Morning Comment

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AFS Insights

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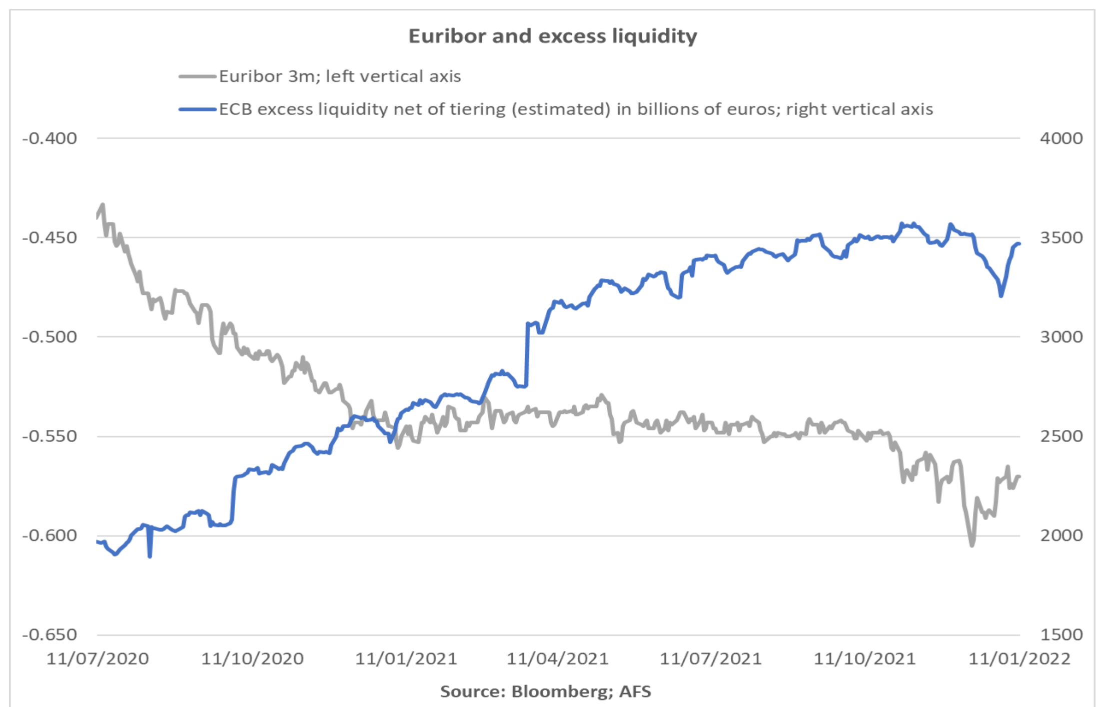
Headline Sweep

- Europe Slowly Starts to Consider Treating Covid Like the Flu
- Powell Assures Americans That Fed Will Tackle High Inflation
- China Inflation Fuels Rate-Cut Calls as World Starts to Tighten
- Cannabis Compounds Prevented Covid Infection in Laboratory Study

With less excess liquidity you get lower rates[1]

- **In today's Comment we will discuss the seemingly perplexing decline in excess liquidity in the Eurozone banking system since the summer, which paradoxically coincided with lower settlements of 3-months Euribor even after the year-turn**. The chart below tells all: excess liquidity levels in the Eurozone banking system are still slightly lower than they were in the summer, despite Lagarde & Co running the printing press without interruption. And while Euribor showed an extraordinary decline into the year-turn, subsequent settlements are lower than they were before the turn effect came into play in the fourth quarter of 2021:

