EUROPEAN CENTRAL BANK

EUROSYSTEM

12 March 2025

ECB Bond Market Contact Group

11 March 2025
Summary of the discussion

1) Review of recent bond market developments, update on the recent bond supply absorption and the outlook for future issuance

Christoph Rieger (Commerzbank) reviewed the most recent developments in euro area bond markets and **Marie-Anne Allier (Carmignac)** reviewed how this quarter's issuance has been absorbed by the market so far, and provided an outlook for future EUR bond issuance, particularly in light of recent (geo)political and fiscal developments.

Despite heightened market volatility over the past few months, euro area government bond issuance was seen to have been well-absorbed in Q1 amid strong investor demand and high quality order books. Discussions highlighted the importance of non-euro area investors, bank treasury demand, and - for a small subset of countries - retail investors. At the same time, it was cautioned that recent loss making in equity markets by some market players could also affect their bond positions.

Regarding the recent very significant increase in long term yields after the German and European fiscal announcements, members considered those market movements as orderly, reflecting a fundamental change in the macroeconomic outlook. Trading volumes were very robust and there was no significant impact on market liquidity.

Members generally were confident that the increased future bond issuance would be well absorbed by the market. The increased issuance was generally seen to be stimulative for growth, provided it results in targeted spending, which should enhance overall investor sentiment towards the euro area. In this context, some members also mentioned that a steeper German yield curve stemming from the higher issuance would further attract long-end investors to German debt. More generally, higher yield levels were seen to attract additional investor classes, as long as the rise in yield was relatively orderly. On Bund swap spreads (the difference between the interest rate swap rate and the yield on a German government bond of the same maturity), it was largely expected that the recent widening would continue as bond yields were likely to increase at a faster rate than the corresponding maturity swap rates. While this was seen as largely driven by likely significant increase in the Bund free-float, regulatory treatment and cost of capital considerations were also seen as relevant over the medium to long term.

There were mixed views on the future direction of bond spreads between jurisdictions, with the majority expecting spreads to remain close to current levels. Some members viewed recent developments as bring more German-specific, and so other countries' spreads should tighten vis-a-vis Germany, also supported by possible positive growth spill-overs from Germany to other countries. Moreover, the simultaneous announcement of common European issuance by the European Commission provided to the market a strong signal of European unity, conducive to spread stability or tightening. At the same time, a minority of members felt that spill-over yield increases for some euro area countries with higher debt burdens could raise their debt funding costs to an extent that might in turn see their spreads vs. Germany actually widen.

Overall the consensus view was that there will be a positive growth impact throughout the continent from the German fiscal package, together with the European Commission's announced EUR 150 billion package of loans to Member States for defence investment. In particular, the fiscal stimulus moves the euro area further away from a "left tail" scenario of having to deal with the zero lower bound of policy rates again.

Several members stressed that the timing of implementation of fiscal spending, and the related additional bond issuance, would likely be backloaded from 2026 onwards and stretch over many years, with issuance prospects for 2025 being less affected. There were comments on the risk of under-execution in the short to medium term, given past history, capacity constraints and lead times.

2) Primary dealers' intermediation capacity

Olivier Herregods (HSBC) presented on primary dealers' intermediation capacity before **ECB staff (Anne Duquerroy)** presented the aggregate results of a survey on the topic that was conducted amongst 16 dealer banks who are members of either the BMCG or MMCG.

Dealers have had to adapt to significantly higher issuance volumes in recent years, which has gone smoothly so far thanks to improved use of technology to increase their transaction velocity, allowing for larger volumes to be absorbed without significant balance sheet expansion. While daily handled volumes are increasing, banks' internal rate of return remains the primary constraint on their activity, which suggests that profitability, rather than capacity, is the key factor driving dealer behaviour in the current environment. The increasing role of hedge funds and leveraged players as intermediaries was discussed with members having mixed views. Some were of the view that that they were a welcome addition to the euro area market-making ecosystem, with others warning that the disparity of regulation between primary dealers and hedge funds made for an unlevel playing field. Moreover, some members made the point that hedge funds were more opportunistic in nature than traditional dealers, and so could not be relied upon to continue to provide liquidity when the benefit of doing so was less apparent for them.

It was noted that periods of market stress can serve to reveal vulnerabilities in this system, as widening bid-offer spreads reduce transaction velocity and pressure banks' balance sheets. Smaller, less liquid markets (such as off-the-run bonds) are particularly susceptible to these pressures, as balance sheets become stickier, hindering transaction capacity and potentially exacerbating liquidity challenges. This highlights the crucial role of primary dealers and market makers in maintaining market stability during periods of volatility. Despite these stress-related challenges, the overall liquidity picture remains relatively stable.

The BMCG-MMCG survey assessed dealer banks' capacity to intermediate in EGB and repo markets and found that dealer intermediation capacity in both markets remains robust, despite some variation among respondents. Demand for intermediation has already grown significantly over the past year and is expected to increase further, especially in repo markets. Encouragingly, dealers reported increased capacity over the last year and the majority plan to expand further to meet future demand. Dealers reported few constraints from reallocation across geographies and business units, further supports this positive outlook.

While the leverage ratio is the most significant constraint for dealers facing limitations, risk-based constraints were most important for unconstrained dealers in both repo and EGB trading. Bilateral netting was highlighted as crucial for supporting repo market intermediation capacity. Profitability, both at the market level and from cross-selling opportunities, influences balance sheet allocation in both markets. Regarding central clearing, limited cross-product netting and high implementation costs, including capital and margin requirements for levered players, were identified as the primary obstacles to greater adoption.