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Cash is the new King

Collateral has lost its crown

December 17, 2024

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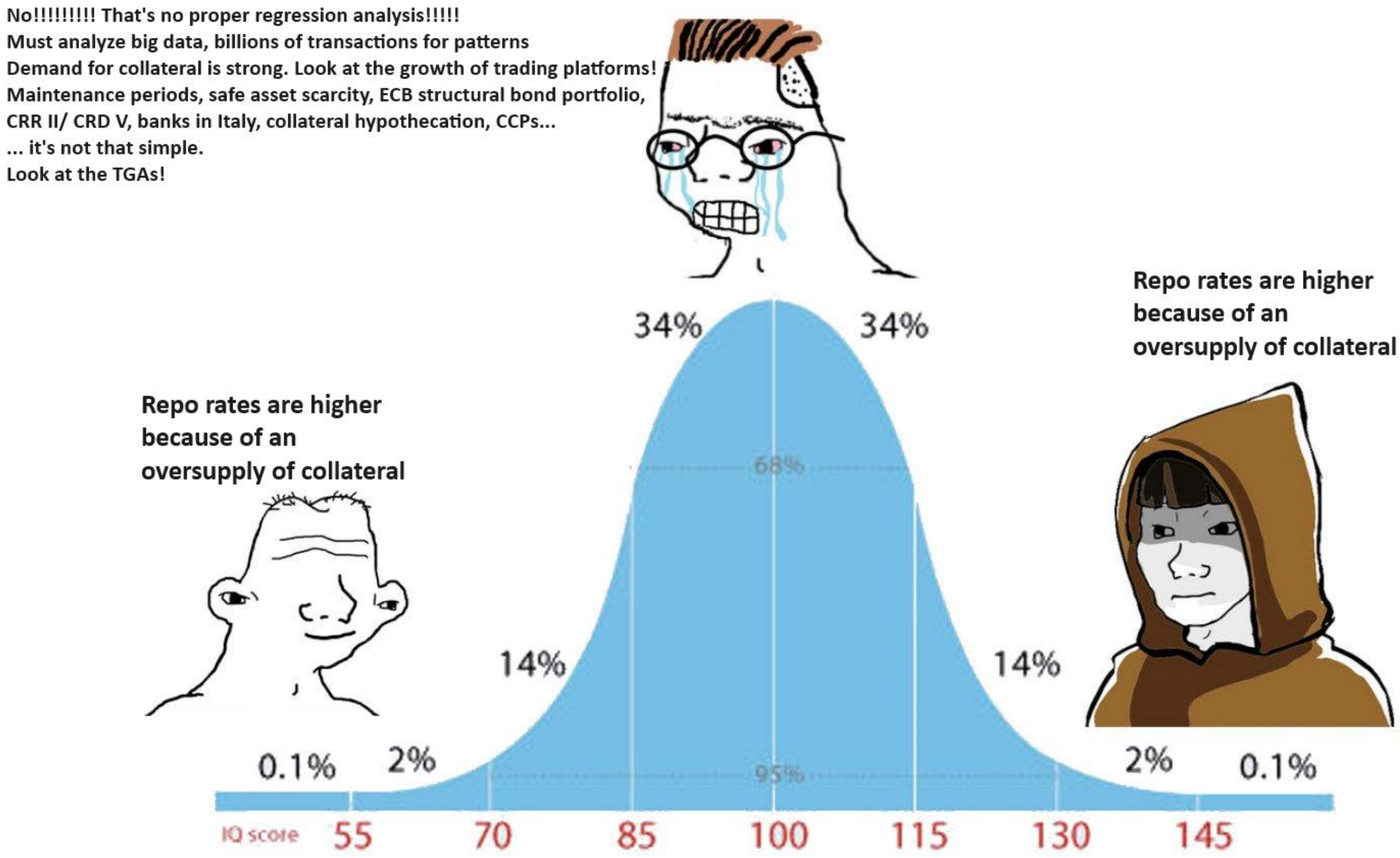
Cash Rules Everything Around Me

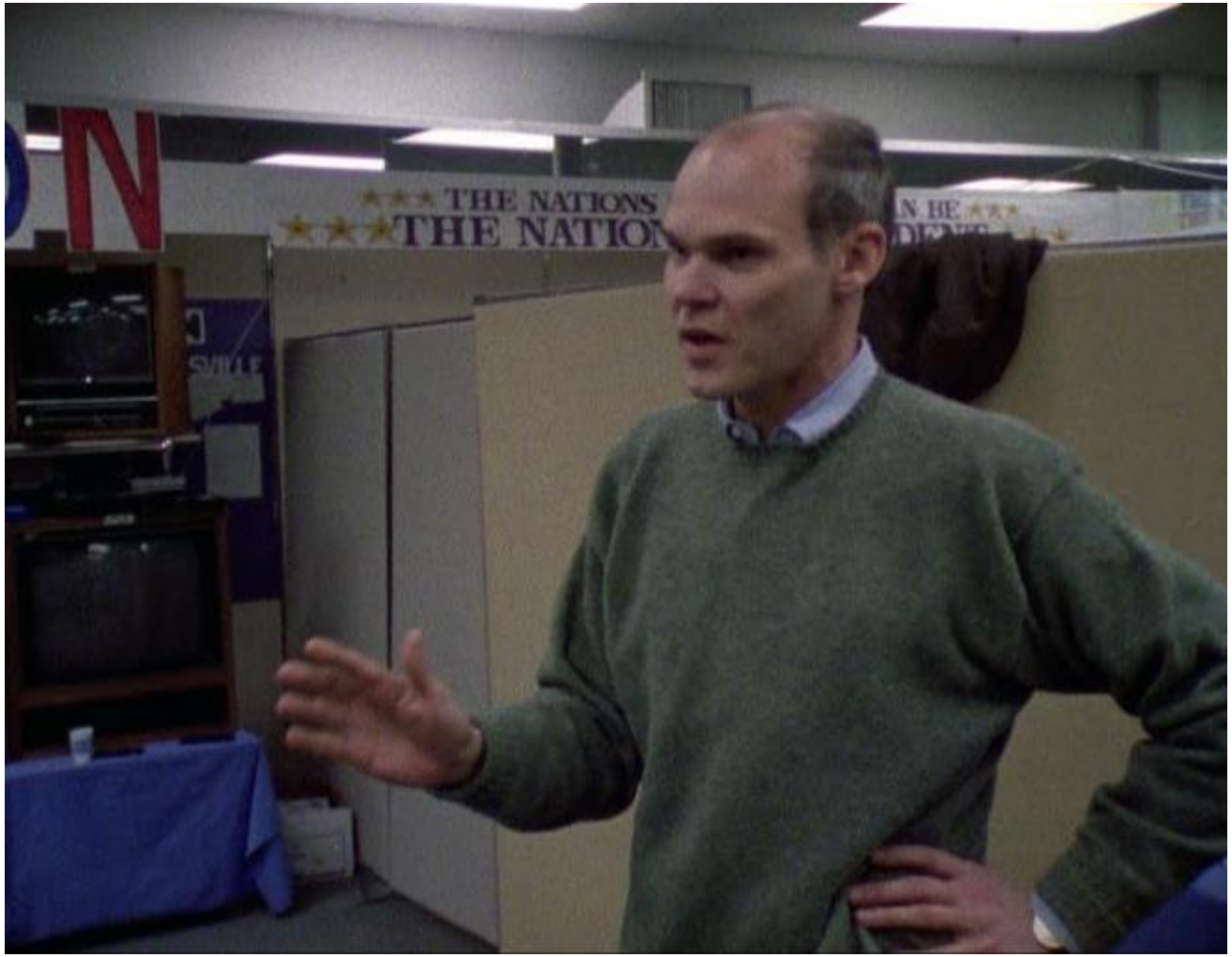
Introduction

- Why are repo rates rising relative to ECB rates?
- Why is the aggregate level of bank reserves in the Euro Area a misleading metric?
- Is there stigma attached to Eurosystem MRO and LTRO?

