Liquid Insight

ECB balance sheet update

03 August 2023

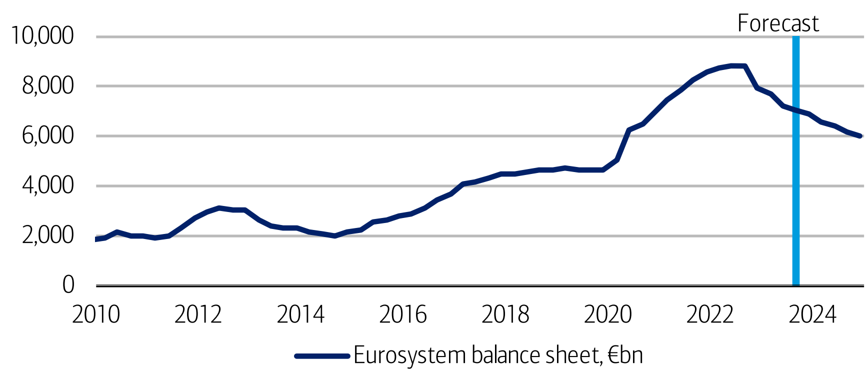
Rates and Currencies Research
Global

Key takeaways

- We expect the Eurosystem balance sheet to fall to €6.9trn at the end of 2023 and €6.0trn at the end of 2024
- We incorporate passive QT assumptions on PEPP in 2H2024 and remuneration changes on certain deposits
- Excess liquidity could be higher than previously expected in 2024 and is a risk to our Mar24 Euribor-€str view

By Ronald Man

Chart of the day: Eurosystem balance sheet
We forecast Eurosystem balance sheet to fall to €6trn by end-2024



Source: BofA Global Research

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Shifting components

We forecast the Eurosystem's balance sheet to fall from €8.trn at the end of 2022 to €6.9trn at end-2023 and €6.0trn at end-2024. Our forecast is based on the assumption of continued full passive quantitative tightening (QT) in the asset purchase programme (APP) portfolio and a start of partial passive QT in the pandemic emergency purcahase programme (PEPP) portfolio from 2H 2024.

We also assume remuneration changes to government and non-euro area resident deposits at the Eurosystem, given the European Central Bank's (ECB) recent focus on minimising the interest it pays on its liabilities. This is likely to cause a shift among the central bank's liability components, with these deposits flowing into reserves, and consequently slow the decline in excess liquidity. While we continue to expect bank demand for reserves and term funding to sustain, upside risks to the excess liquidity profile is a risk to our Euro interbank offered rate (Euribor) vs euro-short term rate (€str) widener view.

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Assumptions

QT

- **APP:** The ECB fully stopped reinvestments in the APP portfolio since July 2023. We use the redemption profile provided by the ECB where available, which implies on average a c. €30bn reduction in APP holdings per month. We expect this to continue in the foreseeable future.

- **PEPP:** Our economists believe it is more likely than not that passive QT in the PEPP portfolio will begin in mid-2024 (see the report European Rates Viewpoint, 1 August 2023). As with APP, we assume QT in the PEPP portfolio is progressive at 50%, which would equate to c. €15bn per month in 2H 2024 (Exhibit 1).

- **Risks are two-way.** A stronger desire to reduce losses on its balance sheet or stronger-than-expected growth and inflation outlook may bring forward even more the start of QT in the PEPP portfolio, or starting QT in the PEPP portfolio by full non-reinvestment. The risk of active QT remains low as we believe the ECB's focus on losses means it will not want to crystalise losses in its QE portfolios. Conversely, potential use of the Transmission Protection Mechanism (TPI) may temporarily increase the Eurosystem's balance sheet. A weaker-than-expected growth or inflation outlook may also cause the ECB to not bring forward the start of QT in its PEPP portfolio as we assumed in this report.

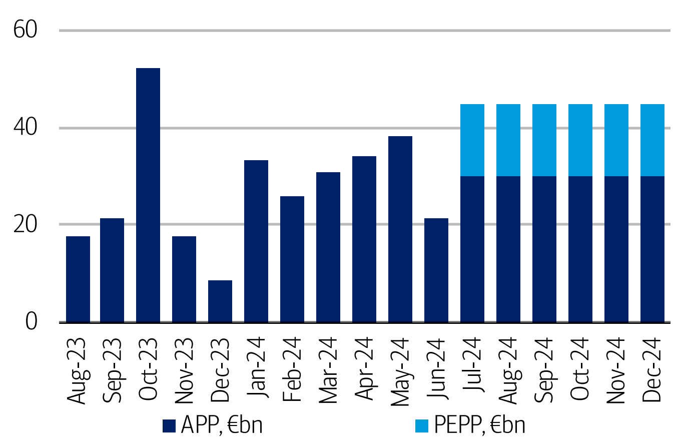
Targeted longer-term refinancing operations (TLTROs)

- We assume banks will repay 5% of outstanding TLTROs in each quarterly window above and beyond maturing TLTROs, comparable to past behaviour (Exhibit 2).

