Liquid Insight

ECB balance sheet update

30 November 2023

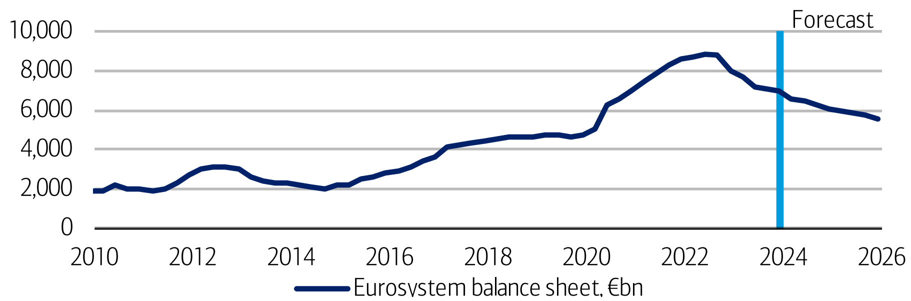
Rates and Currencies Research
Global

Key takeaways

- We expect the Eurosystem balance sheet to fall €820bn to €6.1trn by end 2024, which is the most among developed central banks
- We incorporate minimum reserve changes, TLTRO rolloffs, passive QT assumptions on PEPP, and potential remuneration changes
- Excess liquidity demand may outstrip supply and we like ERM4 vs ERU4 €str spread steepeners

By Ronald Man

Chart of the day: Eurosystem balance sheet
Balance sheet to fall to €6.1trn by end-2024



Source: BofA Global Research, ECB

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ECB balance sheet to decline most vs G6 central banks

We forecast the Eurosytem's balance sheet to fall from €6.9trn at end-2023 to €6.1trn at end-2024. When compared with G6 central banks, the Eurosystem is expected to record the largest balance sheet decline in 2024 (Exhibit 1). We incorporate minimum reserve requirement changes, targeted longer-term refinancing operation (TLTRO) rolloffs, passive quantitative tightening (QT) assumptions on pandemic emergency purchase programme (PEPP), and potential remuneration changes.

Excess liquidity is forecast to fall from €3.5trn at end-2023 to €2.7trn at end-2024. We estimate bank demand for excess liquidity to be between €2.1trn and €3.4trn to meet liquidity coverage ratio (LCR) requirements. This means there is a risk of excess liquidity demand outstripping supply in 2024.

We maintain our ERM4 vs ERU4 €str spread steepeners recommendation, expect the euro short-term rate (€str)-deposit facility rate (depo) spread to gradually reach 0bp by end-2024, forecast 3M euro interbank offered rate (Euribor) fixing at 3.25% by end-2024, and expect repo to stay cheap vs €str with the Germany one-day general collateral (GC) vs €str spread to be c. +5bp.

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Assumptions

QT

- **Asset purchase programme (APP):** the European Central Bank (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 expect the ECB to stop full reinvestments in its PEPP portfolio by June 2024, moving to 50% reinvestments until the end of 2024 and a full stop in 2025, as long as spreads remain well behaved (see Global Economics Year Ahead 2024). We estimate this will mean a reduction in its PEPP holdings of c. €7bn per month in 2H 2024 and €15bn per month in 2025.

- **Risks of faster than expected QT**: 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 it would imply crystalising losses.

- **Risks of slower than expected QT:** potential use of the TPI may temporarily increase the Eurosystem's balance sheet. Weaker-than-expected growth or inflation outlook may cause the ECB to not bring forward the start of PEPP QT. The prospect of insufficient reserves may prompt the ECB to consider maintaining a large balance sheet over the medium term as part of its operational framework review. The operational framework review is scheduled to be concluded in Spring 2024 but we would not rule out the possibility of another delay.

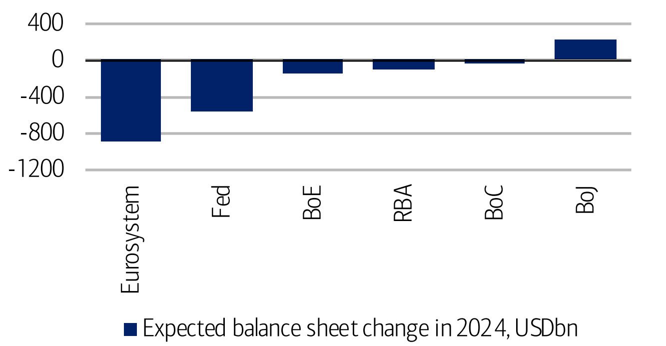
TLTRO

- **Assumption**: banks will repay 5% of outstanding TLTROs in each quarterly window above and beyond maturing TLTROs, comparable to past behaviour. Our assumptions imply TLTROs will drive the Eurosystem balance sheet decline in 1Q 2024 (Exhibit 2).

