EUROPEAN CENTRAL BANK

EUROSYSTEM

Quantitative Tightening and Financial Stability

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Three questions and three "Is" of market functioning in the context of QT

How do DMOs cope with central banks' withdrawal?

Do banks provide the liquidity the market needs?

Who buys bonds now?

Issuers

- Euro area debt management offices (DMOs) displayed **adaptive behaviour**
  - Reconfiguration of **maturity structure** of new issuance
  - Active **targeting of retail investors** with dedicated products

Intermediaries

- Euro area banks' **balance sheet utilisation** does not appear to be stretched
- No signs of impairment in liquidity provision, with bond market **liquidity better than predicted by volatility**

Investors

- Portfolio rebalancing has been unfolding smoothly, with a noticeable **return of foreign investors** to euro area bond markets
- **Bond absorption by households** has played a crucial role in some euro area jurisdictions

QT communication strategy was similar across central banks, but operations differ

Commonalities

- Gradualism
- Predictability
- Ex-ante communication

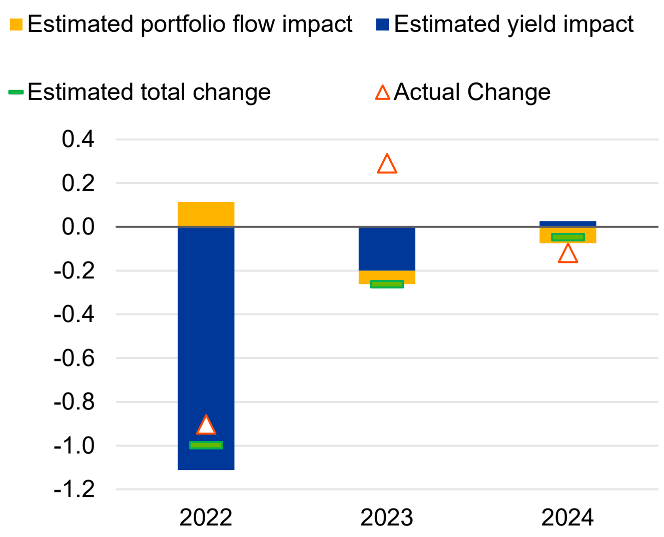
Differences

- Passive vs active implementation
- Credit operations / demand-driven balance sheet reduction
- Different monetary policy portfolios

DMOs' adaptive behaviour helps sustain strong bond demand

Change of weighted average maturity of new bond issuance in the largest EA government bond markets

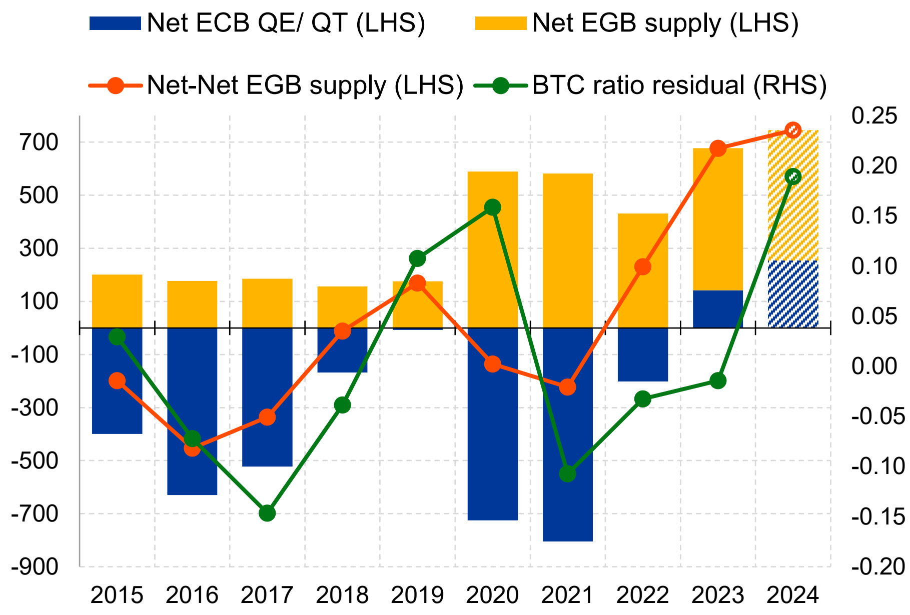
(years)



Source National Debt Management Offices, ECB calculations.
Notes: Includes DE, FR, IT and ES. See Plessen-Mátyás et al, Funding Behaviour of Debt Management Offices and the ECB's Public Sector Purchase Programme (2022). 2024 actual change is adjusted for seasonal effects.
Last observation: 30 April 2024.