What determines repo rates relative to ECB rates?



“[it’s] the economy, stupid”



What determines repo rates relative to ECB rates?

- It’s so simple. That’s why nobody has figured it out. It’s the law of supply and demand. Bank reserves on the one hand, and the supply of collateral on the other;
- So, what determines repo rates relative to ECB rates? Repeat after me: “it’s the supply, stupid.”

Why bank reserves?

- According to ECB data, the banking system's share in the 2.5 trillion euros secured market is only about 1/5. However, banks' importance cannot be overstated;
- Even if a bank isn't a counterparty in the secured trade, cash payments mean that a bank is involved. If the counterparties do not share the same bank, there is an interbank payment. And that means that bank reserves 'change hand';
- In any case, in any model of money market spreads, bank reserves are always *the* independent variable. Bank reserves have predictive power.

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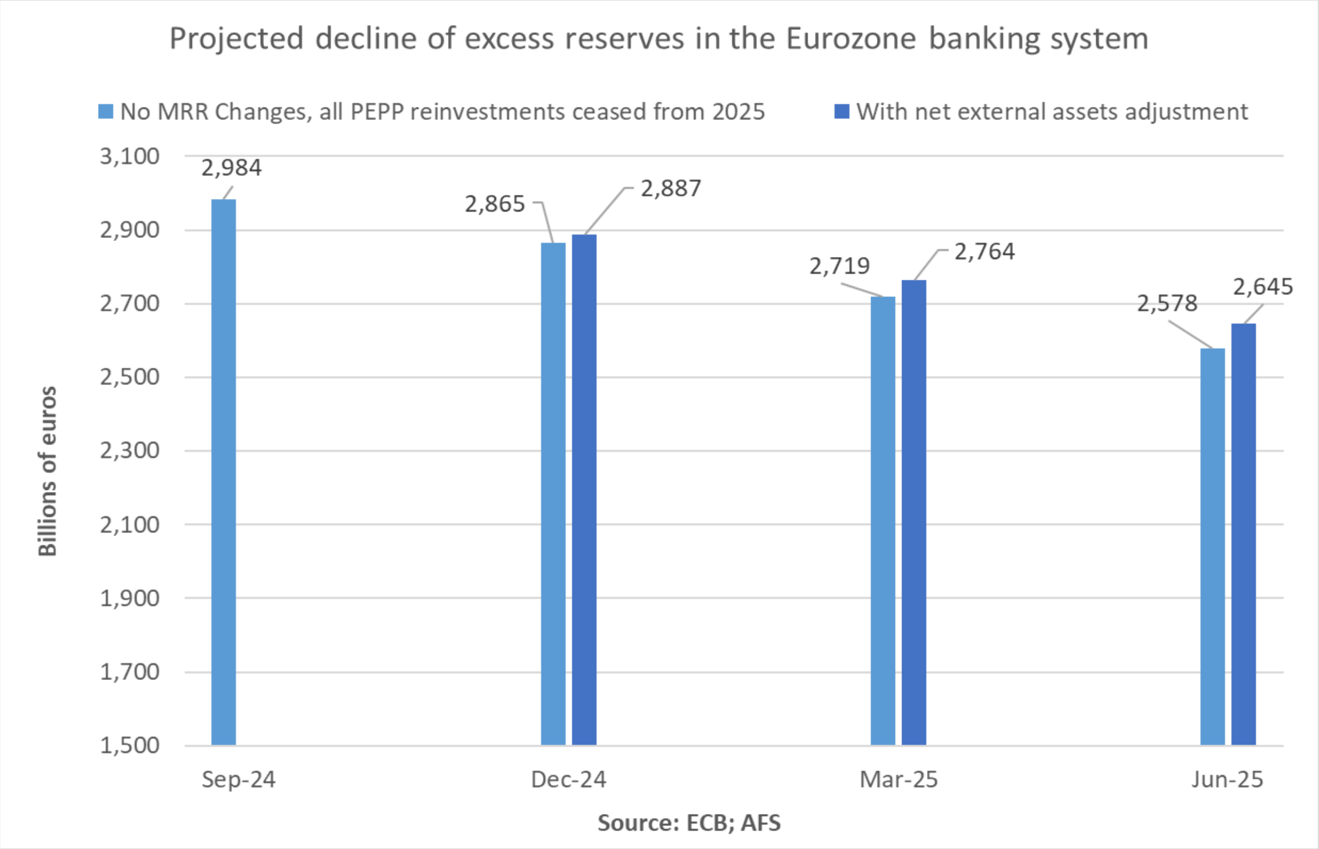
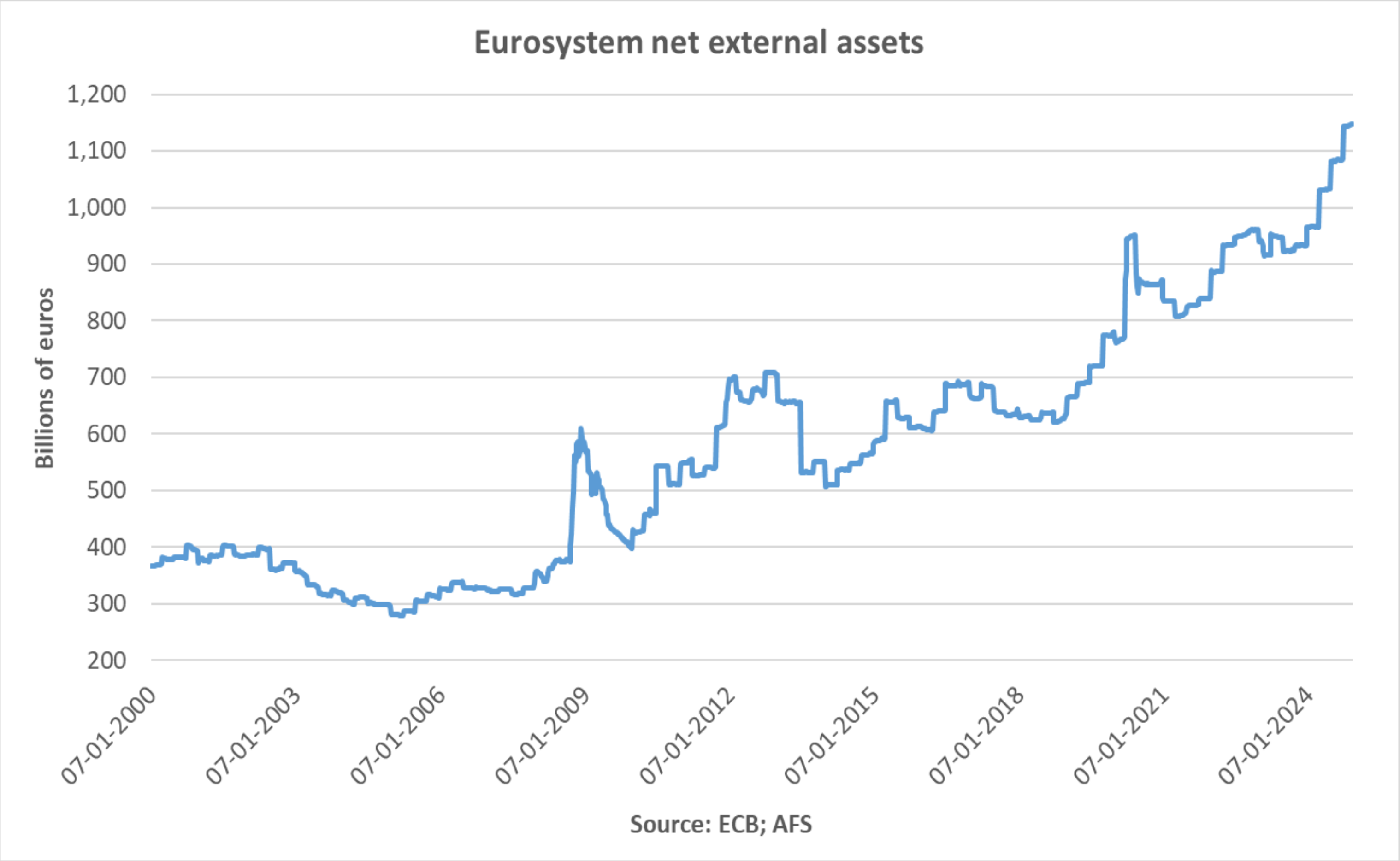
A forecast for bank reserves

