
- High quality collateral scarcity alleviated
- Flexibility of term of issuance, starting with short maturities
- Flexibility to target issuance (e.g. banks first)

**Potential side effects**

- The importance of euro as a reserve currency may grow
- Although part of the ECB toolbox, its use could lead to some political questions

*Source: RaboResearch*