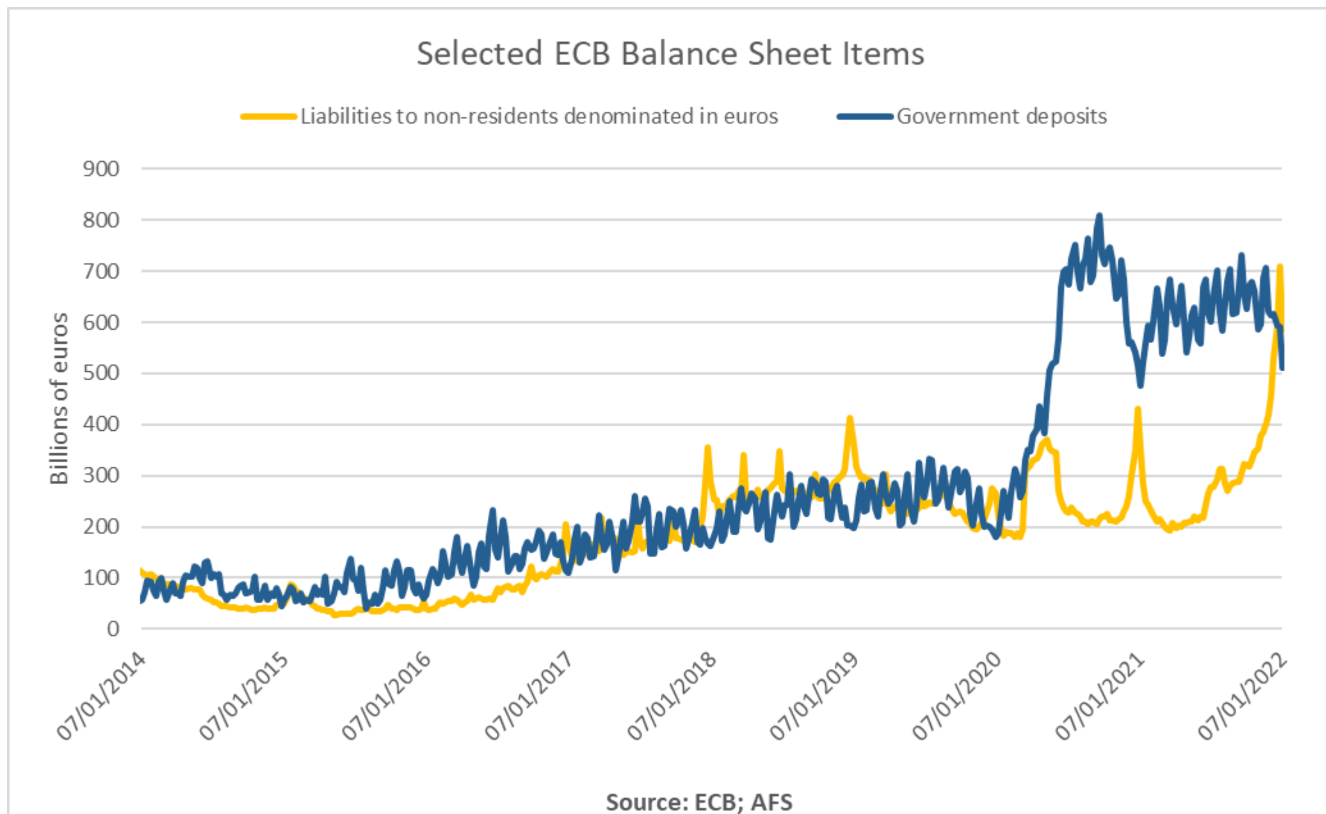


[1] For the connoisseurs: a pun on former President Draghi's quote "with low inflation you can buy more stuff".