- Bank reserves will fall to around 2.6 trillion euros six months from now according to the ECB's QT schedule;
- Net external assets are the wildcard. An increase in Eurosystem net external assets increases reserves in the banking system one-on-one.



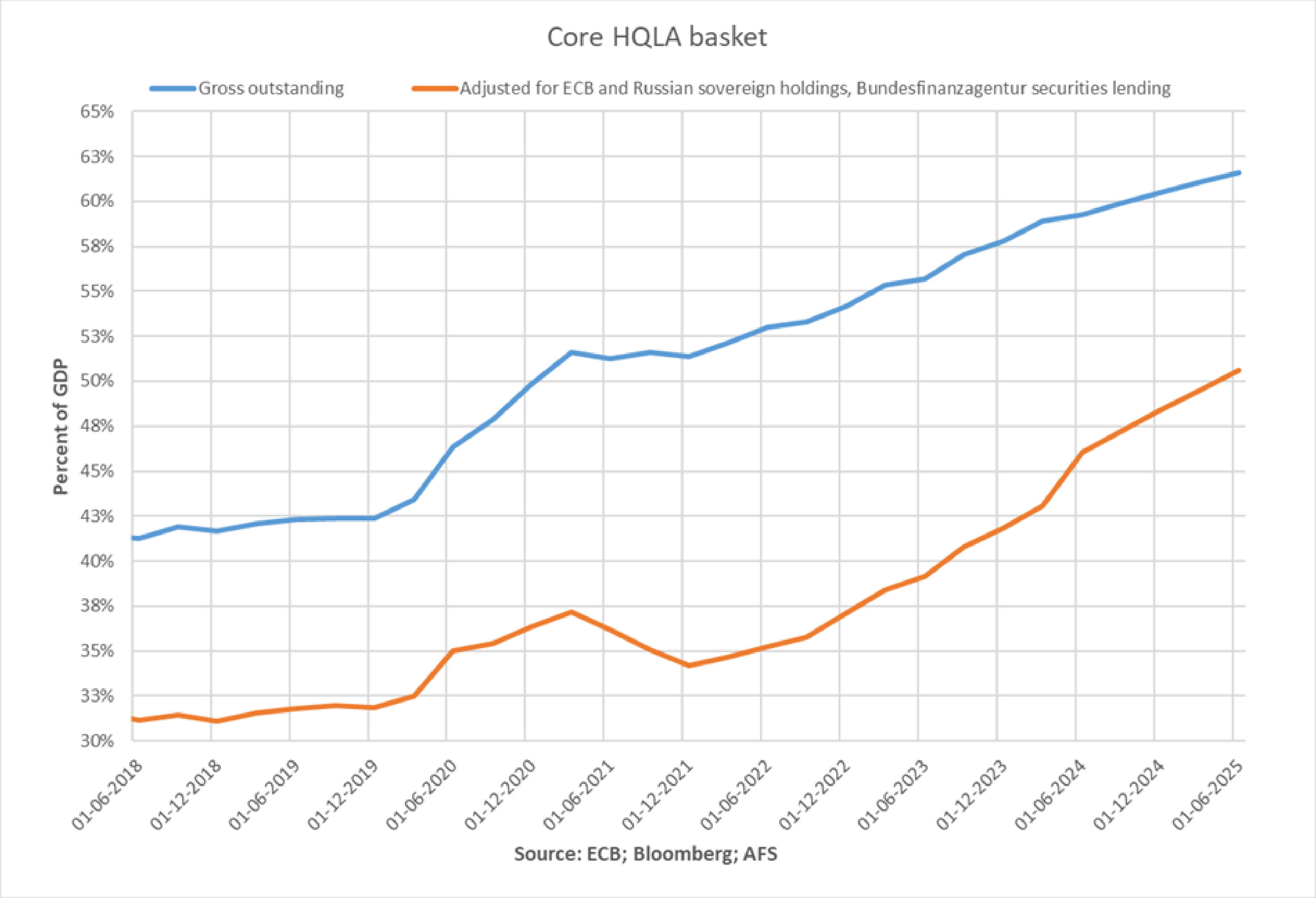
QT sterilization

- ECB QT amounted to 370 billion euros in 2024;
- Eurosystem net external assets increased by 264 billion in January through early December 2024, sterilizing the bulk of ECB QT.

