Box 7

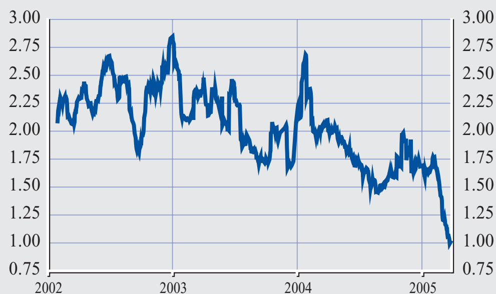
THE NARROWING OF BID-OFFER SPREADS IN MONEY MARKET INSTRUMENTS

A notable pattern in the euro area money market – which comprises short-term deposits, FX swaps, repos and EONIA swaps – has been the continued narrowing of bid-offer spreads, especially in 2004. Bid-offer spreads can provide a yardstick of liquidity in the market; the increased volume and liquidity in the EONIA swap market has sometimes compressed spreads to less than a basis point, making it less attractive for banks to act as market makers. This Box reviews some of the factors that lie behind this compression of bid-offer spreads and assesses some of the possible implications.

Between early 2002 and early 2005, bid-offer spreads for EONIA swaps narrowed substantially over the whole money market maturity spectrum up to 12 months. On average, they roughly halved from around 2 basis points to around 1 basis point over this period. Most recently, spreads for maturities beyond one month traded even narrower than one basis point (see Charts B7.1 and B7.2).

Chart B7.1 Bid-offer spread of one-week EONIA swaps

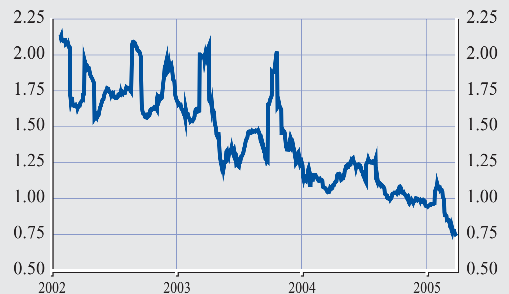
(basis points, 20-day moving average)



Source: E-mid.

Chart B7.2 Bid-offer spread of three-month EONIA swaps

(basis points, 20-day moving average)



Source: E-mid.

Market observers have attributed the narrowing of bid-offer spreads in the euro area money market to several factors, five of which seem most significant. First, market transparency has increased and there has been an increase in professionalism outside the banking industry, so that clients are generally well-informed about market conditions and require the best prices. Second, the market has benefited from economies of scale, with larger ticket sizes reducing the number of deals and hence the costs per individual transaction, with this cost reduction being passed on to narrower quotations. Third, deepening liquidity in other segments of the money market has also played a role: in the Euribor futures market, a natural hedge for the EONIA swap market, spreads tend to be as narrow as 0.5 basis point. Fourth, the importance of cash lending for longer maturities has been declining, triggered by banks' growing awareness of the solvency costs for their assets. This has led to increased competition in shorter-term cash products as well as in derivatives markets (such as the EONIA swap market), which require less solvency capital than traditional interbank lending, while allowing a more effective management of interest rate risk. Fifth, the very low level of interest rates, coupled with low volatility, has also played a role by lowering the risk of market-making activity.

While a deep and liquid money market can make an important contribution to the stability of the financial system, it cannot be excluded that, by eroding buffers for market movements, very tight bid-offer spreads could adversely affect risk-return trade-offs in market-making activity. This could ultimately tempt market makers into deals with higher margins, but which most likely also entail higher risk.