Liquid Insight

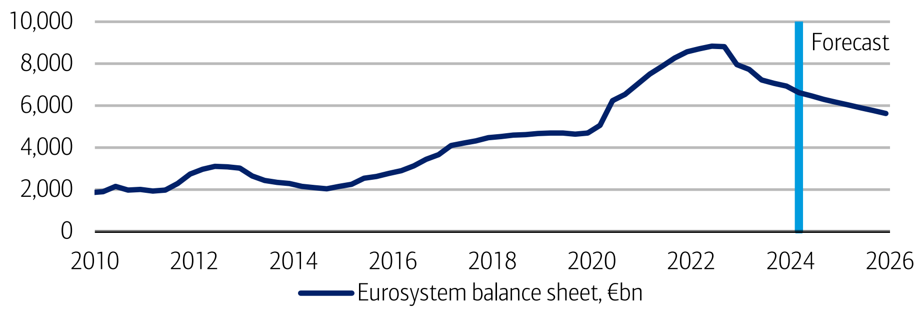
ECB balance sheet update

Key takeaways

- We expect the Eurosystem balance sheet to fall to €6.2trn by end-2024
- We incorporate the ECB's latest guidance on QT and operational framework review
- Stay paid Apr ECB €str vs March, and in Sep24 Euribor-€str wideners

By Ronald Man and Sphia Salim

Chart of the day: Eurosystem balance sheet
Balance sheet to fall to €6.2trn by end-2024 and €5.6trn by end-2025



Source: BofA Global Research, Bloomberg

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Pedal on the metal

We forecast the Eurosystem's balance sheet to fall from €6.8trn at end-2023 to €6.2trn by end-2024 and €5.6trn by end-2025. In its December 2023 meeting, the European Central Bank (ECB) announced it will begin quantitative tightening (QT) in its pandemic emergency purchase programme (PEPP) portfolio at an average €7.5bn per month. The decision by the ECB to accelerate QT is different from the US approach, where our economists expect the Federal Reserve to taper QT in May (see the report US Watch, 31 January 2024).

The outcome of the operational framework review is now likely to be concluded by the end of Spring, according to President Lagarde. The review may introduce new lending operations to help banks satiate their reserve demand as the central bank continues to wind down its balance sheet. This is a source of upside risk to our balance sheet forecasts where the ECB would be offsetting the reduction in its quantitative easing (QE) portfolio with loans. There are also risks of any such operations being introduced too late or proving unattractive to banks to use.

We like to be paid April ECB euro short-term rate euro short-term rate (€str) vs March to tactically fade early rate cuts given the pushback from central banks, including the ECB. We also like September 2024 forward rate agreement (FRA)-€str wideners to position for increased funding pressures and to hedge against a risk-off event.

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Assumptions

QT

- **Asset purchase programme (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**: the ECB stated in its December meeting that it will begin QT in its PEPP portfolio at an average €7.5bn per month in 2H 2024. By our calculations, this will imply a reinvestment rate of around 50%. The ECB also stated it intends to stop PEPP reinvestments at the end of 2024, which we estimate would imply a monthly PEPP holdings reduction of around c. €15bn (Exhibit 1).

- **Risks of faster QT**: stronger-than-expected growth and inflation outlook may bring forward 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 QT**: any use of the transmission protection instrument (TPI) may temporarily increase the Eurosystem's balance sheet. Weaker-than-expected growth or inflation outlook may cause the ECB to push back the start of PEPP QT.

TLTRO

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

- **Risk of more voluntary repayments**: if the ECB introduces new lending operations with attractive conditions to help banks satiate reserve demand, then this may cause banks to switching funding from the central bank by voluntarily repaying more TLTROs sooner to these new operations.

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. €161bn. 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 May 2024.

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 national central banks (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 have taken place by May 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.

Currency growth

- We assume coins and banknotes will grow at 0.2% per month. 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.

Risks from new lending operations

Our assumptions imply the Eurosytem's balance sheet will fall from €6.9trn at end-2023 to €6.2trn at end-2024 and €5.6trn by end-2025. As a % of GDP, this implies the Eurosystem's balance sheet will fall from 49% at end-2023 to 42% at end-2024 and 38% at end-2025. 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 €3.5trn at end-2023 to €2.8trn at end-2024 and €2.2trn at end-2025.