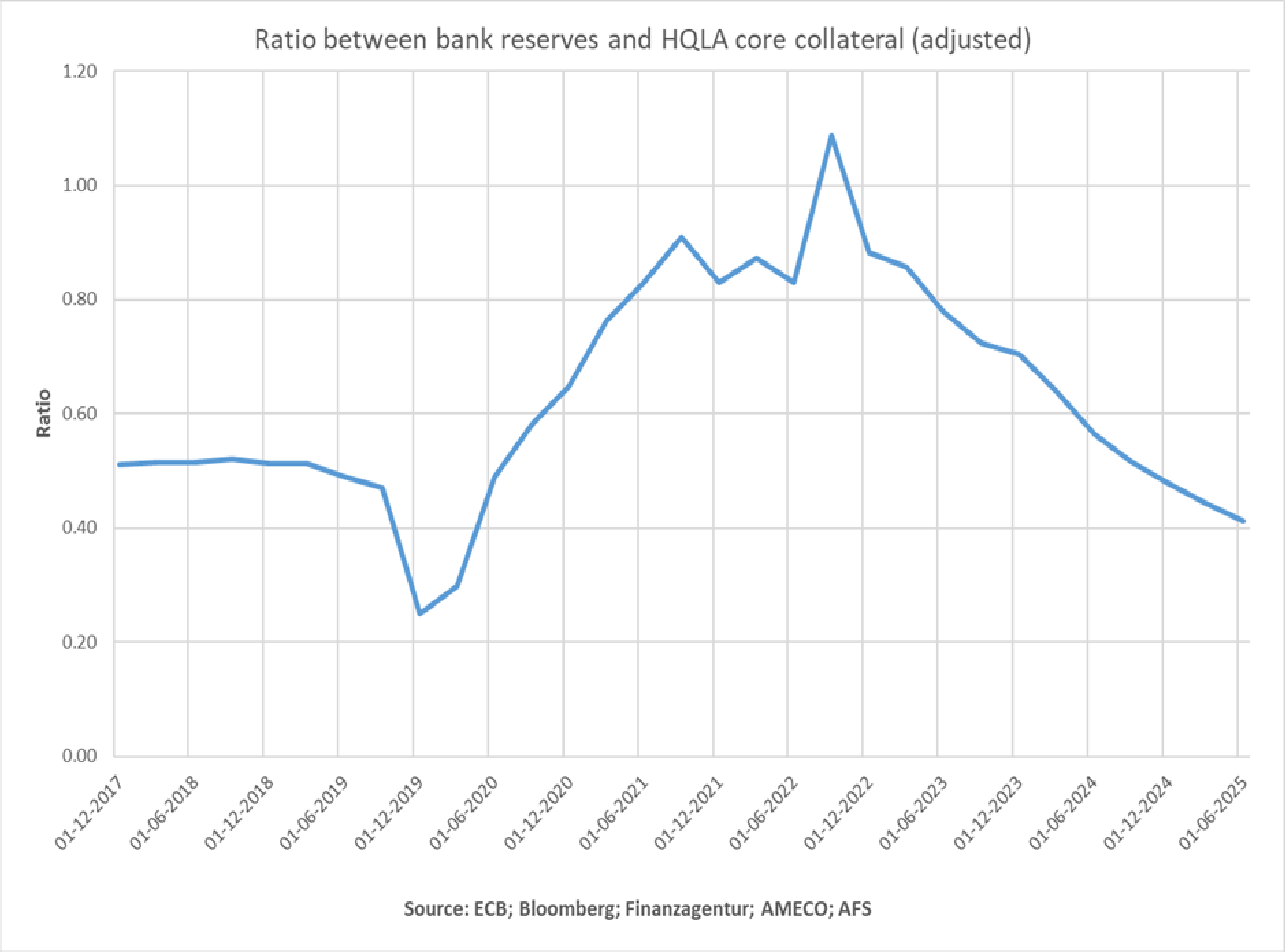


Collateral: the other side of the coin

Eurex ECB HQLA basket replicate = German, French, Dutch central government securities; agencies domiciled in these countries; supras (EU, etc.); Extreme High Quality Covered Bonds

