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

Presentation to the ECB MONEY MARKET CONTACT GROUP

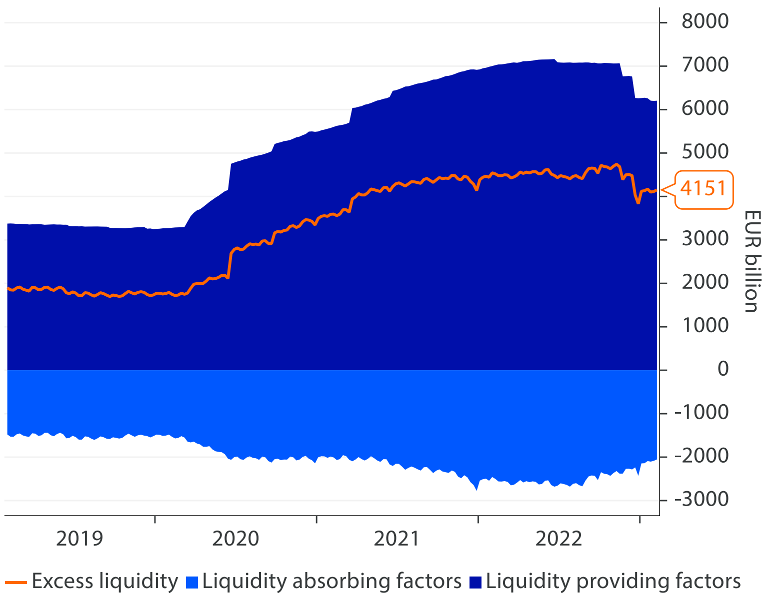
Thursday, March 2nd 2023

de coöperatieve Rabobank

Excess liquidity and collateral scarcity

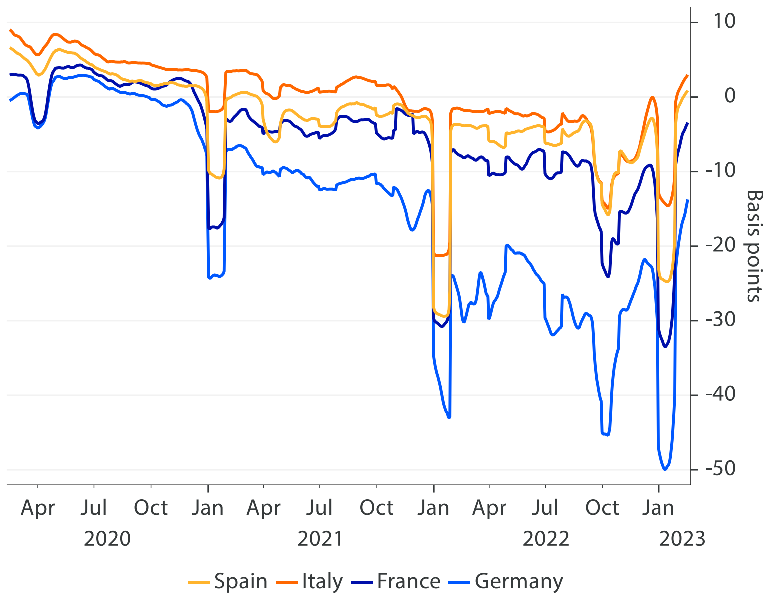
These are some of the main challenges in steering short-term interest rates post QE