Net supply and purchases of government bonds in the euro area

(EUR bn)

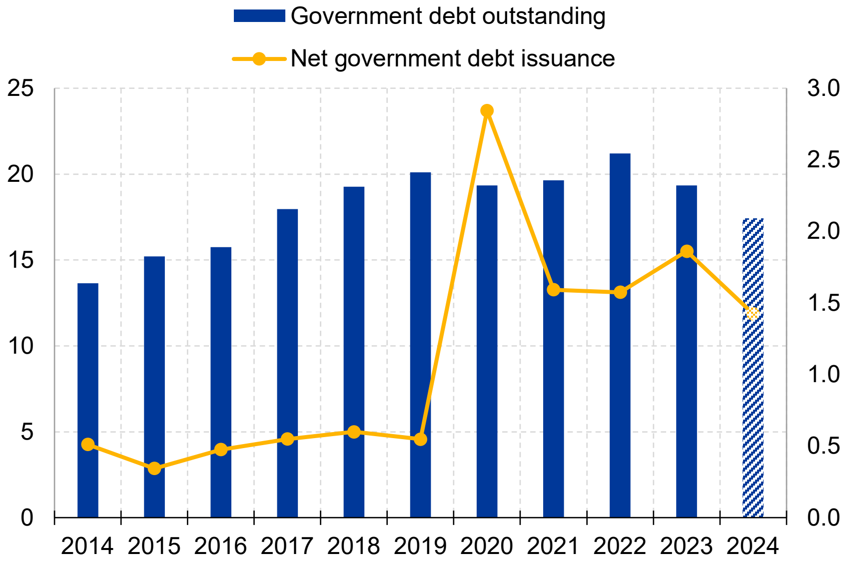


Sources: National Debt Management Offices, ECB calculations.
Note: The bid-to-cover (BTC) ratio residuals correspond to the residuals obtained from a regression of the BTC ratio of each central government bond auctions in Germany, France, Italy, Spain and EU-supranational bond auctions on the maturity of the issue. Syndications and bills are excluded.
Last observation: June 2024.

Dealers' intermediation capacity supports smooth liquidity conditions in bond markets

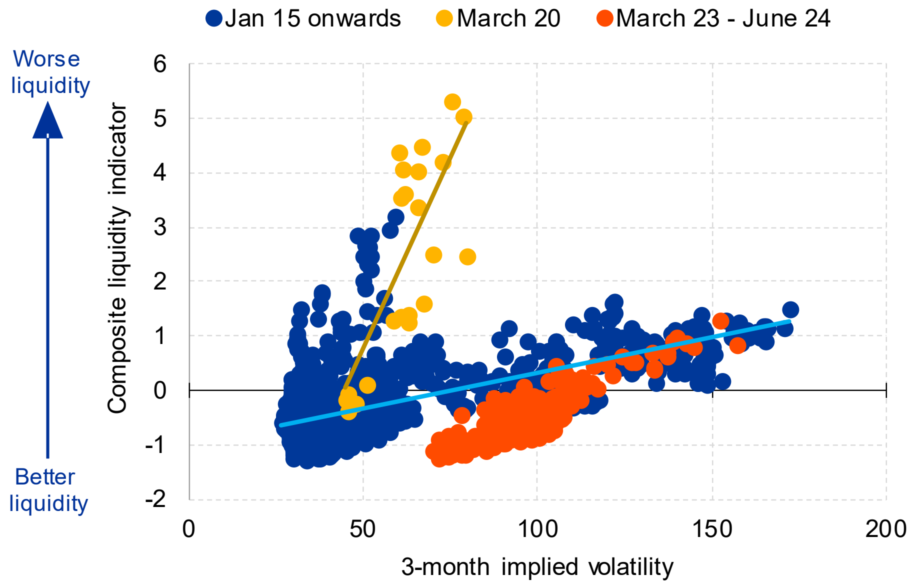
Government debt outstanding and net issuance over primary dealers' securities portfolio

(ratio)



Source: CSEC, IBSI, National Debt Management Offices, ECB calculations.
Note: Nominal value outstanding of government debt issued by DE, FR, IT, ES governments, net of ESCB holdings. Net monthly issuance by DE, FR, IT, ES governments, cumulated by year. Primary dealers from DMOs websites, registered as MFI in EA. Securities portfolio comprises Euro area central and general governments debt securities held by primary dealers.
Last observation: 2024 (value in 2024 corresponds to the projected net issuance and YTD of debt outstanding).