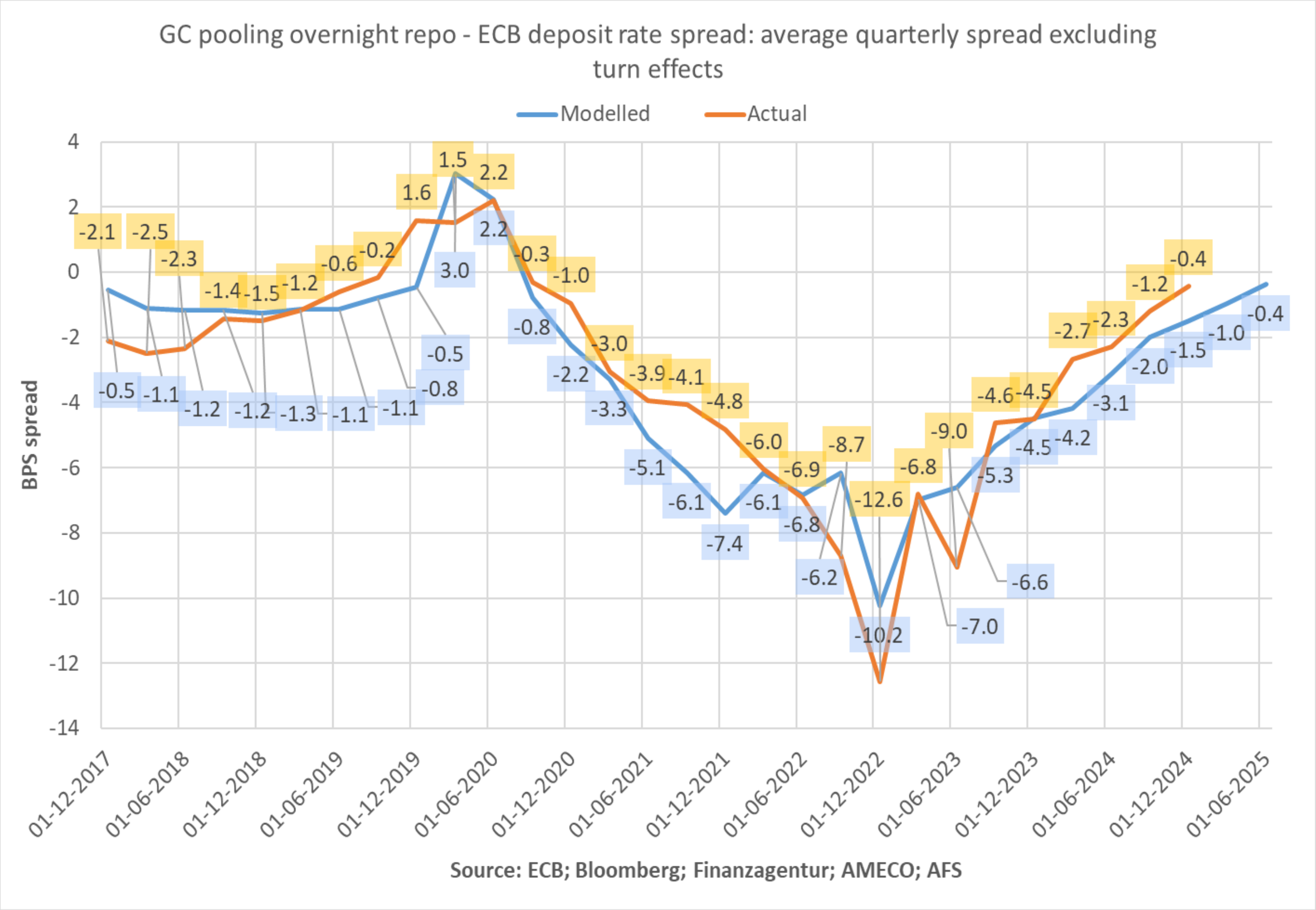


Collateral was king in… 2022

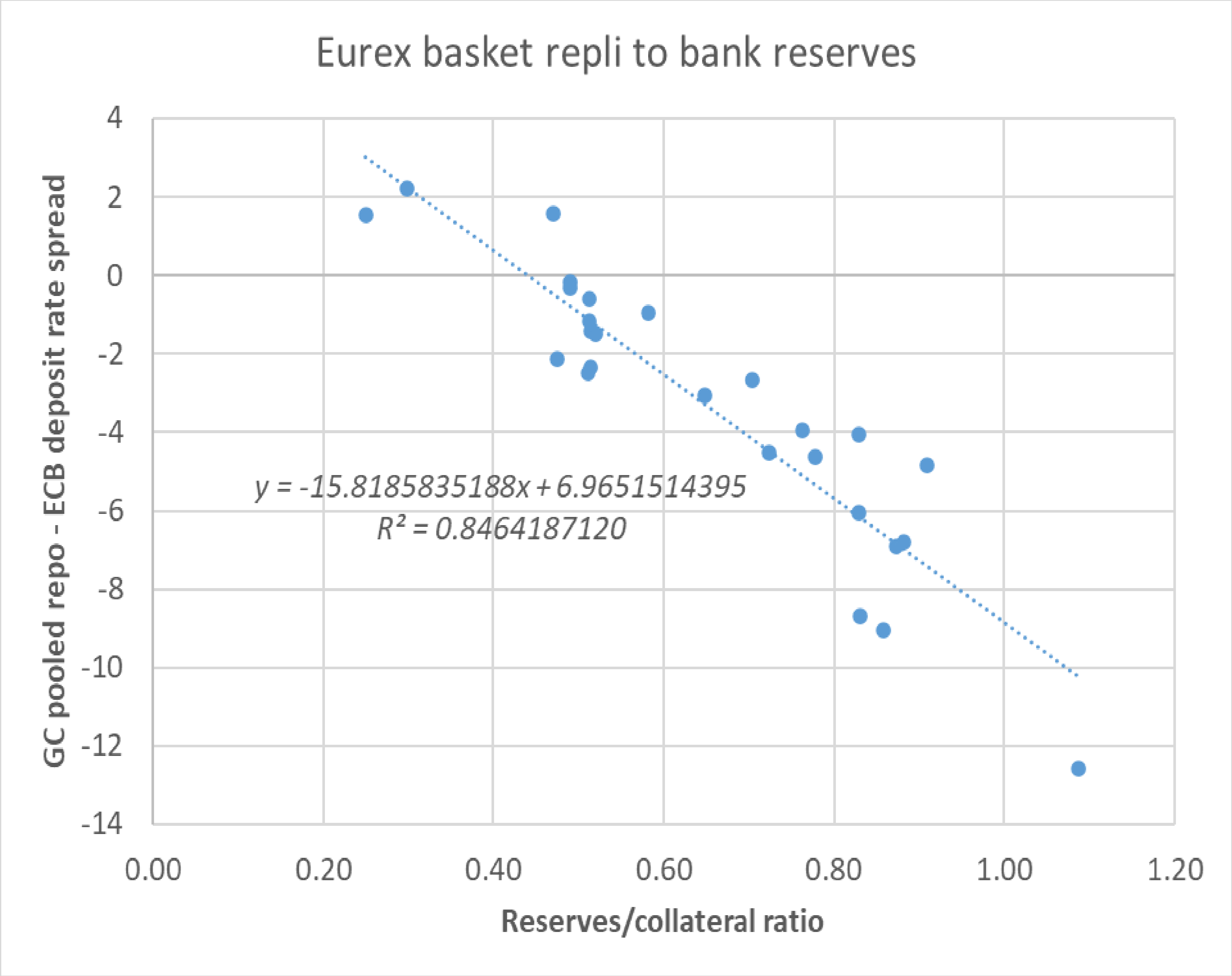


Ratio of bank reserves to core collateral

- GC pooled repo will soon trade at ECB deposit rate flat:



Reserves to collateral ratio versus repo spread



Reserves to collateral ratio versus repo spread

SUMMARY OUTPUT

Regression Statistics	
Multiple R	0.920010169
R Square	0.846418712
Adjusted R Square	0.840019492
Standard Error	1.411888081
Observations	26

ANOVA

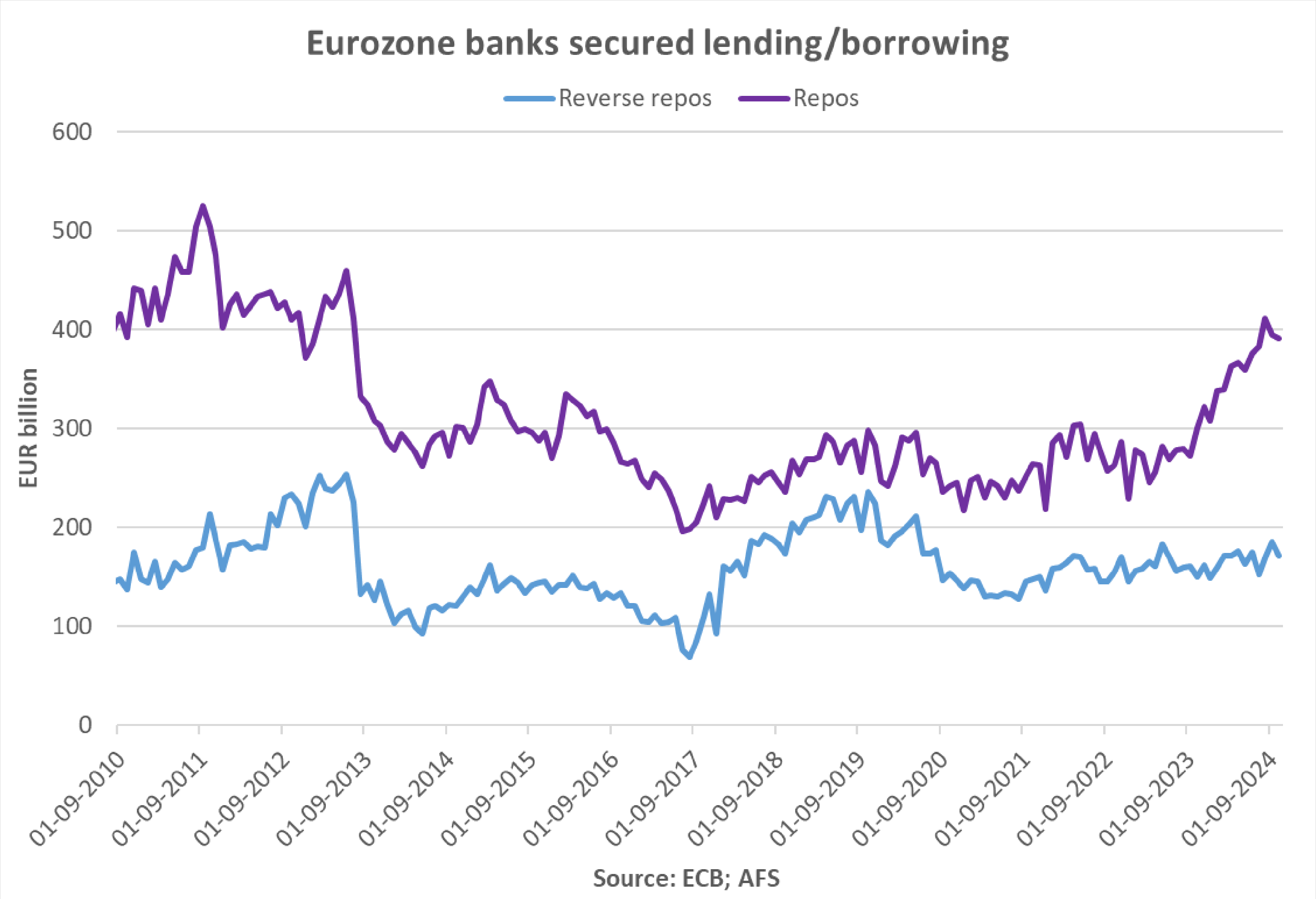
	df	*SS*	*MS*	*F*	*Significance F*
Regression	1	263.668796	263.668796	132.2690371	2.99637E-11
Residual	24	47.8422709	1.993427954		
Total	25	311.5110669			

	Coefficients	*Standard Error*	*t Stat*	*P-value*	*Lower 95%*	*Upper 95%*
Intercept	6.96515144	0.933571157	7.460761176	1.06088E-07	5.038355272	8.891947607
X Variable 1	-15.81858352	1.37543001	-11.50082767	2.99637E-11	-18.65733154	-12.9798355

