

ECB Money Market Contact Group

Developments in the euro
money market and monetary
policy expectations

16th June 2021

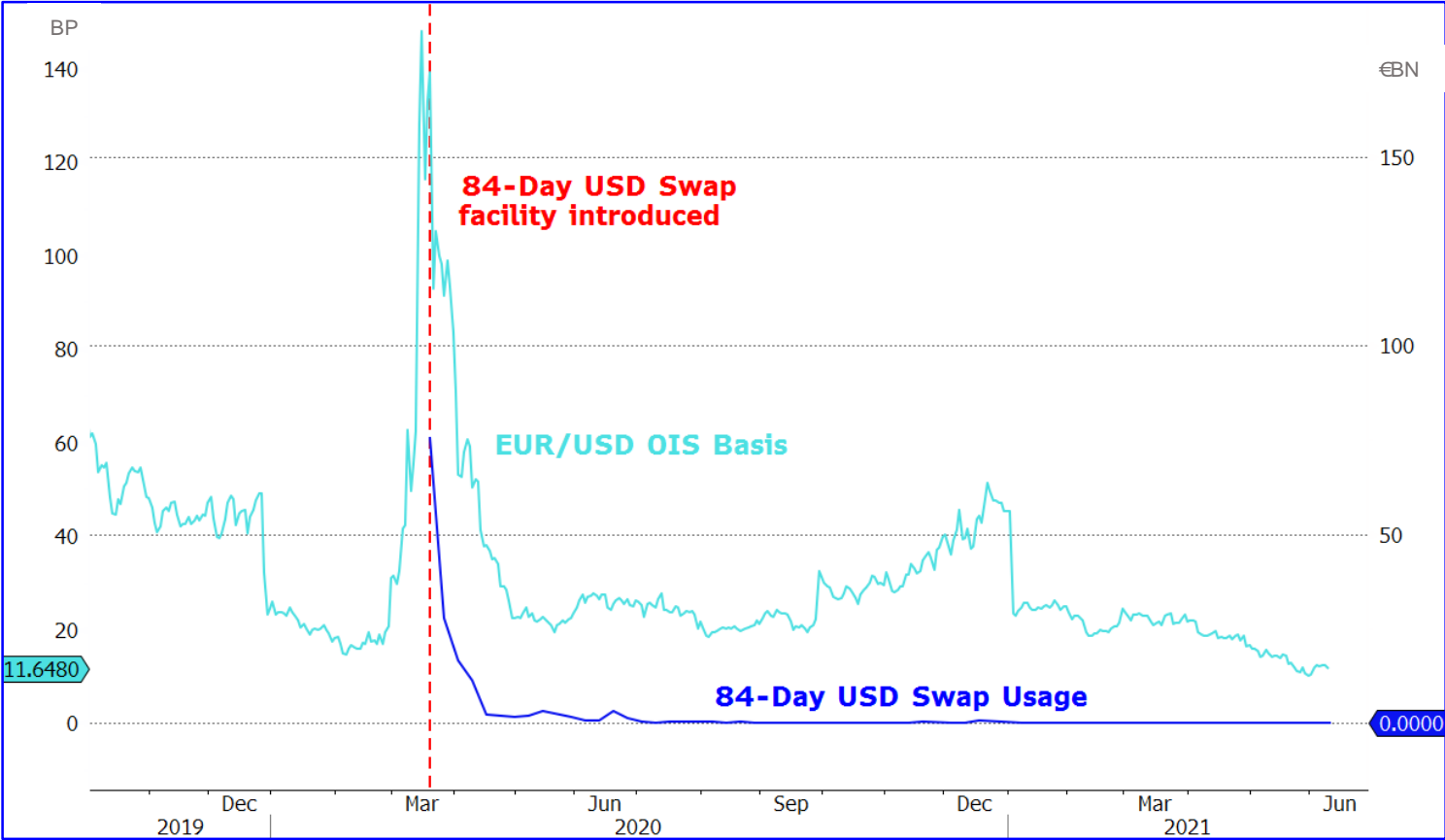
Classification: Red



**Bank of
Ireland**

USD Swap Facility

Impact on EUR/USD OIS Basis

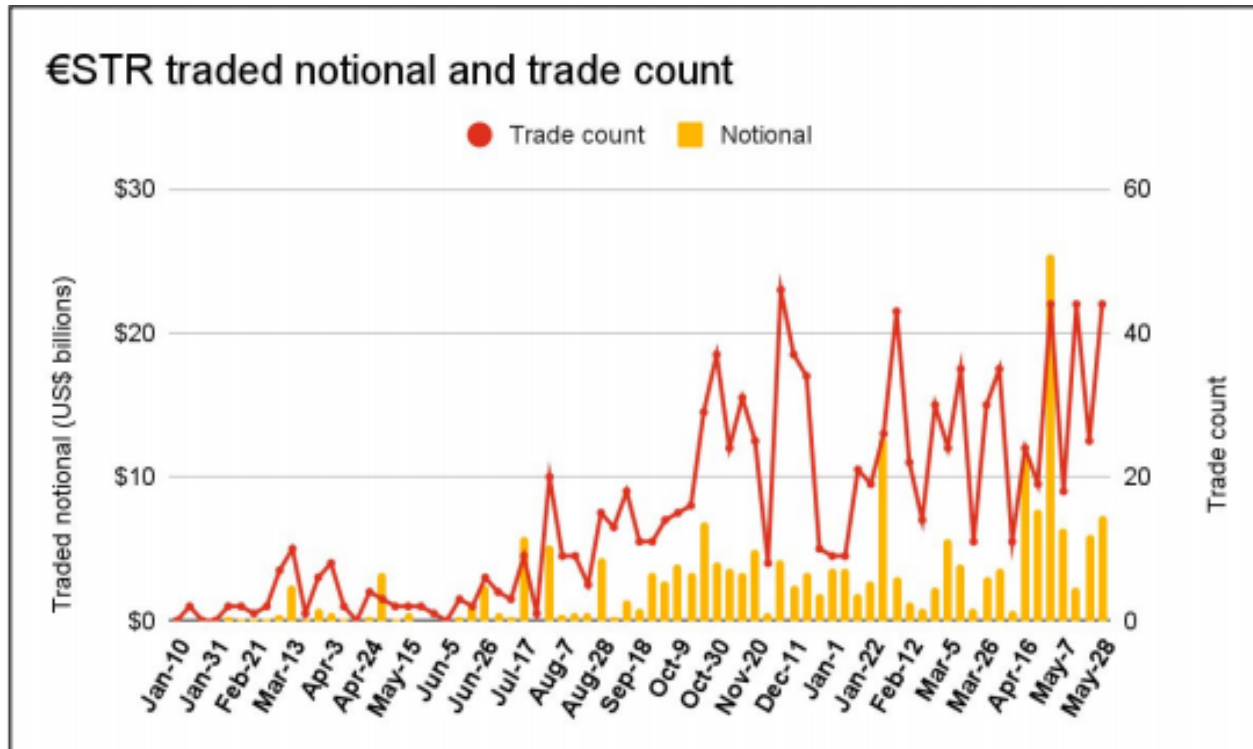


Source: Bloomberg 09/06/2021



OIS Trading Volumes

Switch from Eonia to €STR

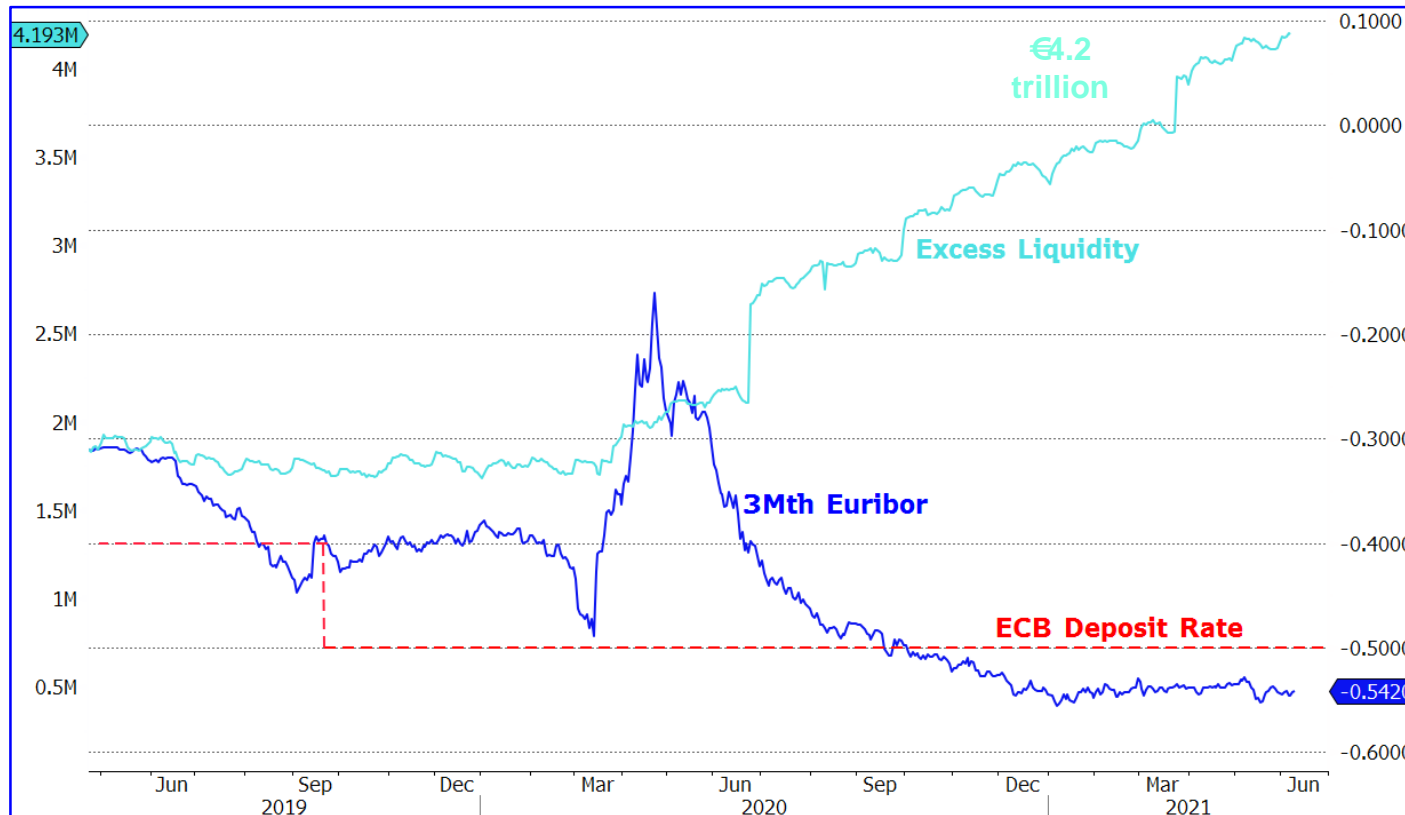


Source: PWC Libor Transition Market Update May 16-31, 2021

