

## Liquid Insight

## ECB balance sheet update

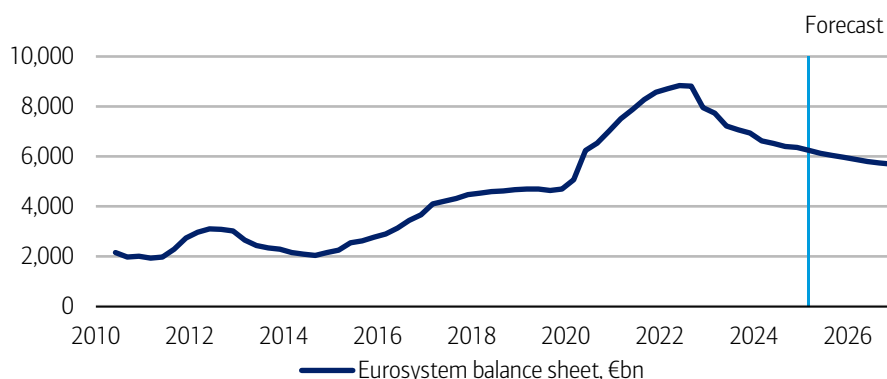
## Key takeaways

- We forecast the Eurosystem balance sheet to fall to €6.0trn by end-2025 and €5.7trn by end-2026
- We forecast excess liquidity in the euro area to fall to €2.5trn and MRO/LTRO take-up to rise to c. €70bn by end-2025
- We expect reserve demand to rise and stay in forward starting Euribor-€str wideners

## By Ronald Man

## Chart of the day: Eurosystem balance sheet, €bn

We expect the Eurosystem balance sheet to fall to €6.0trn by end-2025



Source: BofA Global Research, ECB

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## Staying the course

We expect the European Central Bank (ECB) to continue quantitative tightening (QT) in the foreseeable future as it shifts to a demand-driven floor system. Risks to euro area's outlook have increased: our base case is that the ECB will use interest rates to respond rather than the central bank's balance sheet. President Lagarde stated that the ECB's purpose is not to finance defense and infrastructure spending.

We forecast excess reserves in the euro area to fall to €2.5trn by end-2025. By our estimates, some banking systems, including Italy, are likely to need to raise reserves before the end of the year. We expect growing reserve demand will cause front-end euro spreads, in the secured and unsecured markets, to widen as banks first turn to the market for funding and gradually rely more on the central bank over time as total reserves decline and market rates rise. Our preferred expression of this view is to stay in forward starting euro interbank offered rate (Euribor) vs euro short-term rate (€str) wideners.

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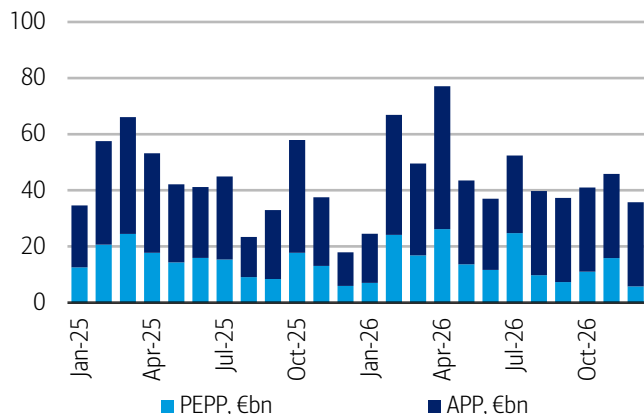
## Assumptions