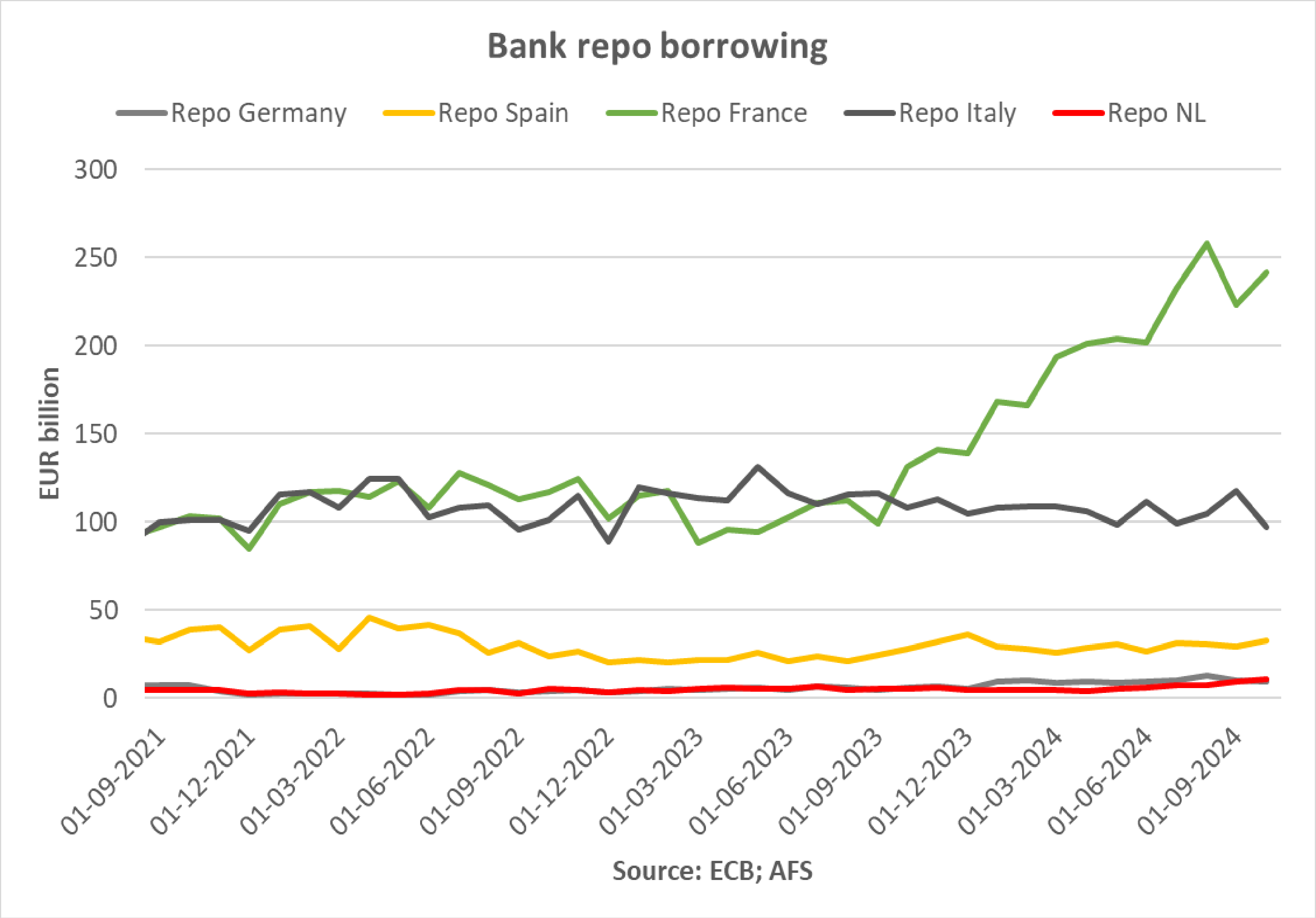
Who is borrowing?