- One risk is the ECB introducing a new TLTRO programme or operations in the future.

- Another risk is punitive tiering by the ECB, which could be an option for the central bank to reduce the cost of its liabilities. This could prompt some banks to repay TLTRO borrowings voluntarily early. But the ECB would risk large distortions in the front-end rates market.

Exhibit 1: QT assumptions
We assume passive QT in PEPP begins 2H 2024



Source: BofA Global Research, ECB

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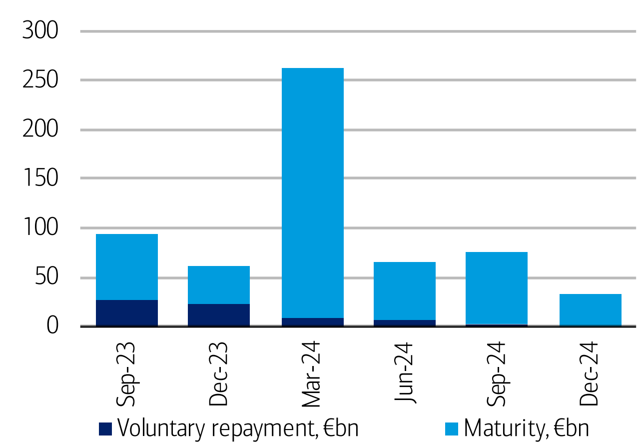
Exhibit 2: TLTRO repayment expectations
The next big repayment will be in March 2024



Source: BofA Global Research, ECB

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Government and non-euro resident deposits

- We believe the likelihood of the ECB setting a 0% remuneration rate, from €str minus 20bp currently, on government and non-euro area resident deposits at the central bank after its operational framework review is now very high. The operational framework is due to be concluded by the end of this year, and we assume implementation of a 0% remuneration rate will be on 1 January 2024 (Exhibit 3).

- Our assumption follows the recent change by the ECB on its remuneration on minimum reserves (Euro Area Watch, 27 July 2023). We assume government and non-euro area resident will bring down their deposits at the central bank to levels pre-June 2014, i.e. before the ECB set a negative deposit facility rate and when the remuneration rate on most government deposits was 0%. This implies government and non-euro area resident deposits will fall to c. €100bn and €50bn, respectively (Exhibit 4).

- The decline in government and non-euro area resident deposits will be reflected in an increase in reserves, which will slow the decline in excess liquidity from QT and TLTRO roll offs.

- Risks are skewed to a smaller drawdown than we assume. Governments may want to hold more absolute cash than they did at the central bank than in 2014. Some non-euro area residents may not have as large as scope to draw down their deposits at the Eurosystem to 2014 levels as before.

Currency growth

- We assume coins and banknotes will grow at 0.5% per month. This is in line with the average rate between 2017 and 2022. Excess liquidity in the euro area banking system would mechanically decrease but the Eurosystem's balance sheet size would not be impacted. One risk to our excess liquidity expectations is changes in currency growth: stronger currency growth would imply a sharper reduction in excess liquidity, and vice versa.

Exhibit 3: Remuneration on deposits at Eurosystem
We expect 0% on government and non-euro area resident deposits in 2024

Category		Current remuneration rate	Assumptions	Latest size, €bn
Current account	Minimum reserve requirement	Depo rate	0% from 20 Sep 23 as announced by ECB	165
	Other cash	0%	0%	9
Deposit facility		Depo rate	Depo rate	3,577
Government deposits		€str-20bp	0% from 1 Jan 24	282
Liabilities to non-euro area residents		Majority likely at €str-20bp	0% from 1 Jan 24	256

Source: BofA Global Research, ECB

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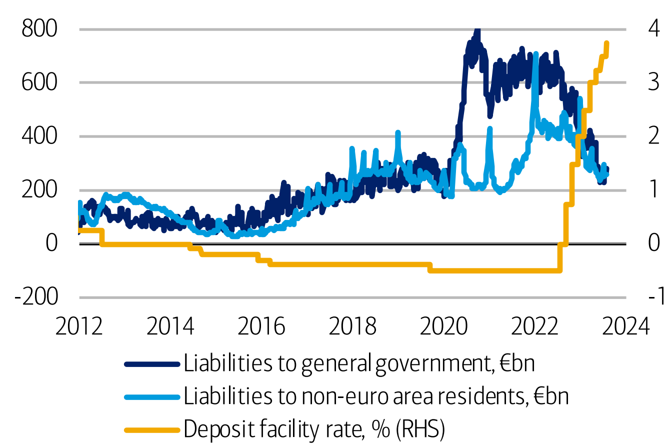
Exhibit 4: Deposits at Eurosystem and the depo rate
A 0% remuneration rate could bring levels back to pre-negative rate levels



Source: BofA Global Research, Bloomberg

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Market implications

Our assumptions imply the Eurosystem's balance sheet will from €8.0trn at the end of 2022 to €6.9trn at the end of 2023, and €6.0trn at the end of 2024. As a % of GDP, this implies the Eurosystem's balance will fall from 59% at end-2022 to 50% at end-2023, and to 41% at end-2024.