- The transition from Eonia to €STR in interest rate derivatives continues, with traded notional increasing further in May, albeit at a slow pace.
- 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

Decline in Euribor Rates Below DFR

Weight of Excess Liquidity



Source: Bloomberg 08/06/2021

- 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 €5trn in H1 2022 as further PEPP, QE and TLTRO funding takes effect

Increase In Inflation Expectations

5Y5Y Euro Inflation Swap

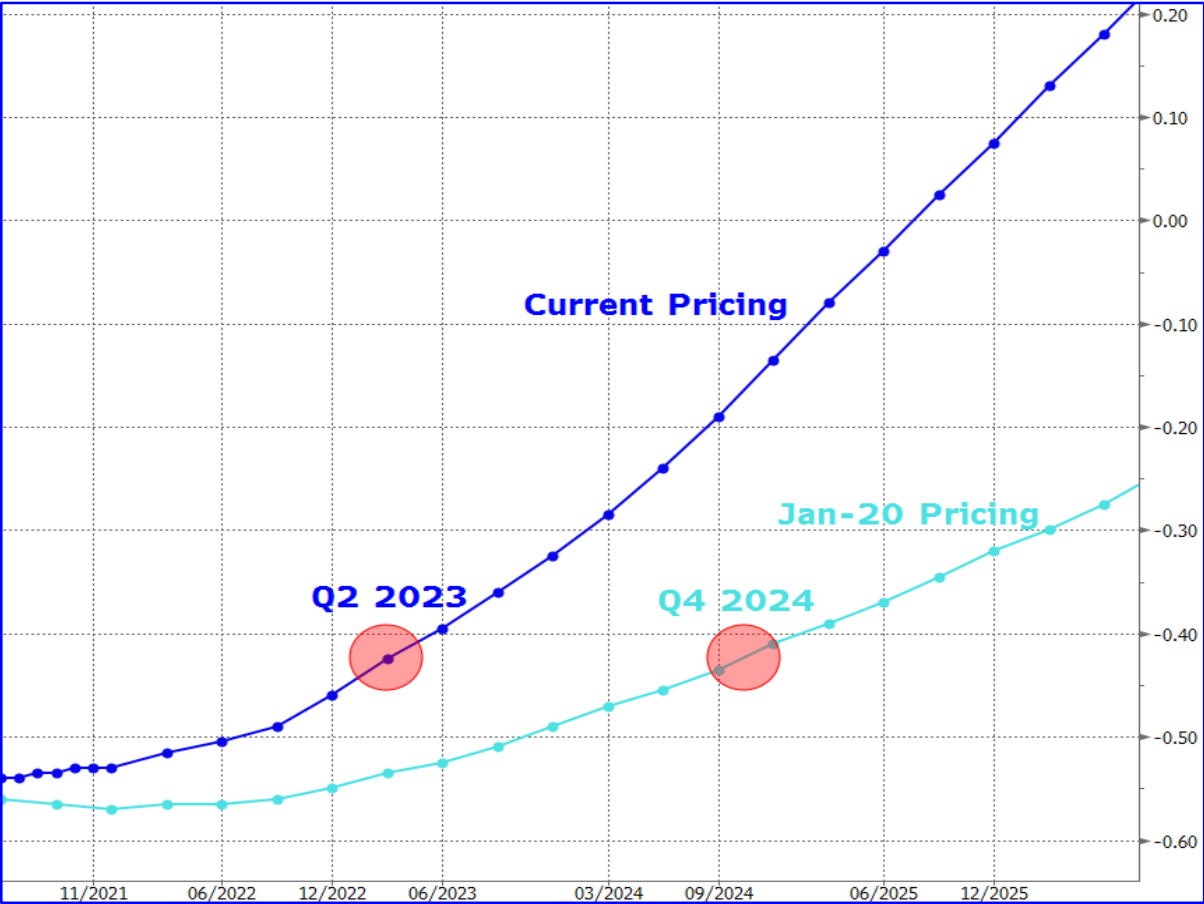


Source: Bloomberg 08/06/2021

- 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%

ECB Rate Pricing

Jan-20 Pricing v Current Pricing



Source: Bloomberg 08/06/2021

- 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

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 €1.85trn 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?