- **Risk of elevated bank borrowing:** the ECB introducing a new TLTRO programme or new lending operations as part of its operational framework review.

- **Risk of faster than expected decline in bank borrowing**: punitive tiering by the ECB could be an option for the central bank to reduce the cost of its liabilities. This may prompt some banks to repay TLTRO borrowings voluntarily early. But the ECB would risk distortions in the front-end rates market.

Exhibit 1: Balance sheet changes in 2024
Largest decline expected in the euro area



Source: BofA Global Research, Bloomberg. USD values based on spot exchange rate.
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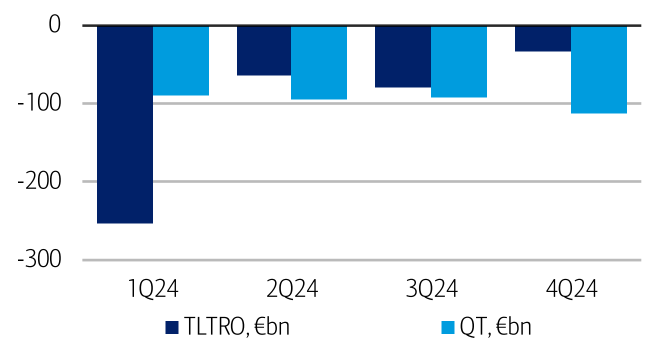
Exhibit 2: Drivers of Eurosystem asset decline
TLTRO and QT to drive decline in 2024



Source: BofA Global Research, ECB
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Minimum reserves

- Our economists expect the ECB to raise the minimum reserve requirement from 1% to 2-3% after its operational framework review. Minimum reserves are currently c. €164bn. An increase in the reserve requirement will mechanically reduce the amount of excess liquidity one-for-one.

- In our calculations, we applied a 2% minimum reserve requirement from April 2024. This means the risks to our excess liquidity figures are skewed to downside and being implemented later.

Government and non-euro area resident deposits

- We expect the Eurosystem to apply a 0% remuneration rate on government and non-euro area resident deposits after the ECB's operational framework review. Currently, all NCBs except the Buba remunerates up to a cap of €str minus 20bp on government deposits. The Buba remunerates its government deposits at 0%.

- We assume government and non-euro area residents 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.

- 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. We assume this shift will mainly take place between January and April 2024.

- 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 2024. Some non-euro area residents may not have as large a scope to draw down their deposits at the Eurosystem to 2014 levels as before. The ECB may also consider potential implications to the euro's reserve currency status if it were to offer a 0% remuneration rate to reserve managers while other global central banks offer a remuneration rate close to their respective policy rate (Exhibit 3).

Currency growth

- We assume coins and banknotes will grow at 0.2% per month. This is a slower growth rate than the five year average, reflecting the currency growth slowdown in recent months (Exhibit 4). Excess liquidity in the euro area banking system would mechanically decrease but the Eurosystem's balance sheet size would not be impacted as it would be a shift among the central bank's liabilities. One risk to our excess liquidity expectations is changes in currency growth: weaker currency growth than expected would imply a slower reduction in excess liquidity, and vice versa.

Exhibit 3: Reserve manager cash deposit options
Rates offered by central banks generally positive

	Facility	Rate
Federal Reserve	Foreign reverse repo facility	Generally equivalent to overnight reverse repo rate
Eurosystem	Eurosystem reverse management services	Not disclosed
Bank of Japan	Banking and custody services	Prevailing market repo rate less 5bp, or 0% if requested by counterparty
Bank of England	Term deposits	Not disclosed
Bank of Canada	Cash accounts	Bank of Canada overnight deposit rate

Source: BofA Global Research, Federal Reserve, ECB, Bank of Japan, Bank of England, Bank of Canada

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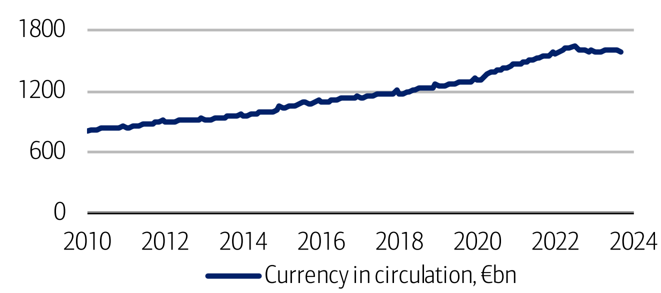
Exhibit 4: Currency stock in euro area
Growth has slowed in recent months



Source: ECB

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Market implications

Our assumptions imply the Eurosytem's balance sheet will fall from €8.0trn at end-2022 to €6.9trn at end-2023 and to €6.1trn at end-2024. As a % of GDP, this implies the Eurosystem's balance sheet will fall from 59% at end-2022 to 49% at end-2023 and to 42% at end-2024.