- **On the surface, market conditions do not appear to be favorable for Euribor lower settlements.** To name just a few besides the somewhat lower level of excess liquidity: expectations of TLTRO repayments and tiering facility increases come June; and wild swings in Euribor future pricings in the second half of 2021 on hawkish ECB bets (or fears). And granted, we may be splitting hairs here: what's a few basis points in Euribor, a make-believe interest rate which doesn't have much in the way of actual transactions backing it if the EMMI transparency reports are to be believed.
- **Below we shine our light on both mysteries: the decline excess liquidity net of tiering and the lower Euribor settlements.** Starting with the former, the ECB continues to buy bonds at a brisk pace. Shouldn't that boost excess liquidity one-on-one for every euro the ECB creates to buy bonds? No, because of a thing called 'autonomous factors' in central banker jargon. Without going into too much detail, autonomous factors are best understood as stuff that drains liquidity from the banking system *which isn't the direct result of ECB monetary policy*.[2] There are two straightforward autonomous factors that are easy to understand: banknotes in circulation and government accounts at the ECB (Eurosystem, actually, or the ECB plus the central banks of the Eurozone member states).
- **When the public withdraws banknotes from the banking system, the banks have to get those banknotes from somewhere when their vault cash runs out.** That somewhere is the ECB. When banks request banknotes from the ECB, the ECB simply debits banks' accounts before shipping the banknotes in armored vans to the bank vaults. Hence, liquidity in the banking system falls when the public withdraws banknotes from the banking system. Now, despite reports of the demise of paper money, paper money remains very popular. So popular in fact, that if we would chart the total notional amount of banknotes in circulation, we get an almost perfect upward sloping straight-line chart with little or no volatility. Thus, when analyzing money market conditions, we can safely ignore banknotes under the current circumstances.
- **Next up are government accounts.** Governments, like the banks, 'bank' with the ECB. That is, they have their payment account at one of the national central banks of the Eurosystem. Thus, when a bank or nonbank private sector entity makes a payment to a government (for example, to pay tax or to buy a government debt security), this *always* entails liquidity moving from the banking system to a government account. Since the ECB has no control (yet) over taxation and government debt security issuance, government deposits are still very much an autonomous factor that is outside of the direct control of the ECB.
- **Government treasuries have developed a penchant for maintaining excessively high balances at the Eurosystem ever since the launch of QE in March 2015.** QE resulted in high levels of excess liquidity in the banking system, pushing a plethora of money market rates below the ECB's negative deposit rate. Unsurprisingly, government bill yields also turned negative, falling below the ECB deposit rate. And since the remuneration for most government balances at the Eurosystem was EONIA most of the time, governments were effectively subsidized to borrow short term and hold liquidity with the Eurosystem.

[2] Conversely, the ECB directly boosts or drains liquidity in the banking system with its open market operations. Bond purchases and lending to banks adds liquidity. Selling bonds or not reinvesting the proceeds of maturing bonds and calling in loans to banks drain liquidity from the banking system.

- **The chart below shows the level of government deposits at the Eurosystem. The data is taken from the ECB's weekly financial statement**. Please ignore for now the yellow line (liabilities to non-residents in euros):



- **In the age of Draghi era QE from 2015 to 2019, the average level of government deposits in any given week tripled to 300 billion euros**. Since the pandemic outbreak two years ago, the level of government deposits surged even further. Thus, at least as far as short term borrowings are concerned, for many government treasuries it literally pays to borrow as the remuneration of the their balances was EONIA plus or minus a few basis points most of the time.
- **With the permanent cessation of EONIA on January 3, the bulk of government balances is now renumerated at ESTR.**[3] Which begs the question: with less favorable treatment of government balances, can we already detect a change in governments' liquidity behavior?
- **According to the ECB financial statement for the week ending Friday January 7, governments appear to be less willing to hold liquidity balances with the Eurosystem.** In the first week of January, government deposits fell to 510 billion from close to 600 billion euros in the final week of 2021. That was the largest weekly decline in government balances for the first week of January ever recorded by a large margin. However, it's too soon to say if government treasuries are changing their behavior. Look closely at the chart and notice a sharp decline in balances over the first weeks of January 2021. A similar scenario might be playing out in the present. Furthermore, this year we have noticed that many government

[3] The exact implementation of the ECB guideline on the renumeration of government balances at the Eurosystem is secret. However, in all likelihood the interest rate that applies to the overwhelming bulk of government balances is ESTR: https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32019O0007&rid=10