Excess liquidity in the Eurosystem



Source: ECB, RaboResearch

RepoFundsRate, spread over €STR



Source: RepoFundsRate

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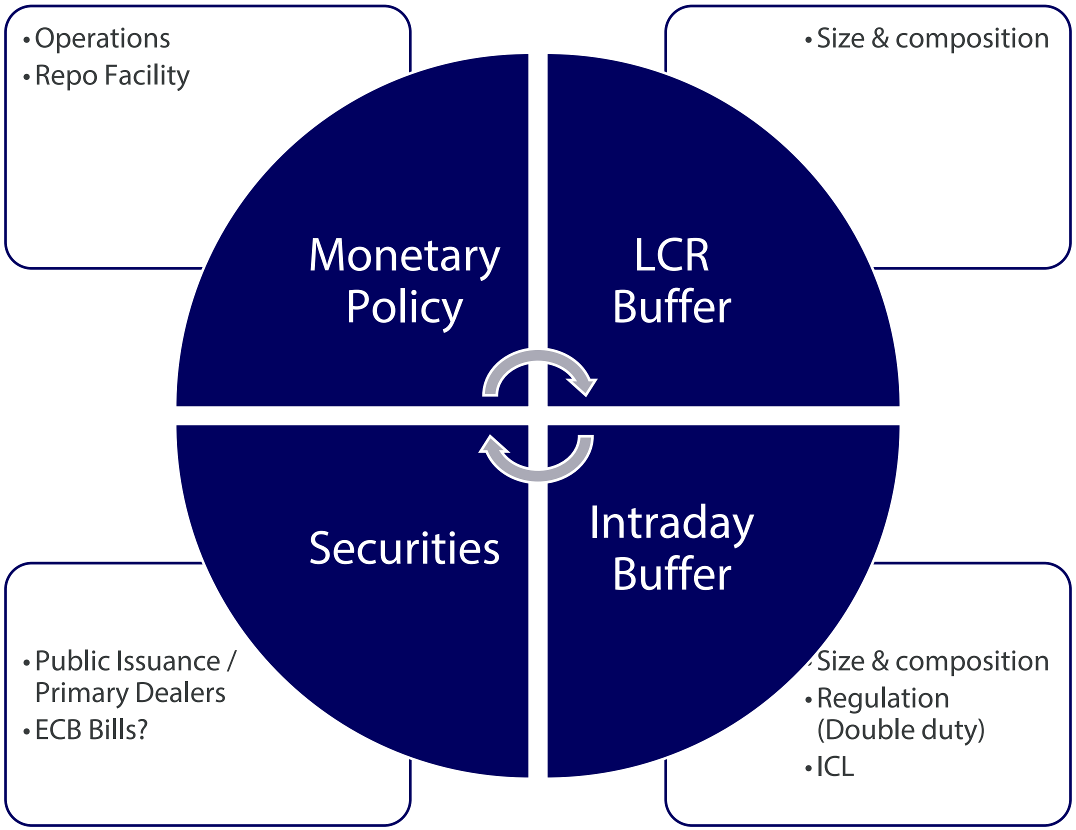
Excess liquidity and collateral scarcity

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



Source: Research paper NY Fed

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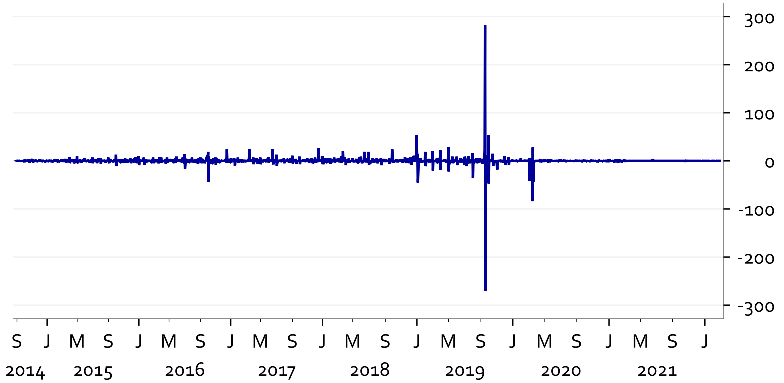
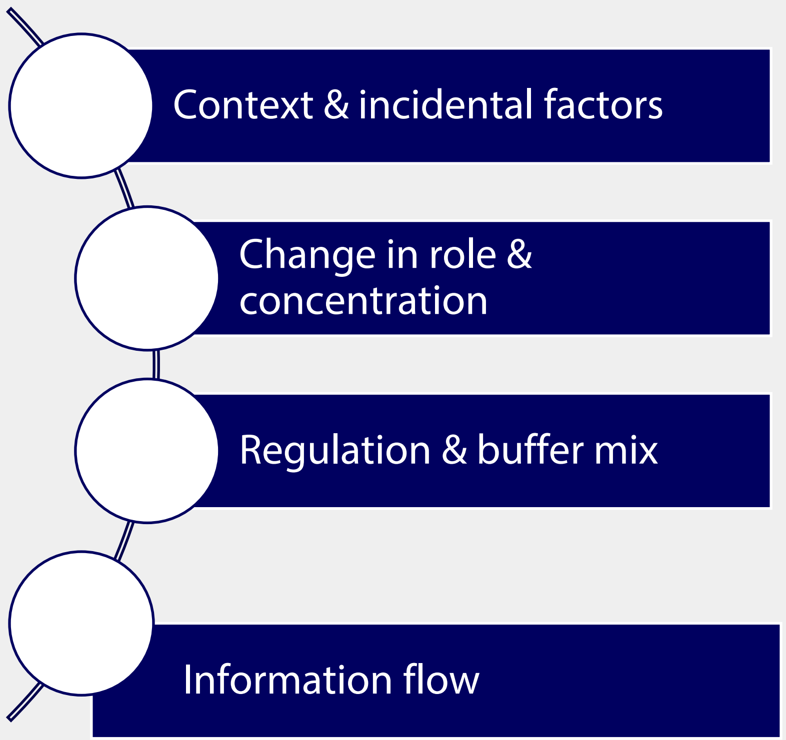
A lesson from the 2019 SOFR spike