Relationship between liquidity and volatility in euro area government bond market

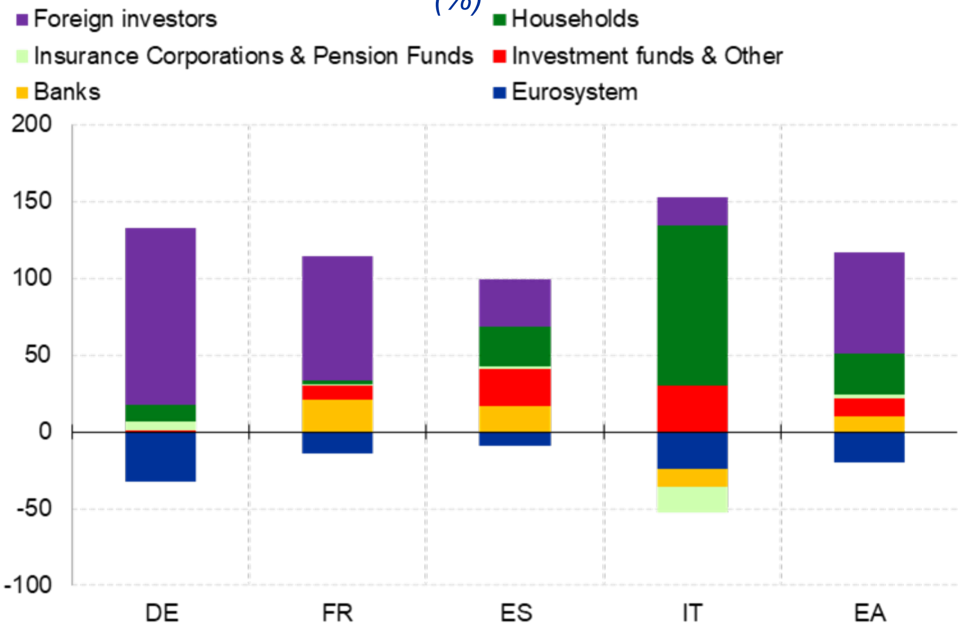


Source: Ferrara et al. (2024), ECB calculations.
Note: Liquidity conditions proxied by a euro area weighted average composite indicator of liquidity in 10-year government bond markets and implied volatility based on euro-denominated 3-month Swaptions. Higher values of the composite liquidity indicator correspond to worse liquidity conditions. Blue dots indicate observations starting in January 2015. Yellow dots indicate observations from March 2020. Red dots indicate observations from March 2023 to June 2024. The light blue regression line is estimated based on all observations except those from March 2020. The yellow regression is estimated based on March 2020 observations.
Last observation: 13 June 2024.

Foreign investors and households played a crucial role to replace the Eurosystem

Sectoral absorption of government securities in 2023-2024

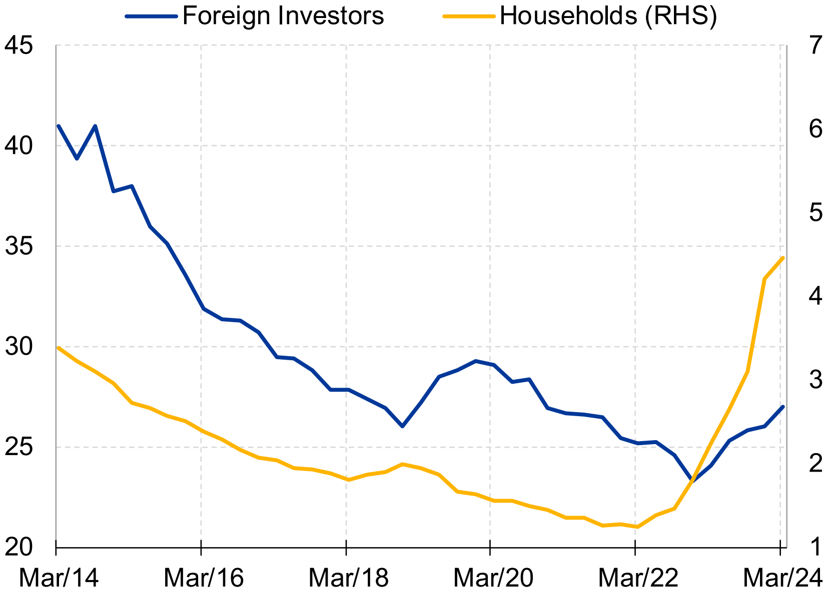
(%)



Sources: SHS, ECB.
Notes: The chart shows the flows into euro area government debt securities in since end of 2022, split between a range of euro area investors (banks, households, etc.) and foreign investors.
Last observation: 31 March 2024.