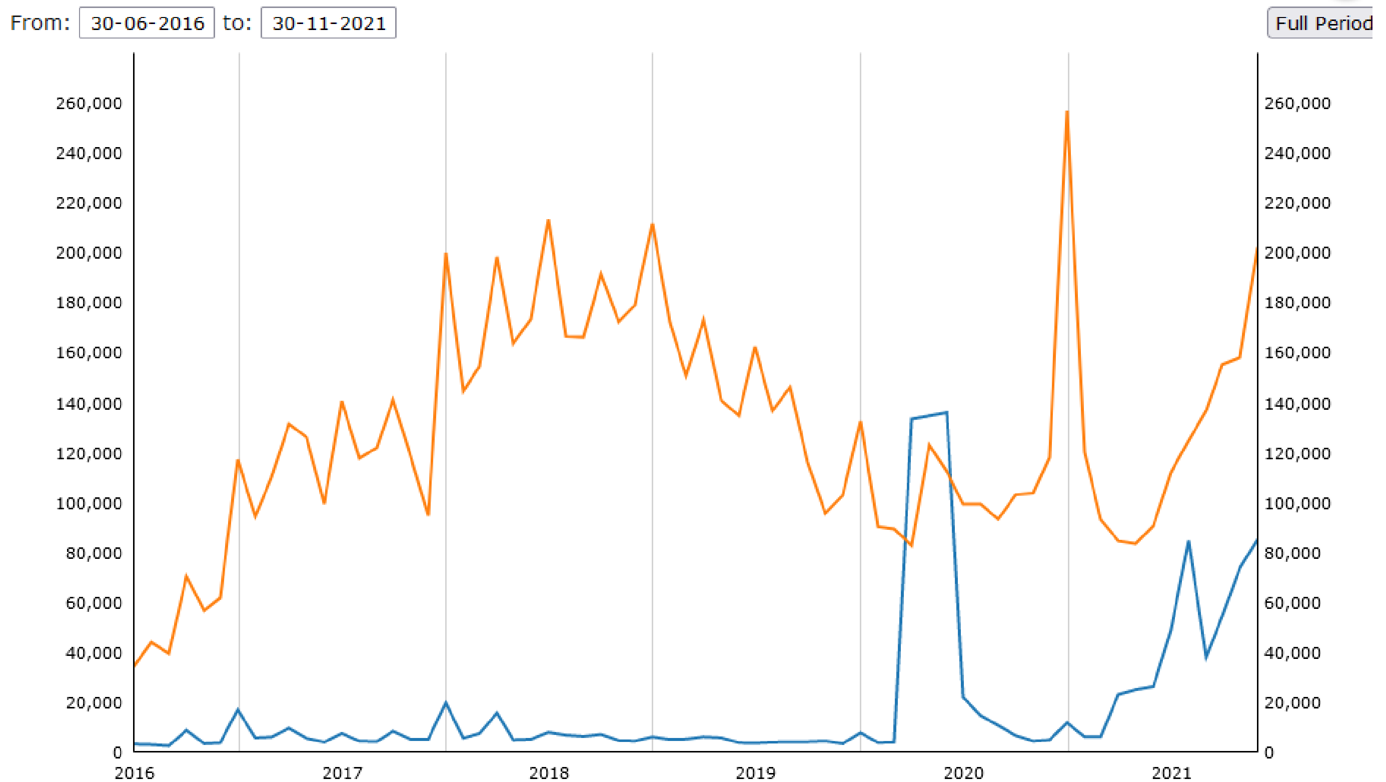
borrowers have been able to (mostly) offset the switch from EONIA to ESTR, forcing their lenders to pay even more negative rates. The pricing power of governments speaks volumes about the extreme easiness of money market conditions these days.

- **Which brings us to the mystery of flatlining excess liquidity levels in the past five months.** A mystery indeed as the ECB's bond holdings increased by a cool 400 billion euros since the summer peak in excess liquidity. If we adjust for the increase in banknotes in circulation and government deposits, excess liquidity net of tiering should have increased by more than 250 billion euros to 3,750 billion euros. [4] At the last count, excess liquidity net of tiering was *only* 3,450 billion euros.
- **Which begs the question: what is driving the sterilization of ECB QE since the usual suspects clearly aren't the culprit?** To find the answer to that question, we have to take a proverbial deep dive into the ECB's weekly financial statement. It turns out so-called *other* autonomous factors have drained liquidity. The chief culprit is the yellow line in the chart on the prior page: liabilities to non Euro Area residents denominated in euros. That is jargon for foreign central banks' and supranational organizations' holdings of euros with the Eurosystem.[5]
- **Our first thought when confronted with the extraordinary increase in non-resident holdings of euros was the EU recovery fund.** Since the EU is a *European* supranational organization, the ECB treats it as a non-resident for statistical and payment purposes. European supranational organizations like the EU (but also the ESM and EFSF bailout funds) have their payment account with the ECB, not one of the national central banks.
- **The EU has gone on a borrowing spree as part of its 800 billion euros recovery fund.** Borrowings from markets and disbursements of the proceeds to the member states started last summer. We can track the EU's balances at the ECB with some delay as the ECB also publishes disaggregated balance sheets of itself and the national central banks of the Eurosystem on a monthly basis and with some delay.
- **The chart below shows euro liabilities of the ECB itself and the Bundesbank to supranational organizations and foreign central banks.** Or in layman's terms: the euro accounts of supranational organizations and foreign central bank at the ECB and Bundesbank:[6]