Excess liquidity, defined as the current account balance plus the deposit facility balance minus minimum reserve requirements and marginal lending facility balance, is forecast to fall from €3.8trn at end-2022 to €3.5trn at end-2023 and to €2.7trn at end-2024. We estimate bank demand for excess liquidity to be between €2.1trn and €3.4trn to meet LCR requirements. This means there is a risk of excess liquidity demand outstripping supply in 2024 (Exhibit 5, see European Rates Viewpoint, 21 November 2023).

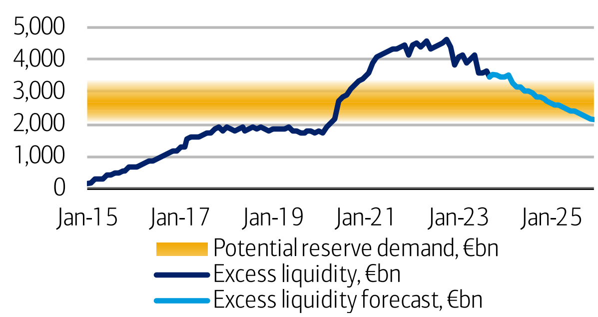
We maintain our ERM4 vs ERU4 €str spread steepener to position for increasing funding costs as reserve demand may outstrip supply in 2024 (current: +0.9bp, target: +5.5bp, stop: -1.6bp; see Global Rates Year Ahead 2024). Risk is a very large short-term shock that causes the Euribor futures-€str spread curve to invert.

€str: We expect the €str-depo spread to gradually reach 0bp by end-2024. Reserve reduction by the central bank will reduce bank balance sheet size and exposure value used for regulatory requirements. This reduces the need for banks to charge their €str counterparties for balance sheet usage when placing overnight deposits. We see risks skewed to the upside, i.e. €str exceeding depo, if the imbalance between reserve demand and supply is greater than expected, causing €str away from the floor and towards the ceiling of the ECB's policy rate corridor. Demand for excess liquidity has increased to an unknown quantum so €str may rise above the floor of the policy rate corridor sooner than when historical relationships would suggest.

Euribor: We forecast 3M Euribor fixing at 3.25% by end-2024, which incorporates a widening of the 3M Euribor-€str spread to 30bp and the expected ECB rate cut cycle from mid-2024. We expect bank demand for term funding to remain strong and for term premium to build across the curve. A risk to our view is bank funding demand is skewed significantly towards longer term funding.

Repo: We expect repo to stay cheap vs €str with the Germany one-day GC vs €str spread to be c. +5bp. This reflects our outlook of high European government bond (EGB) supply, bond positioning remains long, and increased funding demand by banks. We estimate excess liquidity in the euro area as a share of EGB outstanding to fall close to pre-COVID levels by end-2024 (Exhibit 6). We also expect Italy GC to widen vs Germany GC because the excess liquidity decline in the euro area is likely to prompt cash poor banks to raise cash first, including from the repo market. The risk to our view is significant search for yield flows from remuneration changes to the Eurosystem's liabilities that causes front-end euro assets to richen.

Exhibit 5: Euro area excess liquidity
Demand may outstrip supply in 2024



Source: BofA Global Research, ECB

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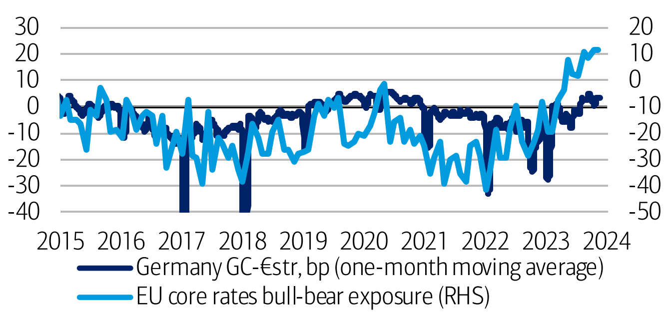
Exhibit 6: Germany one-day GC vs €str and rates exposure
Long bond positioning has supported cheaper repo



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

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