Bank reserves appear to be ample

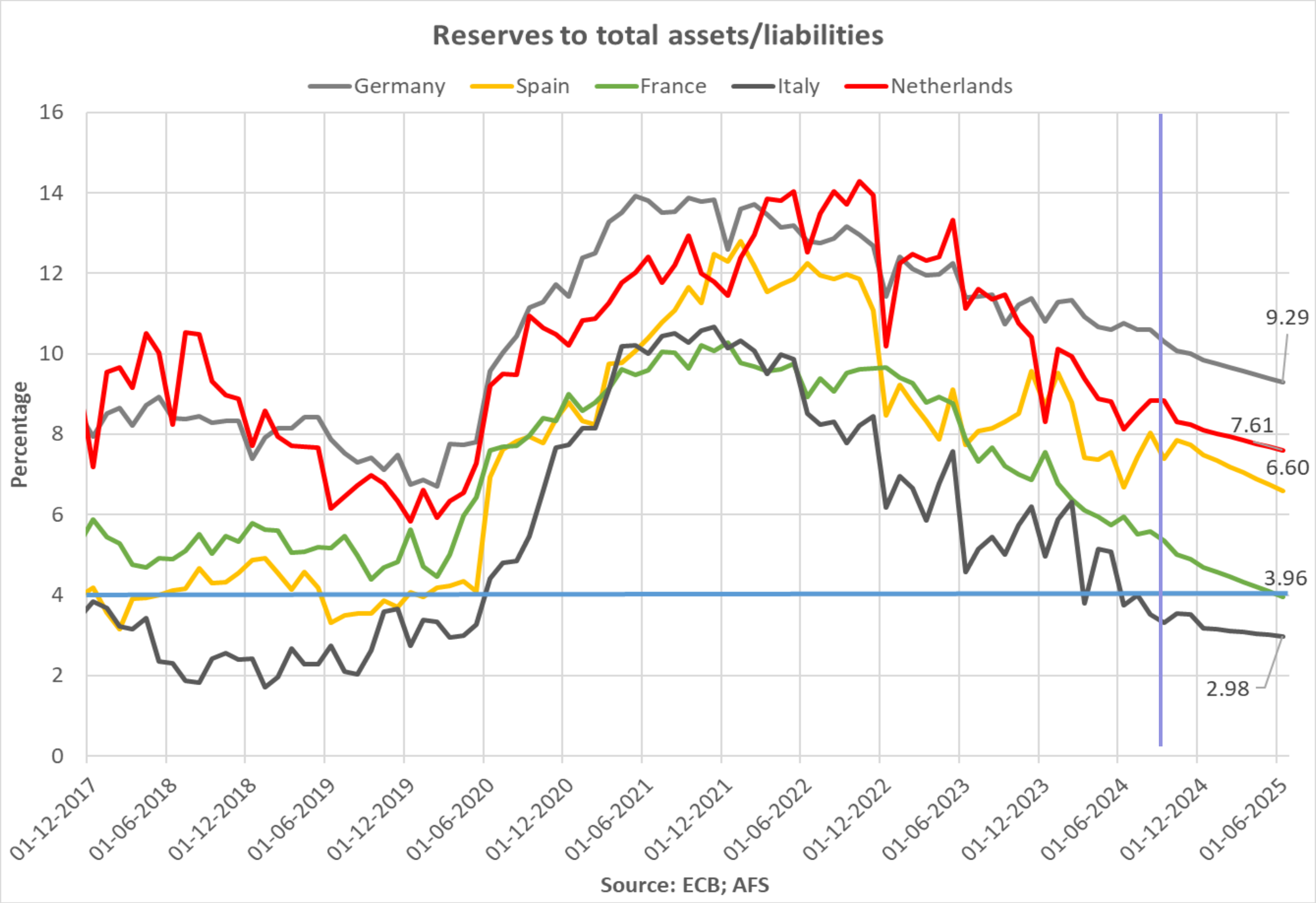
Repo borrowing is rising



Where the pain is felt



Bank reserves: the postal code matters



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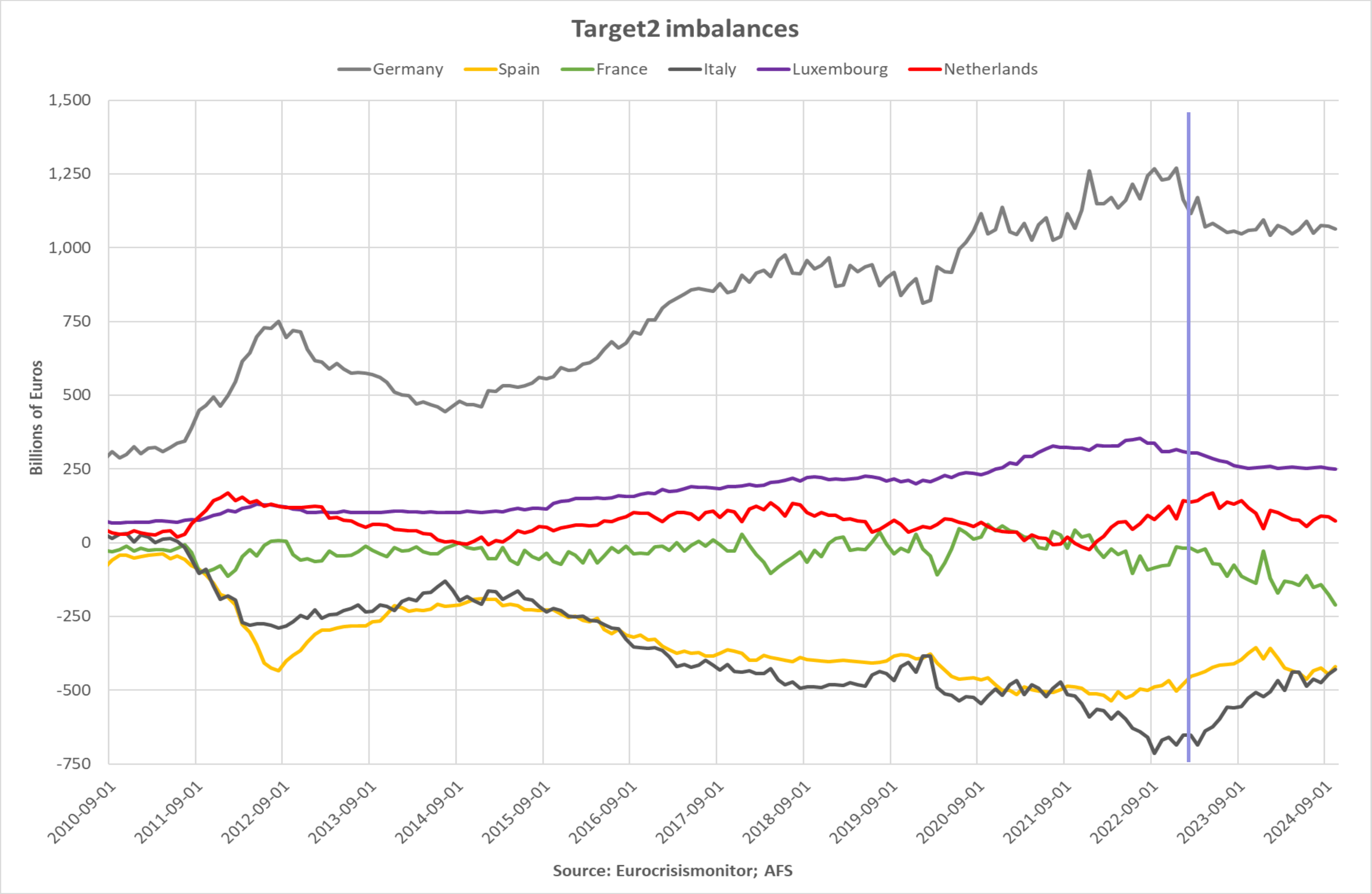
The Great Reserves Migration



Target2 balances and banking system liquidity

- When a member state's Target2 claims fall or liabilities rise, this is matched by a corresponding decrease in bank reserves in that member state;

- Concurringly, when a member state's Target2 claims rise or liabilities fall, this is matched by a corresponding increase in bank reserves in that member state;

- Target2 is a closed system. And the pile of bank reserves is shrinking by the day because of ECB QT;

- We can track Target2 balances and find out which banking system's share in the pile of bank reserves is rising or falling.

Is the sovereign doom loop broken? Not so fast!

- Target2 surpluses and deficits are a function of intra-Eurozone balance of payments surpluses and deficits;
- Balance of payments = current account balance plus financial account balance;
- Example. France has a current account deficit. By definition, it has a financial account surplus. But that surplus falls short of ‘covering’ the current account deficit. Hence Target2 liabilities rise, and bank reserves fall;
- We do not know what causes the rise in Target2 liabilities: current account financing and/or capital flight – I strongly suspect it’s the latter;
- Regardless, banks lose reserves. *Banks are still beholden to their sovereign irrespective of their holdings of their home country’s sovereign debt.*

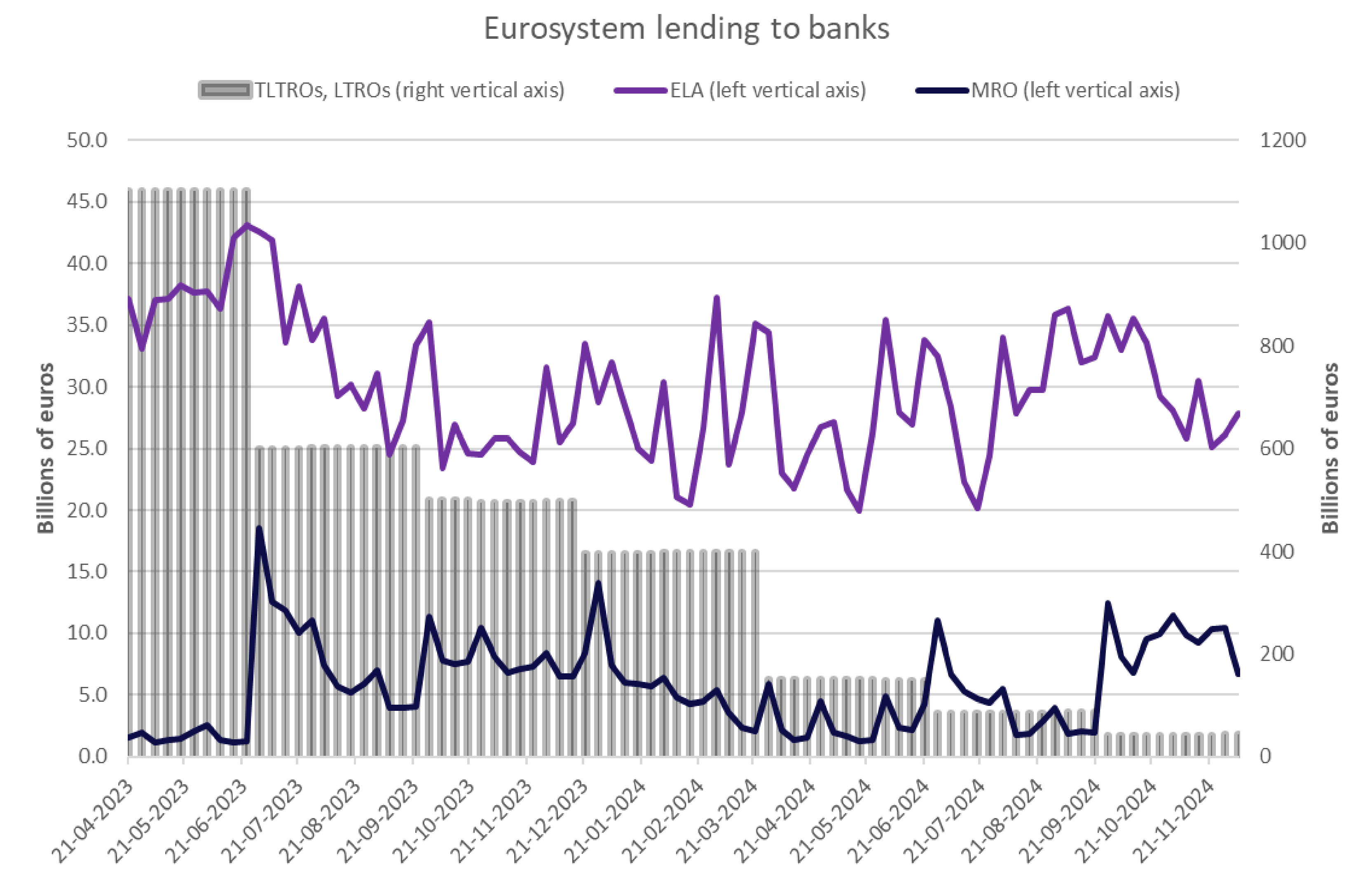
Outright demand for cash (reserves)