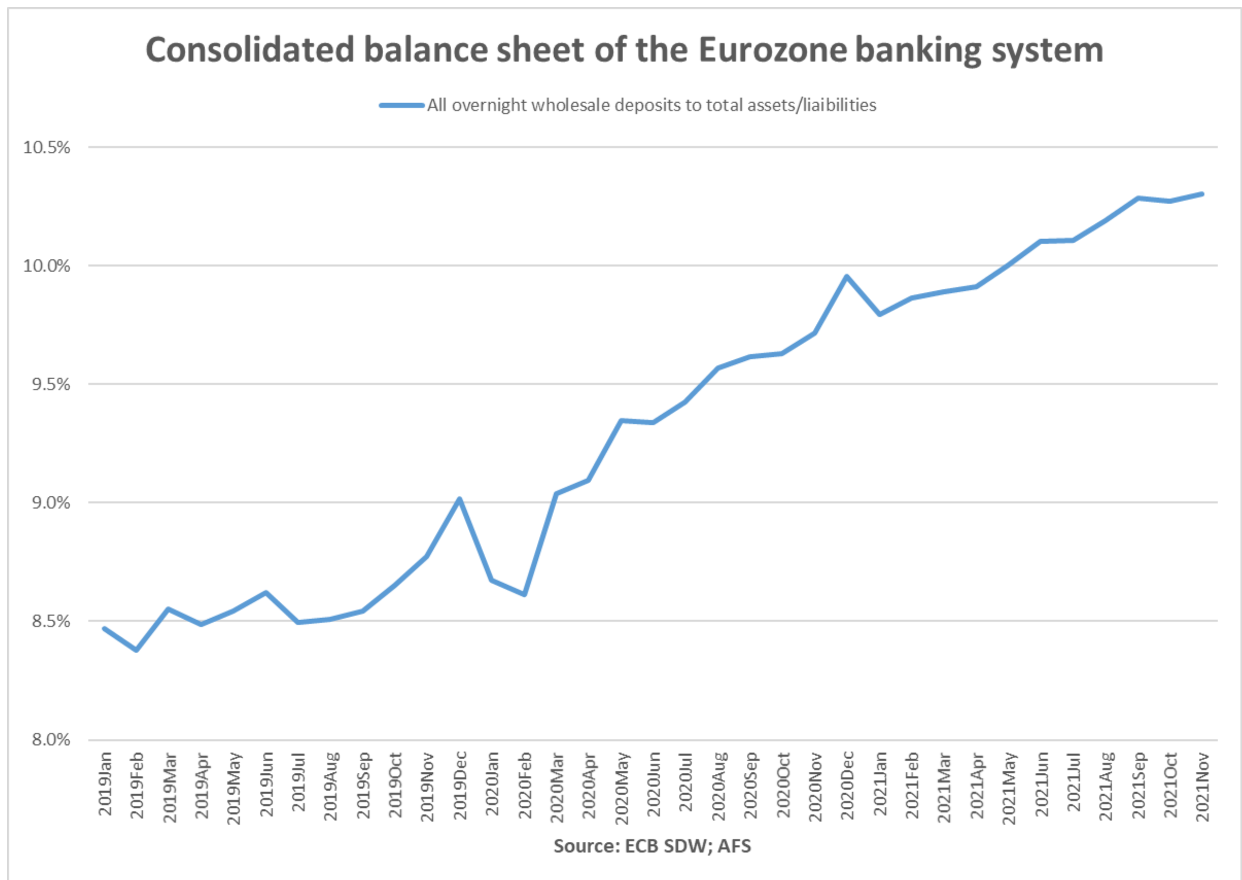
[4] Note that effect of reserve requirements and TLTROs on excess liquidity since the summer has been next to zero.

[5] The ECB also reports claims on non-Euro Area residents denominated in euros. The amount reported under this line is next to zero as foreign central banks have tapped the ECB's euro swap lines for negligible amounts.

[6] Foreign accounts at the other national central banks of the Eurosystem have negligible balances.