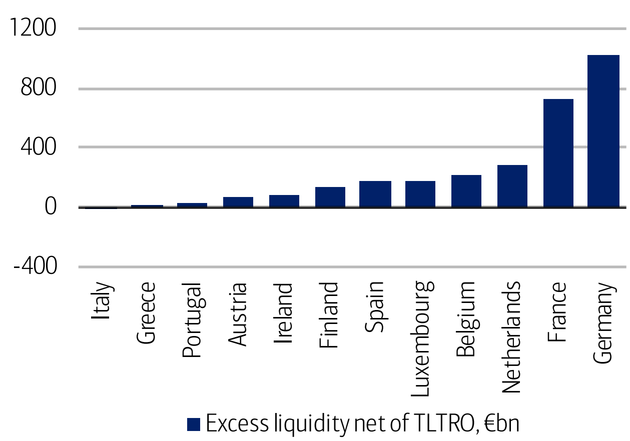
Excess liquidity is projected to fall from €3.8trn at the end of 2022 to €3.3trn at the end of 2023, and €2.7trn at the end of 2024. Our end-2024 projections increased because we now assume government and non-euro area residents will reduce their cash balance at the central bank to c. €150bn collectively from 1 January 2024. This is a risk to our Mar24 3M Euribor futures vs €str widener recommendation (current: 10bp, target: 25bp, stop: 8bp). That said, the risks to the combined €150bn government and non-euro area resident deposit balance assumption itself are skewed to the upside, which means risks to our latest excess liquidity projections are biased to the downside.

We still expect bank demand for high quality liquid assets (HQLA) to sustain as QT continues and TLTROs roll off. At the end of June 2023, banks in Italy at the aggregate level still have a c. €15bn gap between their TLTRO borrowings and excess liquidity balance (Exhibit 5). Competition for reserves is likely to sustain, especially for term deposits. Therefore term premium in bank's unsecured wholesale borrowing market is still expected to increase beyond what the market is pricing in.

For €str, we continue to expect its spread against the deposit facility rate to tighten as excess liquidity declines. We expect the €str-depo spread to be 0bp by end-2024.

For repo, we had expected general collateral (GC) rates to cheapen as the cash-rich collateral-scarce environment unwinds. Yet the recent magnitude of cheapening has been stronger than what we had expected. Germany and France one-day GC vs €str spreads has been consistently positive for most of July. The positive spread itself suggests that the recent repo cheapening may be driven more by more collateral availability than cash scarcity. We now expect Germany one-day GC vs €str to be 2bp by end-2023. For Germany one-day SC vs GC, we assume long positioning may scale back slightly from multiyear highs, as measured by our FX & Rates Sentimeny Survey (Exhibit 6). We expect the SC vs GC spread to be -15bp by end-2023.

Exhibit 5: Excess liquidity net of TLTRO by country
Banks in Italy face an aggregate gap of € -15bn in June 2023



Source: BofA Global Research, ECB
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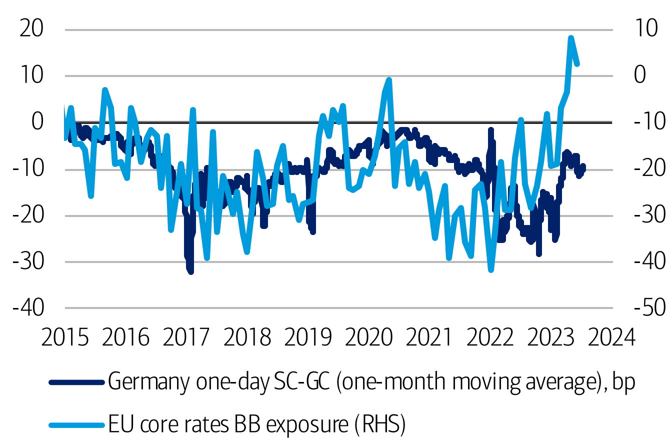
Exhibit 6: Germany one-day SC vs GC and positioning
Less long positioning could widen SC-GC spreads.



Source: BofA Global Research FX & Rates Sentiment Survey, Bloomberg, CME Group
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Notable Rates and FX Research

- **Global Rates, FX & EM Year Ahead 2023 –** Year Ahead 2023: Pivot ≠ Peak, 20 Nov 2022
- Don't underestimate central bank commitment to 2% inflation **Global FX Weekly**, 28 July 2023
- Goldilocks and the 3 banks **Global Rates Weekly**, 28 July 2023
- Ahead of major central bank meetings, **Liquid Cross Border Flows**, 24 July 2023

Rates, FX & EM trades for 2023

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Global FX Weekly: Don't underestimate central bank commitment to 2% inflation 28 July 2023

Global Rates Weekly: Goldilocks and the 3 banks 28 July 2023

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