### QT

- **Asset purchase programme (APP) and pandemic emergency purchase programme (PEPP):** the ECB fully stopped reinvestments in the APP portfolio and the PEPP portfolio since July 2023 and January 2025, respectively. We use the redemption profiles provided by the ECB where available, which imply on average a c. €30bn and c. €15bn reduction in APP and PEPP holdings per month, respectively. We expect this to continue in the foreseeable future (Exhibit 1).
- **Risks of faster QT:** we believe the prospect of active QT remains low as it would imply crystallising losses and raising net supply from already historically high levels.
- **Risks of slower QT:** any use of the transmission protection instrument (TPI) may temporarily increase the Eurosystem's balance sheet. Much weaker-than-expected growth or inflation outlook may cause the ECB to consider slowing the pace of QT.
- **Risks of quantitative easing (QE):** the restart of QE would pose upward risks to the Eurosystem's balance sheet forecast. Our economists believe QE is not a zero-probability event given what it seems to be a persistent and chronic insufficiency of aggregate demand. Meanwhile, President Lagarde stated in March 2025 that the ECB's purpose is not to finance infrastructure and defense spending.
- **Structural bond portfolio:** the ECB may begin building its structural bond portfolio and this will lead to purchases of securities, posing upside risks to our Eurosystem balance sheet forecasts. The ECB stated this, and structural longer-term refinancing operations, will be introduced once the Eurosystem balance sheet begins to grow durably again. However, our estimates imply the Eurosystem balance sheet may not be growing durably in the foreseeable future.

#### Exhibit 1: QT expectations, €bn

ECB to move to full passive QT in 2025

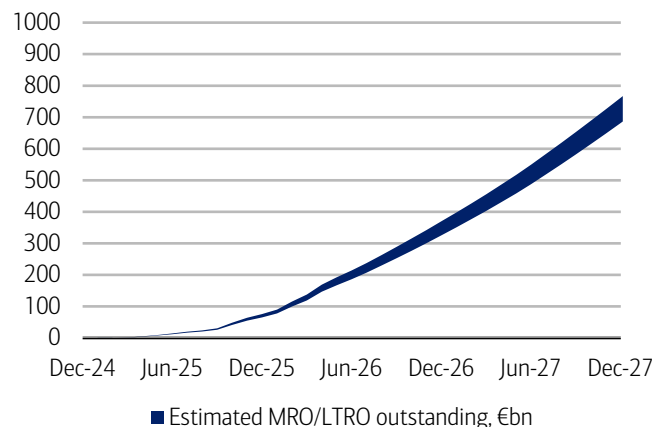


Source: BofA Global Research, ECB

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#### Exhibit 2: MRO/LTRO expectations, €bn

We expect a take-up of c. €70bn by end-2025



Source: BofA Global Research

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### Lending operations

- We estimate banks' liquidity coverage ratio (LCR)-related demand for reserves to be between €1.7trn and €2.8trn (see [European Rates Viewpoint, 7 October 2024](#)).
- We expect bank usage of main refinancing operation (MRO) and longer-term refinancing operation (LTRO) to increase gradually to c. €70bn by end-2025, c. €350bn by end-2026, and c. €720bn by end-2027 (Exhibit 2). The gradual pace, at least initially, reflects 1) redistribution of reserves, 2) bank willingness to hold less



reserves in its HQLA portfolio, and 3) potential stigma that may limit bank usage of ECB's open market operations (OMOs) (see [European Rates Watch, 2 April 2025](#)). Only when market rates rise sufficiently close to – if not above – the refi, do we expect bank usage of the central banks' OMOs to rise meaningfully.

- Our MRO and LTRO take-up estimates are based on estimated LCR-related reserve demand estimates by country. We assume banks in countries with insufficient excess liquidity will initially make up the c. 50% of their shortfall via central bank funding. Reliance on central bank funding is likely to increase as the ECB reduces its QE portfolio and competition for existing reserves rises.
- **Risks for higher take-up than expected:** banks need more reserve than our LCR-related estimates imply, reserve distribution between euro area banks slow sooner than expected, and pace of QT is faster than our base case.
- **Risks for lower take-up than expected:** perceived stigma among banks that further limit their take-up of the ECB's OMOs, existing cross-border flows reduced amount needed by banks with less reserves to borrow from the central bank, banks need less reserve than our LCR-related estimates imply, pace of QT slower than our base case or the restart of QE, structural securities portfolio creates meaningful reserves over our forecast horizon.
- **Structural longer-term refinancing operations:** the ECB may introduce structural longer-term refinancing operations when, as per its current guidance, the Eurosystem's balance sheet begins to grow durably. These operations could reduce the pace of Eurosystem balance sheet decline if terms are sufficiently attractive. But we do not think they will be designed to make the ECB the lender of first resort.

