European money market rates come out of their hibernation

By Bastien Drut, Chief Thematic Macro Strategist

Money market rates propelled by ECB rate hikes

It is an understatement to say that European money market rates were in hibernation until recently. Indeed, the €ster, which replaced the EONIA and which represents the non-collateralised overnight interbank rate in the euro zone, remained within a range of 3 basis points (between -0.59% and -0.56%) over the 12 months preceding the ECB's rate hike in July 2022. Volatility was therefore extremely low.

See Appendices – Graph 1

With the three ECB rate hikes since this summer (50 bps in July, 75 bps in September and 75 bps in October), the €ster has risen sharply and is slightly below the ECB deposit rate, which is now at 1.50%. This phase is probably not over because the ECB should continue to raise its key rates over the coming months as part of its fight against high inflation.

From EONIA to €ster

From October 2019, the ECB published the €ster rate which corresponds to an average overnight interest rate weighted by the volume of transactions carried out on the Target 2 platform. This calculation is carried out by the ECB with a wider and more diversified panel of banks than the EONIA index. From October 2, 2019 until the end of 2021, the two indices coexisted and the EONIA was calculated until the end of 2021 by adding 8.5 bps to the €ster rate. The fact that the €ster is lower than the EONIA is explained by the fact that the former is an average of the rates at which banks borrow while the latter is an average of the rates at which banks lend.

Money market rates have moved (slightly) away from the deposit rate in recent years

Since 2015, the gap between market rates and the deposit rate has continued to narrow. The reason is simple: the quantities of excess reserves held by European commercial banks at the ECB have only increased since the central bank embarked on unconventional monetary policies (negative rates, QE, long term refinancing operations). It is this abundance of liquidity that has led to downward pressure on money market rates (abundance of lenders).

Secured overnight interest rates (or "repo rates") have fallen even further relative to the deposit rate due to collateral shortages caused by QE operations.

See Appendices – Graph 2

Two main factors determine the amounts of reserves held by commercial banks at the ECB:

- large-scale asset purchase operations (QE) financed by creation of reserves. The two main programs are the APP and the PEPP,
- long-term refinancing operations (currently TLTRO III).

There is therefore a major difference with the Fed for which the balance sheet has increased mainly because of asset purchase operations (QE). The ECB's balance sheet reduction (known as Quantitative Tightening, QT) will therefore relate to two levels.

Towards a reduction in excess liquidity

The amounts of reserves held by commercial banks at the ECB are set to fall from 2023, which will exert upward pressure on market rates relative to the deposit rate, because:

- the ECB will probably stop reinvesting APP securities that mature from the beginning of 2023 and it is supposed to no longer reinvest PEPP securities from 2025,

- at the October Governing Council, the ECB tightened the conditions for the TLTRO III, with the explicit expectations to trigger early redemptions rapidly.

TLTRO redemptions will result in both a decline in excess reserves and an easing of collateral shortages (because refinancing operations mobilize collateral). This should therefore eventually allow the €ster and the repo rates to converge towards the ECB deposit rate.

The ECB has already experienced a form of QT in 2013 when banks early and massively redeemed the 3-year LTROs launched at the start of Mario Draghi's mandate. The depletion of excess reserves led to a sharp rise in the EONIA relative to the deposit rate, which continued into 2013 and 2014. Nevertheless, it is unlikely that the decline in excess reserves will be as spectacular in 2023 as at the time.

