

European Rates Watch

Running into a wall

Key takeaways

- We see risks of excess liquidity demand in the euro area outstripping supply in 2024
- This would leave Euribor-€str spreads vulnerable to sharp widening pressures
- Bank HQLA up EUR2.2tn on new requirements. ECB cannot be confident of a reduction or mix shift to bonds

Excess liquidity supply to continue falling rapidly

We estimate excess liquidity in the euro area will fall to €2.7tn by end-2024 and €2.1tn by end-2025. Our estimates are primarily based on the expected balance sheet reduction by the ECB via the expected acceleration of QT and TLTRO rollovers.

Regulations increased reserve demand

Excess liquidity is used by banks to meet regulatory requirements introduced in recent years. One regulatory requirement is the LCR (see [European Rates Viewpoint, 1 August 2023](#)). By way of illustration, assuming a LCR of 130%, potential changes in expected net outflows of between -15% and +5%, and cash at the central bank accounting for between 60% and 80% of banks' HQLA: we estimate bank excess liquidity demand for LCR would be between €2.1tn and €3.4tn (Exhibit 1). The parameters in our illustration may be adjusted, but the key point is that any reasonable range implies much higher demand for excess liquidity than before, and that quantum is unknown.

Front-end spreads vulnerable to sharp widening pressures

There is a risk of bank excess liquidity demand outstripping supply sooner than the ECB intends. Bank demand for funding in the wholesale market may increase sooner and more than expected, leading to sharp widening pressures on Euribor-€str spreads. Spillovers to other short-dated assets cannot be ruled out as banks optimise their HQLA portfolio. For example, bank demand for sovereign bills may increase for HQLA purposes if the cost of competing for reserves becomes too high.

Bank liquidity demand elevated

Bank reserve demand was transformed by the Liquidity Coverage Ratio. HQLA preference has remained very high, falling by only €0.4tn in the face of a €1.6tn reduction in the ECB balance sheet. Further, government bond prices can fall and this creates capital demand for European banks through the ECB stress test: bonds are a less-good substitute for cash than ever before. A strong cash preference is evident, up from 45% in 2016 to 79% today (Exhibit 6).

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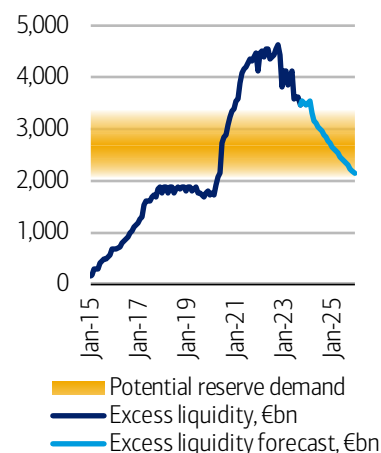
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Glossary

€str = euro short-term rate
ECB = European Central Bank
Euribor = euro interbank offered rate
HQLA = high quality liquid assets
LCR = liquidity coverage ratio
QT = quantitative tightening
TLTRO = targeted longer-term refinancing operation

Exhibit 1: Euro area excess liquidity
Demand may outstrip supply in 2024

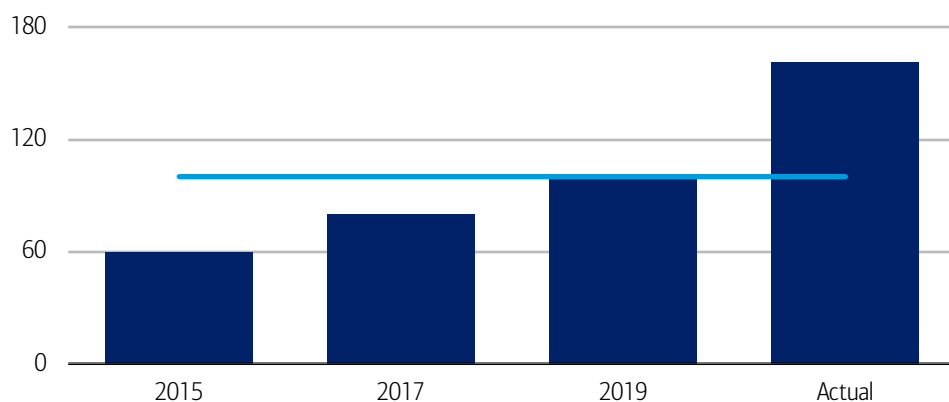


Source: BofA Global Research, ECB

Key charts

Exhibit 2: Liquidity Coverage Ratio from 60% to 161% since 2015

Basel requirements for LCR coverage in %, 2015-2019 and current actual euro area average

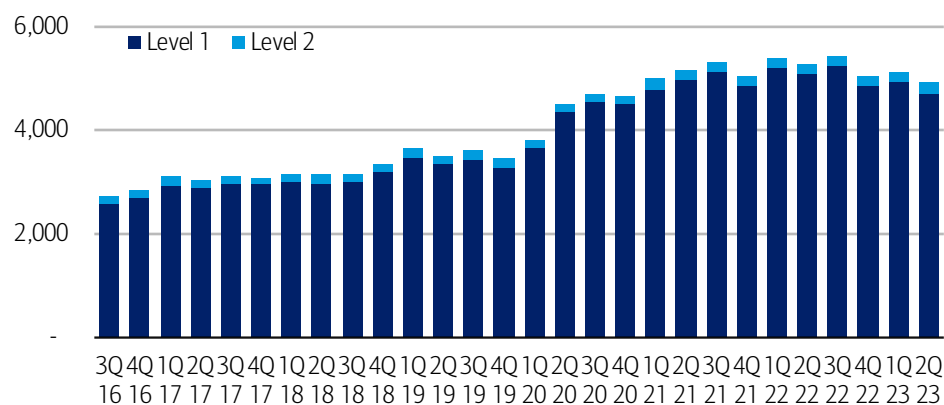


Source: Basel Committee, ECB

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Exhibit 3: Bank High Quality Liquid Assets are up strongly, almost all in level 1