#### Government and non-euro area resident deposits

- All national central banks (NCBs) except the Bundesbank (Buba) remunerates up to a cap of €str minus 20bp on government deposits. The Buba remunerates its government deposits at 0%. Our base case is for no change in the remuneration rate and government deposits at the Eurosystem and for government deposits to be close to their current level.
- Non-euro area resident deposits at the Eurosystem are generally remunerated at €str-20bp. We expect non-resident deposits at the Eurosystem to be roughly at their current level.
- We would not rule out a change in the remuneration rates on government deposits in the future, with risks skewed to a decline in remuneration rates.
- Risks are skewed to further drawdowns of deposits by government and non-residents. 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. Further deposit drawdown by governments may be motivated by cash efficiency considerations, while further cash drawdown by non-residents may be motivated by higher pickups from other short-dated assets.

#### Currency growth

- We assume coins and banknotes will grow at 0.1% per month. Excess liquidity in the euro area banking system would mechanically decrease as coins and banknotes grow, 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.



## Minimum reserves

- We assume no change to the 1% minimum reserve requirement in the foreseeable future.

## Market implications

Our assumptions imply the Eurosystem's balance sheet will fall from €6.4trn at end-2024 to €6.0trn by end-2025, and €5.7trn by end-2026. As a % of GDP, this implies the Eurosystem's balance sheet would fall from 42% at end-2024 to 38% at end-2025, and 36% at end-2026.

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 €2.8trn at end-2024 to €2.5trn at end-2025, and €2.2trn by end-2026.

## €str

We expect the €str-depo spread to gradually reach 0bp by c. mid-2026 as total reserves decrease. The 15bp refi-depo corridor implemented since September 2024 and associated take-up by banks is likely to reduce the urgency of banks to pay up for overnight deposits from their €str counterparties. We believe bank demand for deposits would be skewed to term deposits for net stable funding ratio (NSFR) purposes.

## Euribor

We forecast 3M Euribor fixing at 1.70% by end-2025 and 2.00% by end-2026. This incorporates a gradual widening of the 3M Euribor-€str spread and our economists' forecast of the depo rate reaching 1.50% by September 2025, and rising 25bp in December 2026. We expect bank demand for term funding to build and for term premium to build across the curve, and stay in 1y1y Euribor-€str wideners (initiated: November 2024, current: 22.5bp, target: 30bp, stop: 17bp; see report: *Global Rates Year Ahead*, 24 November 2024). Risks are a slowdown or stop to QT.

## Repo

We expect repo to cheapen vs €str with the Germany one-day general collateral (GC) vs €str spread gradually rising to main refinancing rate (refi)-c. 10bp, from refi-c. 16bp currently. Our cheapening expectations are based on 1) increasing funding demand by banks as excess liquidity declines, 2) high European government bond supply outlook, and 3) net long bond positioning by leveraged investors sustaining funding demand in repo. Our expectations imply the German one-day GC-€str spread will stay positive in the foreseeable future.

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. We estimate banks in Italy, France, Spain, and Greece may need to increase reserve holdings further from current levels for high quality liquid asset (HQLA) purposes.

Risks to our view are: 1) a decline in net long positioning by leveraged investors would reduce their associated funding demand and may lead to less cheapening pressure than we expect, 2) more stigma of banks in accessing the ECB OMO than we thought, which could cause German GC to trade even closer to the refi rate.

## EUR FX-Secured overnight financing rate (Sofr)

Structurally we expect the tightness in the EUR FX-Sofr basis to sustain given the expected divergent QT paths between the ECB and the Federal Reserve. We expect the ECB to continue QT in the foreseeable future as it moves to a demand-driven floor system, and the Federal Reserve to stop QT in December 2025.



## Notable Rates and FX Research

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- **Global Macro Year Ahead 2025** – [Stretching the rubber band](#), 24 November 2024
- **Global Rates Year Ahead 2025** – [Continental Drift](#), 24 November 2024
- **G10 FX Year Ahead 2025** – [Policy Uncertainty](#), 26 November 2024
- [Post “Liberation Day”](#), **Liquid Cross Border Flows**, 7 April 2025

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[Global FX weekly: The bond market can intimidate everybody 11 April 2025](#)

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