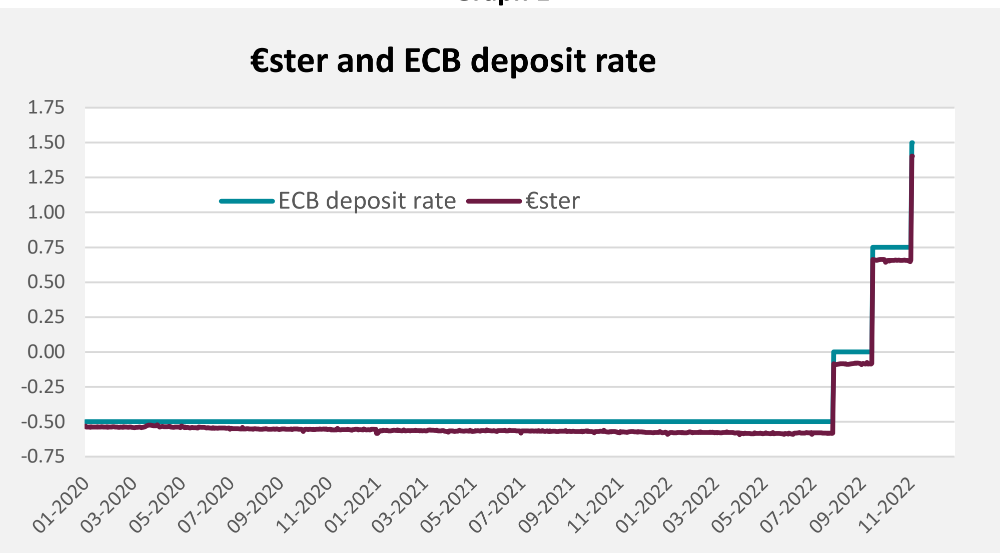
In a speech focusing on the subject, the ECB's chief economist Philip Lane pointed out that the first rate hikes had only partially passed on to market rates, and in particular to repo rates and government rates of short maturity. A first response from the ECB in September 2022 consisted in suspending until April 30, 2023 the ceiling on the remuneration of national treasuries for their accounts at the central bank (which is at the minimum of the €ster and the deposit rate) , to avoid aggravating imbalances in the repo market with an influx of new lenders, which would have lowered market rates even further. Among the other possible solutions, the ECB could issue securities to absorb liquidity (debt certificates) or could set up a mechanism similar to the Fed's reverse repo (the ECB would borrow).

In short, the question of managing the amount of excess reserves held by commercial banks will therefore quickly become an important subject for the ECB.

Published on November 9th, 2022

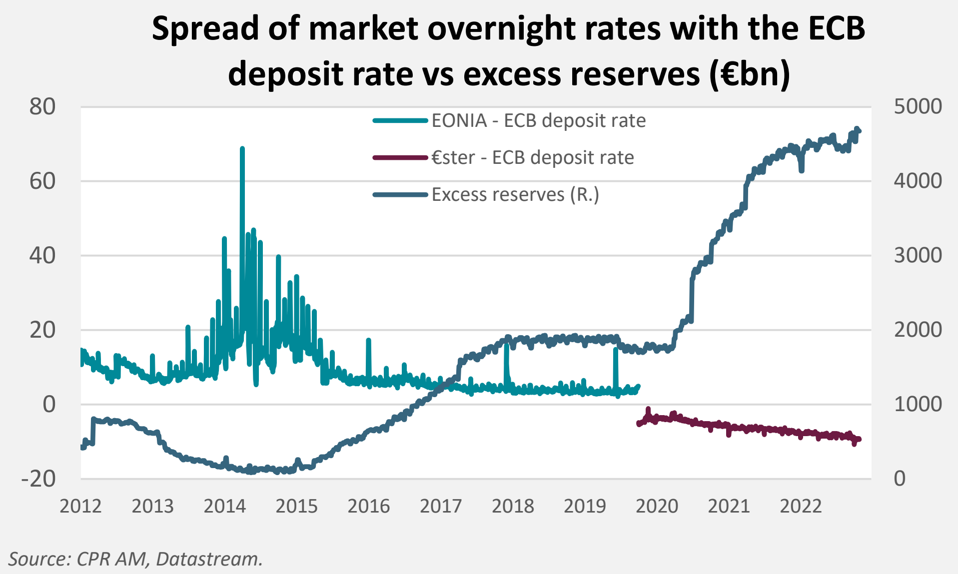
Appendices

Graph 1



Source: CPR AM, Datastream.

Graph 2



Source: CPR AM, Datastream.

CPR ASSET MANAGEMENT, limited company with a capital of € 53 445 705 - Portfolio management company authorized by the AMF n° GP 01-056 – 91-93 boulevard Pasteur, 75015 Paris - France – 399 392 141 RCS Paris.

cpr-am.com @CPR_AM cpr-asset-management