Article | 6 September 2022

Rates: Government cash management set to worsen the euro collateral shortage

Eurozone government deposits at the central bank are subject to a 0% rate cap. This means hundreds of billions of euros could be shifted around. In some cases, this will reduce repo lending or boost demand for safe bonds, all exacerbating the existing collateral shortage

Source: Shutterstock

The return to positive policy rates will change the incentives for public sector actors in markets

> *Germany's and Austria's debt agencies no longer want to lend securities against cash*

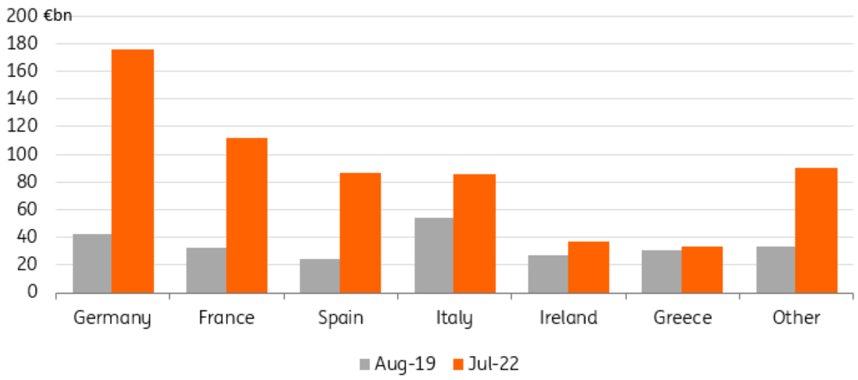
Exiting negative and eventually zero interest rate policies does not simply mean higher rates, but it also means some of the incentives that have dictated the basic market structure and functioning we have become accustomed to over the years of extraordinary policies will change as well. One such change has been highlighted by reports that Germany's and Austria's debt agencies are planning to change their repo rules. They no longer want to lend out their securities against cash, but only against other collateral.

Why now? And what are the amounts involved?

Government cash deposits held at central banks are remunerated at the ECB's deposit facility rate, but importantly that remuneration is capped at zero. Given the vast amounts of excess liquidity in the banking system, short term market rates have traded noticeably below the deposit facility rate. With the deposit facility rate below or at zero the incentive for governments to park cash outside of the central bank were low.

But the ECB is now expected to hike the deposit facility rate at a fast pace to well above zero, possibly by 75bp already this week – and the gap to the remuneration capped at 0% will widen quickly. For the abovementioned repos that means that the economics of government debt agency lending out a security against cash and redepositing at the ECB will change dramatically.

Ballooning government central bank deposits are a problem as their remuneration is capped at 0%



Source: Refinitiv, ING

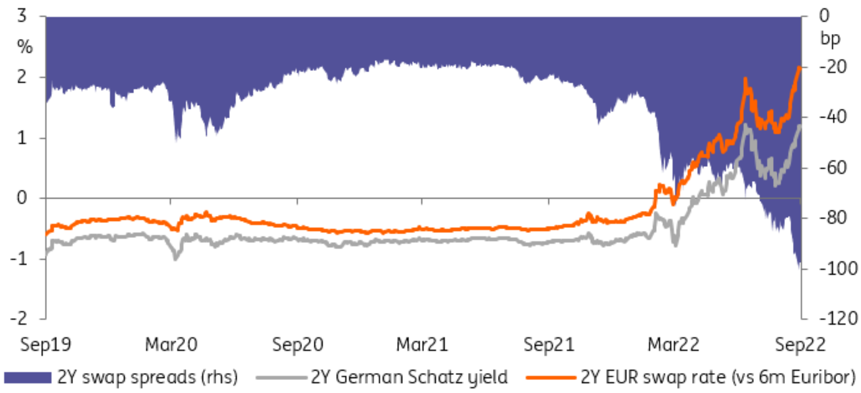
Eurozone government deposits at their respective central banks amount to around €600bn currently, fluctuating between €600 to 700bn over the past year. Pre-pandemic they were in the region of €200 to 300bn, already up from around €50 to 150bn before negative interest rates (and then QE) were introduced. But it was the pandemic that has led governments to build up vast cash buffers. Remuneration at the negative depo rate did not matter, it was actually better than market rates.

Germany's government deposits at the Bundesbank amount to currently €176bn, €120bn of which from the central government. Those of Austria at the Oesterreichische Nationalbank amount to €17bn. Certainly not all of that cash originates from the debt agencies' repo operations for which the rules are now tweaked. The operations affected are those that the agencies conduct to support market functioning and market liquidity.

Collateral scarcity is set to worsen

It all boils down to the one burning issue, the scarcity of high quality collateral. The incentives for the German debt agency to reduce its cash holdings at the central bank are clear. The options are to either seek alternative short term investments, or – in this special case the simpler solution – to tweak the rules to avoid generating the cash in the first place. Crucially, allowing market participants to effectively only swap securities does not add to the overall availability of government bonds as lending against cash does. While it may still ease price distortions for individual securities, the overall high price for already scarce collateral is unaddressed. As an aside, the ECB's own securities lending against cash (capped at 150bn) has gained importance since late last year, tripling in volume to now account for half of the ECB's overall securities lending.

Worsening collateral scarcity is already visible in widening 2Y German swap spreads



Source: Refinitiv, ING

There should be an incentive to reduce the cash holdings at the central bank

Looking beyond the case where just repo rules are tweaked, there should be an incentive to reduce the cash holdings at the central bank, thus limiting those holdings to the need for safety liquidity buffers. Some countries already have institutional arrangements in place to transfer the cash back to the banking system, via daily repos or the collection of non-collateralised deposits. Those arrangements were more likely meant to smoothen the volatility of the accounts to facilitate the ECB's liquidity management rather than to structurally reduce the vast amounts that have now accumulated. Cash could of course also be invested in high quality liquid assets - think government bills or similar assets. Alternatively, debt agencies could run down cash buffers, simply by issuing less government paper. All of this to the same effect that the market's collateral availability for is further reduced. This is already visible in the stretched bond valuations (2Y German Schatz in the chart above) relative to swaps.

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