HQLA, euro area banks, 2016-23 (€ mn) and by quality

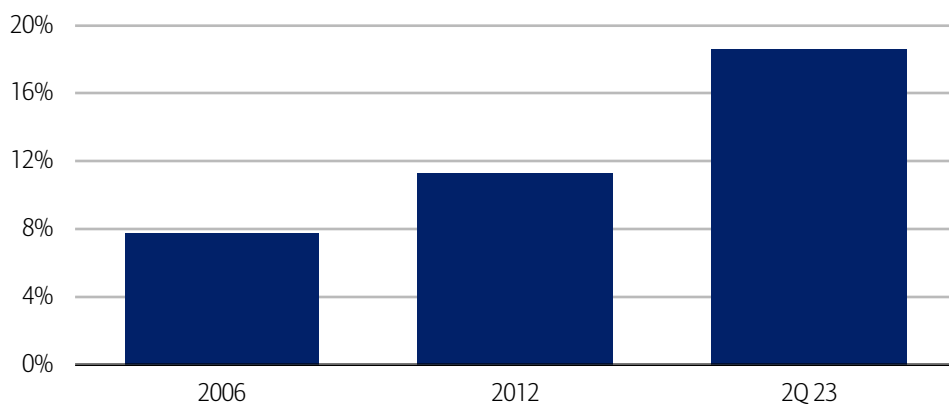


Source: BofA Global Research estimates, ECB

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Exhibit 4: Bank High Quality Liquid Assets, % assets, 2006-2023

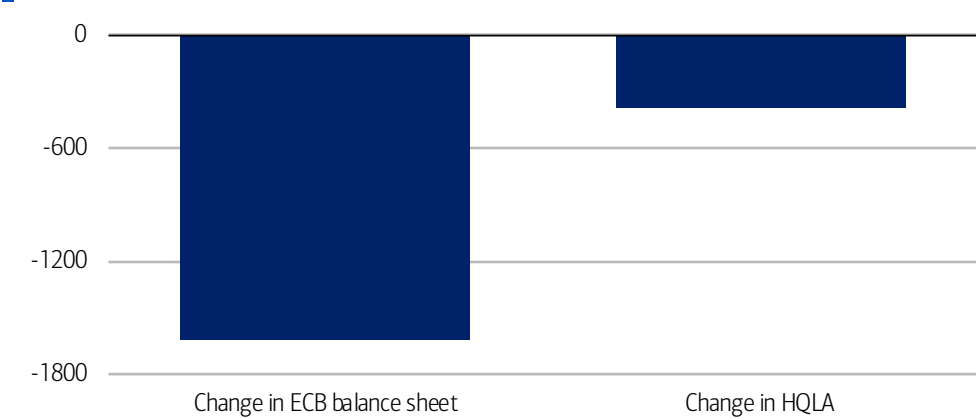
A more than doubling as a proportion of assets since before the financial crisis



Source: ECB, for euro area banks, 2Q 23. EBA for European banks, 2012. Basel for banks, 2006

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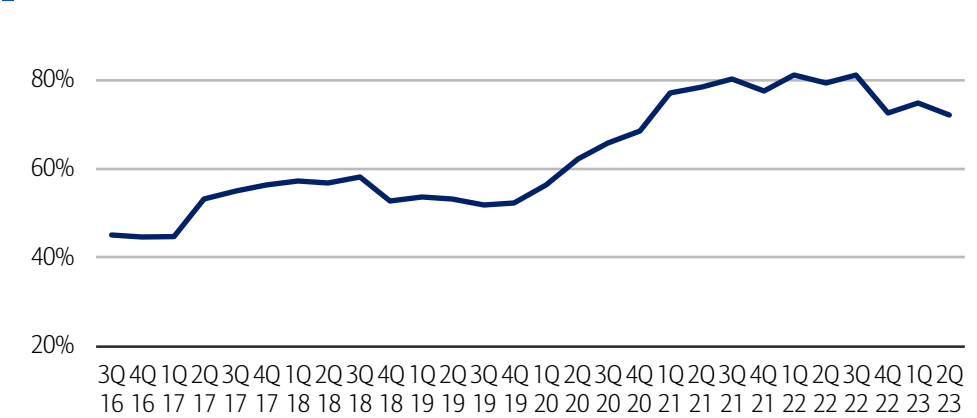
Exhibit 5: HQLA decline in the euro area only a quarter of the reduction in the ECB's balance sheet
Change from peak, € mn, ECB total assets and euro area bank HQLA



Source: BofA Global Research estimates, ECB

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Exhibit 6: banks have a strong cash preference within HQLA
Euro area bank cash position, % HQLA, 2016-23 (%)



Source: BofA Global Research estimates, ECB

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