- **Unfortunately, the data is through November while these balances exploded higher in December**. Furthermore, since neither the ECB nor the Bundesbank give any detailed information on these liabilities, we're left guessing as to what's going on here. The spikes in the ECB liabilities are probably the result of EU borrowings related to the pandemic in 2020 and the recovery fund in 2021. Note that ESM/EFSF balances are very low and play only a marginal role at best.
- **Going forward, there seems to be seasonality at play in the Bundesbank liabilities.** But while the Bundesbank liabilities are likely to fall by sizeable amounts at the start of the year, the declines do not necessarily have to translate to increases in excess liquidity in the banking system. What is very likely though, is that the EU will continue to hold sizeable balances with the ECB. That's not just because the EU will be borrowing large mounts for the recovery fund and making piecemeal transfer payments to member states every now and then. Like the archetypical Eurocrat in Brexit lore, being the EU has its perks. Namely: its balances at the central bank are renumerated at zero when the ECB deposit rate is negative. *Eurocrats really do take care of each other.*
- **Having discussed the intricacies of the ECB/Eurosystem balance sheet first, we still have to explain the decline in Euribor settlements**. If we stick with a Eurozone-centric explanation, our answer is this. On the one hand, banks could be taking a cue from government treasuries being able to (mostly) offset the switch to ESTR from EONIA. Another piece of the puzzle is to be found on banks' balance sheets. Euribor is a wholesale borrowing rate these days, not an interbank rate. And because of the turbo-charged post-outbreak growth in the money supply, banks are literally awash with deposits: both retail and wholesale. The chart below shows overnight wholesale deposits as a percentage of total assets/liabilities:

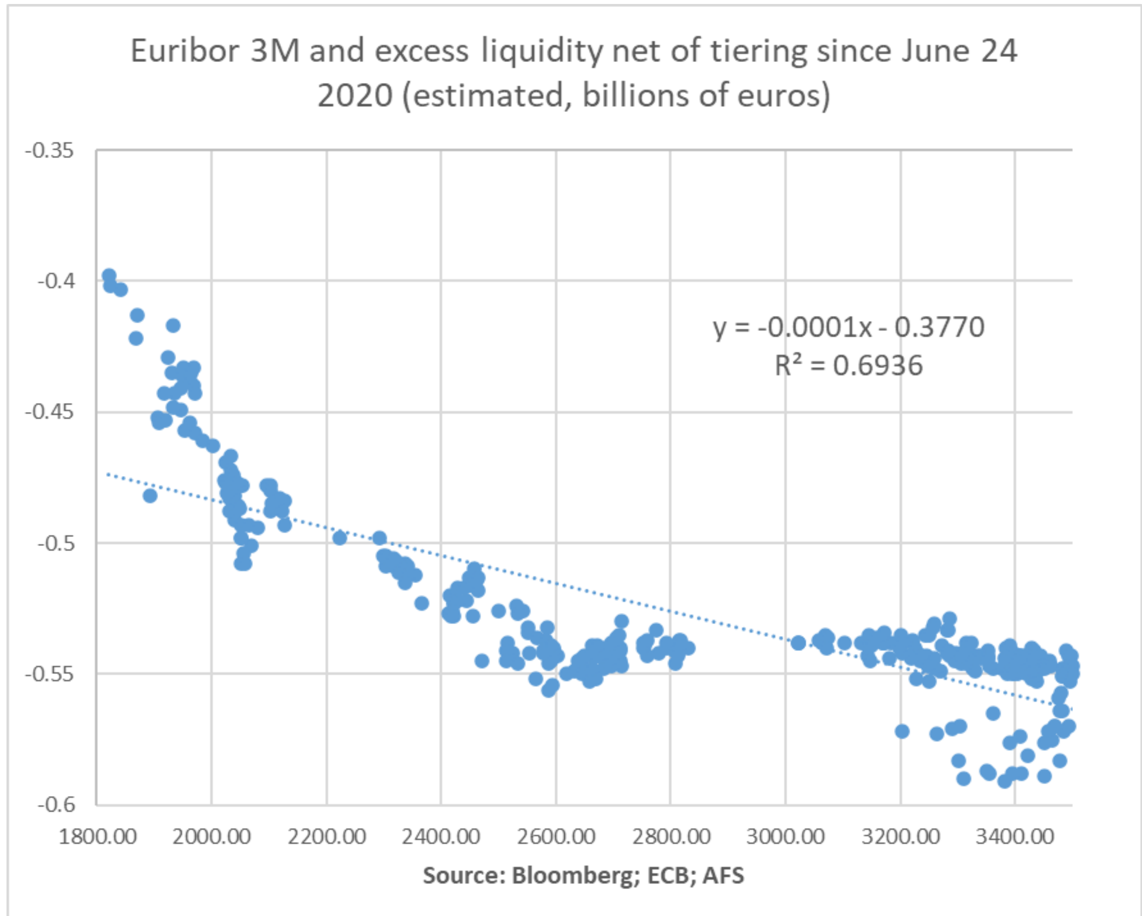


Notice the relentless growth in wholesale deposits. Note that the pattern is the same for both overnight retail deposits and when we include repos in overnight wholesale deposits. Banks literally have deposits coming out of their ears. That, together without extraordinarily high levels of excess liquidity has resulted in excessively high regulatory Liquidity Coverage Ratios.

- **While banks charge rates below the ECB deposit rate to wholesale depositors most of the time, this is no free lunch for the banking system**. Loan-to-deposit ratios are at all-time lows (bad for profitability) while leverage ratios are restricting balance sheet growth. Put differently: banks have too many unprofitable or loss-making assets and are 'sharing that burden' with their depositors, principally their wholesale depositors.
- **While excess liquidity will surely fall this year, we strongly question if it will move Euribor relative to ECB interest rates unless it involves sizeable TLTRO repayments or the ECB going literally overboard with increasing the tiering multiplier**. Euribor doesn't just reflect liquidity conditions in the banking system, it also reflects the extraordinary high level deposits on banks' balance sheets, deposits that are often unwanted. Since those deposits won't vanish unless the private sector starts to deleverage and pay off debt, it turns into a question to what extent the ECB is willing to shrink its balance sheet and bring down excess liquidity with it.
- **If we read between the lines of the ECB's top two policymakers – President Lagarde and chief economist Lane – we notice a distinct lack of eagerness to tighten policy via the balance sheet.** It's the same story with the Federal Reserve. In his testimony before Congress yesterday afternoon, Chair Powell said he was in no rush to shrink the balance sheet with quantitative tightening. The regional Fed

Presidents that went on the wires in the past several days on the other hand were all very hawkish, signaling that they want to move to Quantitative Tightening ASAP.

- **Based on the historical relationship between excess liquidity and the settlement of 3-month Euribor, 3-month Euribor should start to rise when excess liquidity falls below 2,500 billion euros:**



We suspect Euribor may only move up at much lower levels of excess liquidity, in particular when excess liquidity is removed via tiering instead of TLTRO repayments.

Calendar

TIME	REGION	EVENT	PERIOD	CONSENSUS	PRIOR
10:15	Denmark	Sells 46-Day; 138-Day; 230-Day Bills			
11:00	Eurozone	Industrial Production SA MoM	Nov	0.20%	1.10%
11:00	Eurozone	Industrial Production WDA YoY	Nov	1.40%	3.30%
11:00	Italy	Sells EU6.5 Billion of 364-day Bills			
11:30	Germany	Germany Sells EUR 1.5 Bln of 2052 Bonds (DE0001102572)			
12:00	Portugal	CPI EU Harmonized MoM	Dec F	--	0.00%
12:00	Portugal	CPI EU Harmonized YoY	Dec F	--	2.80%
14:30	US	CPI MoM	Dec	0.40%	0.80%
14:30	US	CPI Ex Food and Energy MoM	Dec	0.50%	0.50%
14:30	US	CPI YoY	Dec	7.00%	6.80%
14:30	US	CPI Ex Food and Energy YoY	Dec	5.40%	4.90%
15:15		BOE's Cunliffe speaks at crypto finance conference			
19:00	US	Sells USD36 Bln 10-Year Notes Reopening			
19:00		Fed's Kashkari discusses economic outlook			
20:00	US	Monthly Budget Statement	Dec	-$2.5b	-$191.3b
20:00		Federal Reserve Releases Beige Book			
		BOJ Governor Kuroda Speech at Branch Managers Meeting			

Consensus data: Bloomberg News; All Times Are in Central European Time

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