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



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Collateral scarcity: an alternative is required

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

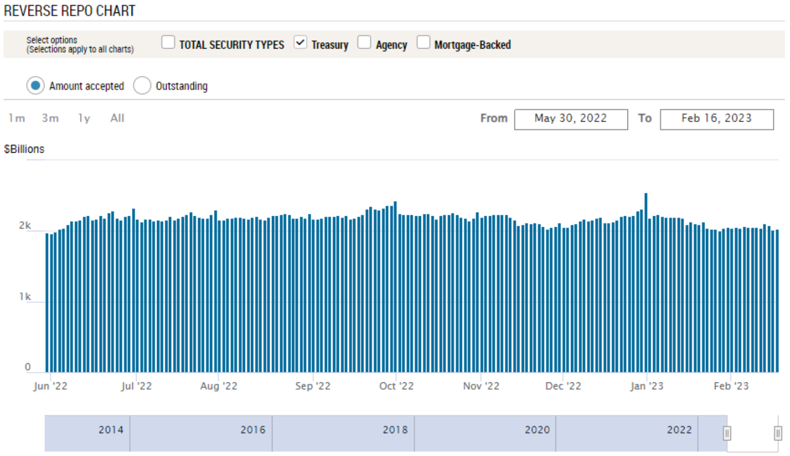
"Granting OTC customers access to interdealer repo markets would decrease dealer market power and improve the pass-through of the policy rate.

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

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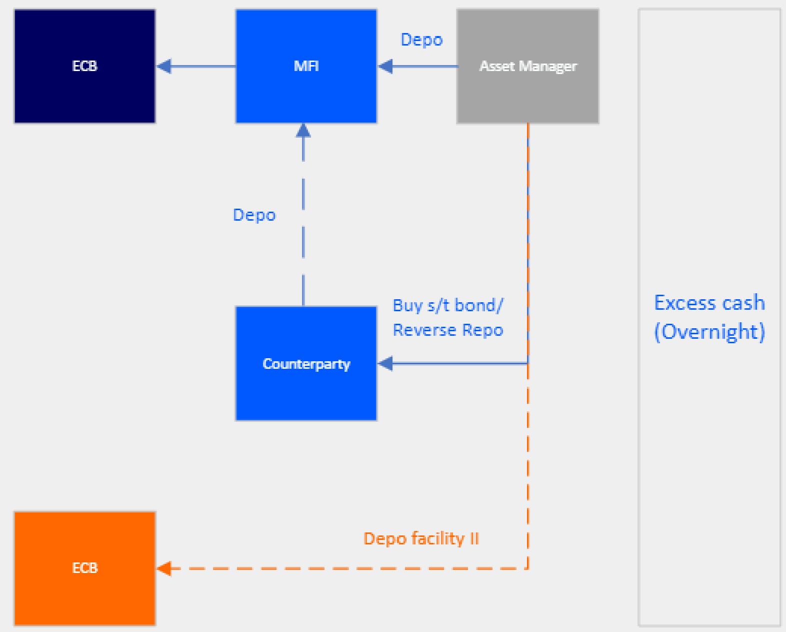
Collateral scarcity: an alternative is required

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?

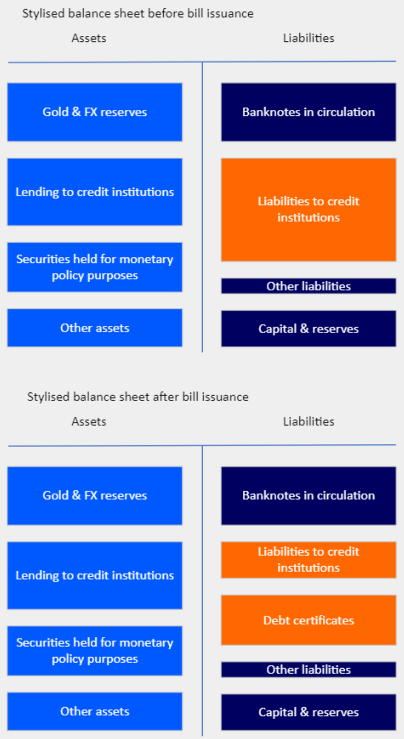
ECB Bills to absorb liquidity on term and create a deep pool of a new high quality tradeable asset

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

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