Selected holders of euro area government securities

(%)

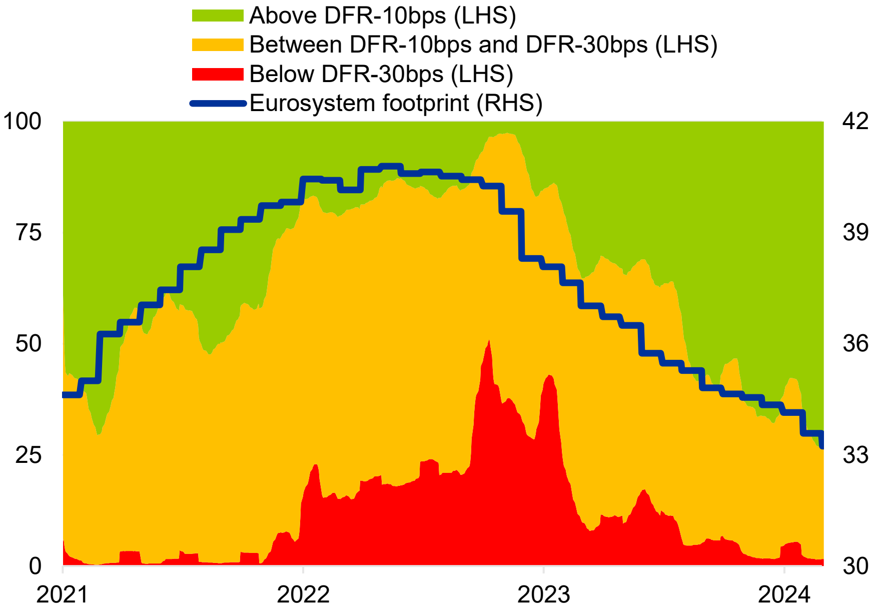


Sources: SHS, ECB.
Last observation: 31 March 2024.

Declining Eurosystem market footprint has eased collateral scarcity in repo markets

Share of euro area repo market trading below the DFR and Eurosystem market footprint

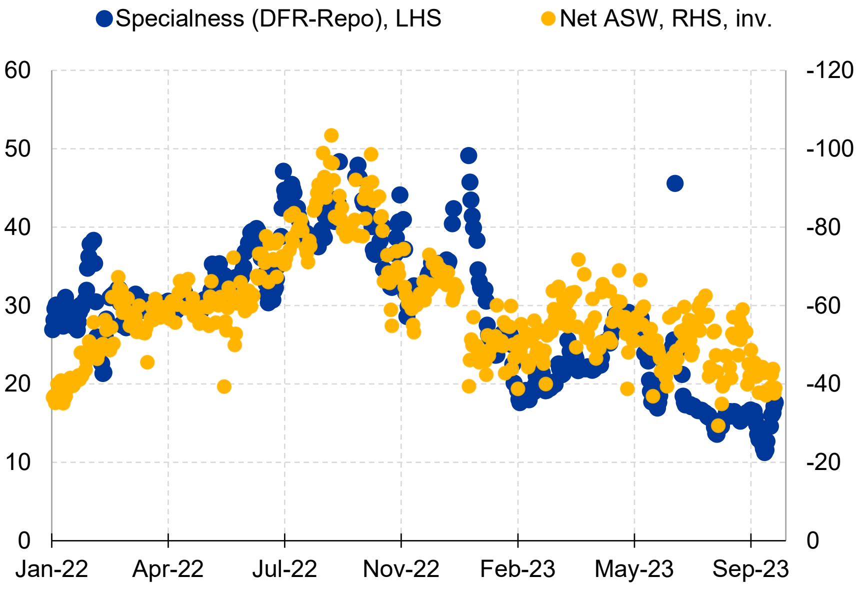
(%)



Sources: MMSR, ECB.
Notes: The Eurosystem's footprint in the EGB market is measured as the share of the Eurosystem's holdings of EGBs compared to the total nominal amount of EGBs outstanding. Specialness of repo market is displayed as share of volumes per rate bucket below the deposit facility rate (DFR).
Last observation: 11 June 2024.

Repo specialness and asset swap spread, Germany

(bps)



Sources: MMSR, Nguyen et al. (2024).
Notes: Net asset swap spread computed on German government bonds, net of CDS.
Last observation: October 2023.

Issues for discussion and challenges going forward

The reduction in central bank reserves resulting from QT will allow **money markets to act as a channel of liquidity redistribution** to all corners of the financial system. The **changes to the operational framework of the Eurosystem will help mitigate liquidity risks** as QT progresses

Although dealers' intermediation capacity does not seem impaired, the new regulatory landscape poses costs on dealer balance sheet utilisation, and **new opportunistic actors** have emerged to fill the gap. The ECB will continue **monitoring risks stemming from new trends in market intermediation**

So far, we see **no evidence that QE has been "addictive"**. QT is proceeding smoothly, supported by robust market absorption. However, drawing conclusions might be premature, as there remains a **considerable journey ahead in diminishing excess liquidity**