- Is there outright demand for reserves from banks? The low level of the ESTR-depo spread, BOR-OIS spreads, and FRA-OIS spreads suggest low outright demand;

- Still, bank repo borrowing is up strongly;

- And there’s more:

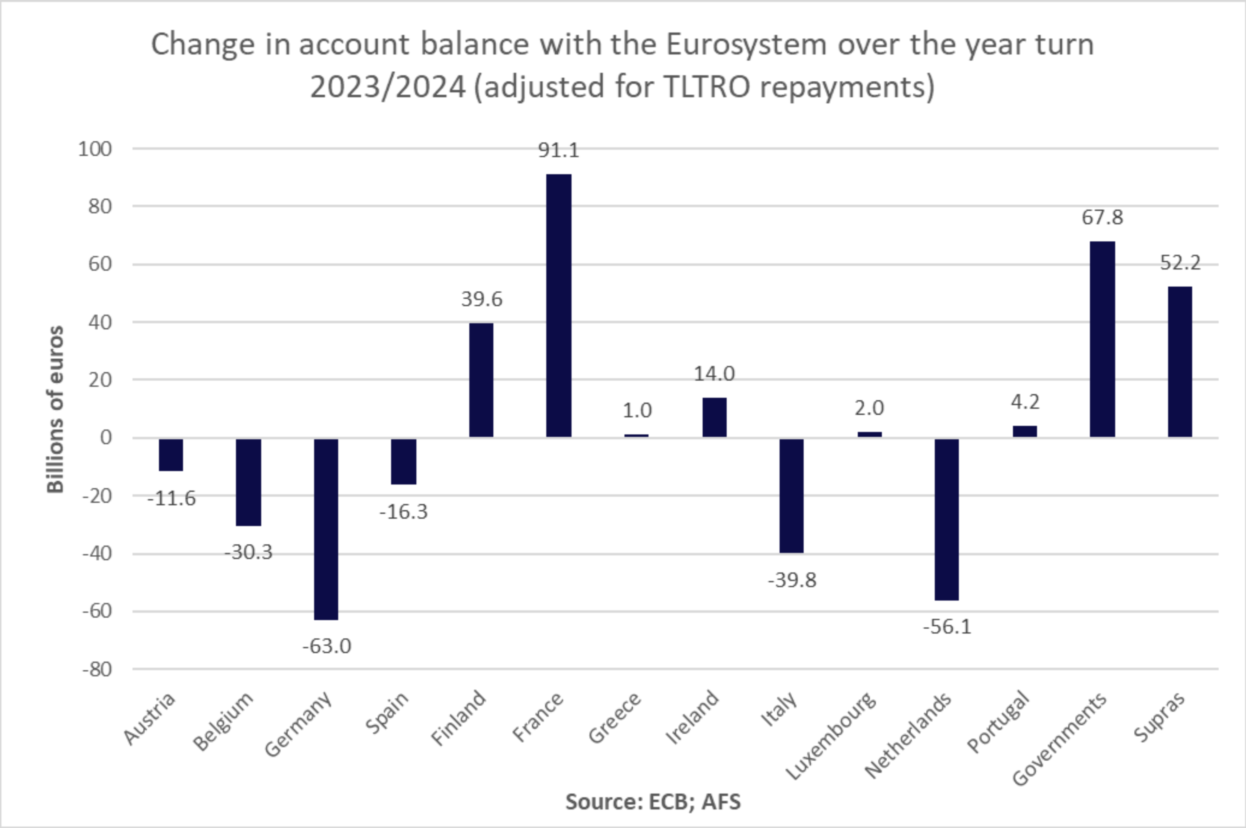
A structural bid for ECB refinancing



Source: ECB; AFS

(window-dressing related) ‘borrowing’ over the turn?

- Traditionally, over the year turn, the banking system in certain member states are either ‘borrowers’ (France), or lenders (Germany, the Netherlands);
- Such ‘borrowing’ and ‘lending’ is reversed in January. Interestingly, changes in reserve balances over the year turn correlate strongly with the level of excess reserves. The lower the level of reserves, the more cross-border ‘borrowing’ and ‘lending’ over the turn. That could indicate outright demand for reserves from a window-dressing perspective.



The pendulum is swinging back

- Before the pandemic, government debt levels were falling, while at the same time the ECB was buying bonds under its various QE programs. With all too familiar consequences for the money market, and secured market in particular. Rates were dragged lower by the scarcity of collateral;
- The explosion in debt in the wake of the pandemic was 'masked' by ECB money printing: the central bank owning an ever-increasing share of the bond market. More importantly: because of QE and TLTROs, the level of bank reserves soared, while for some time collateral become even scarcer, relatively speaking;
- The situation is now the exact opposite. Despite full employment, (government) debt levels are still rising. And the ECB is offloading bonds, destroying bank reserves in the process;
- The pendulum is swinging back. From an oversupply of reserves relative to collateral, to a balanced relationship between collateral and reserves. Collateral will continue to increase, and repo rates will rise further;
- A US 2019-like repo market blow-up will not occur here. In the Eurozone, **repo market risks are 100% political in nature**. In the past: Italy; in the present: France; tomorrow?
- The repo market will remain stable, unless events intrude. The ECB has backstopped the supply of bank reserves with relatively cheap MROs (15bps spread, and lower quality collateral eligible) – *in theory*;
- There could already be stigma involved with borrowing from the Eurosystem. We know the liquidity situation and MRO uptake in individual member states. What if banks avoid MRO/LTRO because rising uptake in that member state begets higher money market rates in that member state?
- **ECB: the aggregate level of reserves is a very misleading metric. If banks refuse MRO/LTRO, QT must end early to safeguard the transmission of monetary policy.**

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