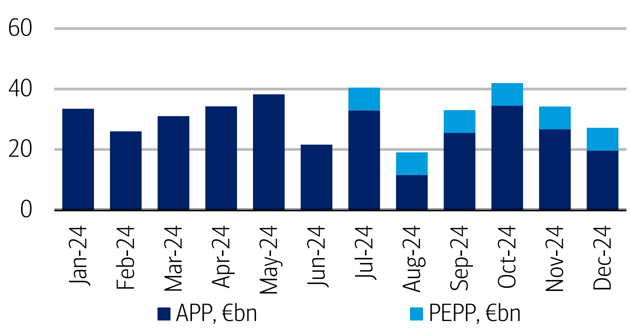
The latest guidance from the ECB on its operational framework review is that it will be concluded by the end of Spring. The review includes potentially introducing new lending operations to help banks satiate their demand for reserves as the central bank continues to wind down its balance sheet.

If new lending operations are introduced and utilised by banks, this would pose upside risks to our Eurosystem balance sheet projections. On the asset side of the balance sheet, the decline in the central bank’s QE portfolio will be offset by an increase in loans from the central bank to banks. On the liability side of the central bank’s balance sheet, the decline in reserves will be dampened.

Usage of such operations will be a function of technical factors, including price and tenor. We estimated bank excess liquidity demand for liquidity coverage ratio (LCR) purposes is between €2.1trn and €3.4trn, and that excess liquidity in the euro area in the absence of new lending operations being introduced would be €2.8trn by the end of this year. This suggest such operations could pose as much as c. €600bn upside risk to our end-2024 balance sheet forecast, but we would stress this is likely to be the upper limit. There are also risks of any such operations being introduced too late to fully avoid funding pressures or proving unattractive to banks to use.

Exhibit 1: QT expectations

ECB to begin QT in its PEPP portfolio in 2H 2024



Source: BofA Global Research, ECB

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Exhibit 2: TLTRO III expectations, €bn

Largest TLTRO drop in 2024 expected to be in March 2024

Operation	Maturity	Outstanding	Expected outstanding			
			Mar-24	Jun-24	Sep-24	Dec-24
III.7	27-Mar-24	215				
III.8	26-Jun-24	53	51			
III.9	25-Sep-24	85	81	77		
III.10	18-Dec-24	39	37	35	33	
Total outstanding, €bn		392	168	112	33	0
Voluntary early repayment, €bn			-9	-6	-2	
Change in outstanding, €bn			-224	-56	-78	-33

Source: BofA Global Research, ECB

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Market implications

€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 and we believe €str may rise above the floor of the policy rate corridor sooner than when historical relationships would suggest.

> We stay paid April ECB €str vs received March ECB €str (current: -15bp, target: 0bp, stop: -28bp). Global central banks, including the ECB, are pushing back against market pricing of early cuts. Our trade also provides protection against risks from a global shock, a potential one being contagion from the US banking system. Risk to the trade is the pricing of a more aggressive ECB cutting cycle (increments of over 25bp) on large downside surprises in Euro area inflation.

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.

> We stay in ERU4 €str wideners to position for bank funding pressures and as a hedge against a risk-off event (current: 11bp, target: 20bp, stop: 5bp). Risks are less reserve demand by banks than we expect, slower QT than we expect, and new lending operations introduced and used by banks to bridge the reserve demand-supply gap as the central bank continues to reduce its QE portfolio.

Repo: We expect repo to stay cheap vs €str with the Germany one-day general collateral (GC) vs €str spread to be between +5 and +10bp. This reflects our outlook of high European government bond (EGB) supply, bond positioning remains long, and increased funding demand by banks. 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. Banks in Italy recently continued to build up reserves via asset sales and debt issuance, rather than borrowing from banks in other euro area countries, in particular from banks in France. Our interpretation is that this shift could be an early signal of growing reluctance among euro area banks to lend reserves and hence funding pressures are likely to build (see European Rates Watch, 23 January 2024). 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.

Notable Rates and FX Research

- **Global Macro Year Ahead 2024 -** Hope for the best, prepare for the worst, 19 Nov 2023
- **Global Rates Year Ahead 2024 –** Cloudy with a chance of landing, 19 Nov 2023
- **G10 FX Year Ahead -** The year of the landing, 20 Nov 2023
- Into month-end and the Fed, **Liquid Cross Border Flows**, 29 Jan 2024

Rates, FX & EM trades for 2024

For a complete list of our open trade recommendations, as well as our trade recommendations closed over the past 12 months, see the reports below:

Global FX Weekly: Despacito 02 February 2024

Global Rates Weekly: Confidence test 02 February 2024

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