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Daiwa's View

Argument for raising ECB's MRR: Central bank financial issues and implications for Japan

- Calls to raise minimum reserve requirement gaining traction at ECB as financial conditions deteriorate
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Argument for raising ECB's MRR: Central bank financial issues and implications for Japan

The ECB is discussing a proposal to raise the minimum reserve requirement (MRR) from the current 1% to 2%. The large amount of reserve deposits following quantitative easing and the deterioration of central bank finances during periods of interest rate hikes are common challenges faced by major central banks, including the BOJ. These are topics of great interest among market participants. In this report, we will first examine the background and challenges surrounding the argument over raising the minimum reserve requirement that has emerged within the ECB. We will then consider any impacts and implications for Japan.

ECB considers raising MRR

At the ECB Governing Council meeting held on 22-23 July, the Council decided not to hike rates after it had just made a hike at the meeting in June. Meanwhile, the market has priced in a September rate hike at a probability of over 90%. Meanwhile, European Central Bank President Christine Lagarde made no remarks at her press conference that would have held these market expectations in check. Even though there is still some time until the next meeting on 9-10 September, it now seems highly likely that there will be a 25bp rate hike. That said, one issue now grabbing attention is the issue of raising the minimum reserve requirement.

On 30 June, Reuters reported, citing sources familiar with the matter, that the statutory reserve portion of the deposits that commercial banks hold with the ECB entails no interest. However, reports now indicate that the ECB is considering raising its minimum reserve requirement from the current 1% to 2%. Regarding a potential increase in the reserve requirement, Lagarde said, "Even though this matter was not discussed at today's Governing Council meeting, that does not mean it will not be discussed in the future." She also did not rule out the possibility of such a move.

The deteriorating financial conditions of the ECB and several central banks within the Eurosystem are cited as the reason behind the consideration of raising minimum reserve requirements. During a period of quantitative easing, after a central bank expands its balance sheet by purchasing large quantities of long-term government bonds from the market and supplying reserve deposits, if interest rates are raised while the massive amount of reserve deposits supplied through quantitative easing remains in place, the central bank is likely to run a deficit. In fact, major European central banks, including the ECB, have posted deficits (primarily due to increased payments on reserve deposits) and their remittances to national treasuries have declined.

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Also, the fact that 2026 marks the point when the ECB is scheduled to conduct a review of its framework is also a factor behind the ongoing discussions regarding an increase for the reserve requirement. In addition to raising the reserve requirement, it appears that other measures are also being discussed. These include expanding the interest-free portion through the tiered structure of reserve deposits and imposing fees on the total amount of reserve deposits. Either proposal would result in a substantial increase in the burdens placed on banks (so-called "implicit tax on banks"). In addition, there are indications that this could impact financial intermediation functions through (1) reduced liquidity in the short-term money market and (2) banks adopting more cautious lending stances. All eyes are now focused on how the discussions will progress leading up to the next meeting in September.

How discussions on hiking ECB's MRR might impact Japan

The deterioration of financial conditions during periods of interest rate hikes (driven by central bank quantitative easing-induced balance sheet expansion and the mismatch between short/long-term interest rates) is a common theme in both Japan and Europe. Developments at the ECB could have some impact on the BOJ as well. Also, the implicit tax on banks is a topic of great interest in the Japanese bond market, where many deposit-taking financial institutions participate.

The ECB has changed the minimum reserve requirement and the rates on those reserves in the past. In 2012, the statutory reserve requirement, which had previously been 2%, was lowered to 1%. Also, previously, interest was applied to statutory reserves, but as of 2023, these reserves became interest-free.

Meanwhile, in Japan, the reserve requirement has not been changed since October 1991, and the BOJ's website explicitly states that it is not used as a tool for monetary easing or tightening[1]. The Reserve Deposit Requirement System Act, to which the Bank of Japan Act refers, also permits changes to the reserve requirement for the purpose of "monetary adjustments." Careful consideration will be needed to determine whether this ratio can be changed on the grounds of reducing the cost burden of quantitative easing.

Act on Reserve Deposit Requirement System

Article 4: The Bank of Japan may establish, change, or abolish the reserve requirement or the reference date (refers to record date or record period pertaining to the increase in the designated account; same applies hereinafter), when it deems it necessary for the purpose of monetary adjustments.

Bank of Japan Act

Article 15 (1) The following matters concerning currency and monetary control are decided by the Board:

(iii) determining, altering, or discontinuing reserve requirement ratios, the base date, and other matters prescribed in Article 4, paragraph (1) of the Act on Reserve Deposit Requirement System (Act No. 135 of 1957).

Furthermore, while European central banks are reporting deficits, the BOJ posted a net current account surplus of Y1.9tn in its FY25 financial results. According to materials released by the BOJ's Planning Division in December 2024[2], assuming that the market had already priced in short-term and long-term interest rates at that time, revenue of approximately Y1.0tn was projected for FY25. They also point out that, depending on how interest rate hikes proceed, the Bank could fall into the red afterward. However, according to the financial results report, investment gains from stocks and ETFs, in addition to interest on government bonds, are helping to underpin revenue. The fact that the BOJ is currently posting a surplus and making remittances to the national treasury should be recognized as a key difference between the conditions in Japan and Europe.

Furthermore, as a result of interest rate hikes, interest payments under the complementary deposit facility (which covers interest payments on interest-bearing deposits) have swelled to Y2.7tn for FY25. The average balance of current accounts for the previous fiscal year was approximately Y500tn, which resulted in the IOER of roughly 54bp. In addition to the interest rate

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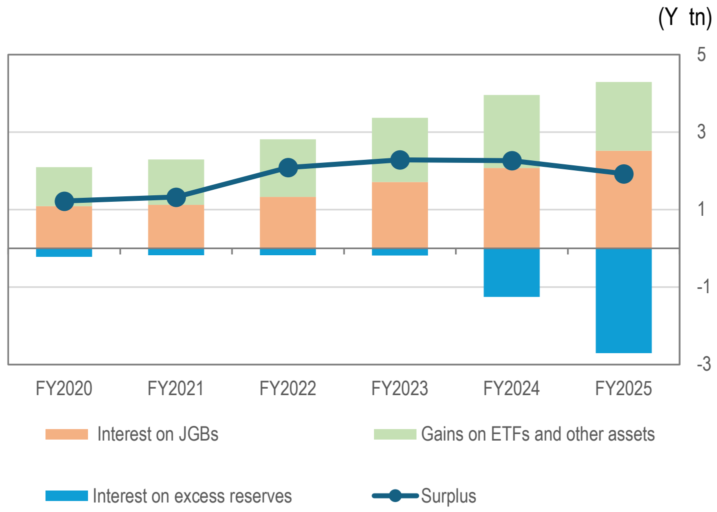
[1] BOJ website: "What is the reserve requirement system? What are excess reserves?"

[2] Policy Infrastructure Division, Monetary Affairs Department (Jan 2025). Bank of Japan Review: The Bank of Japan's Finances and Simulations for Profits and Capital.

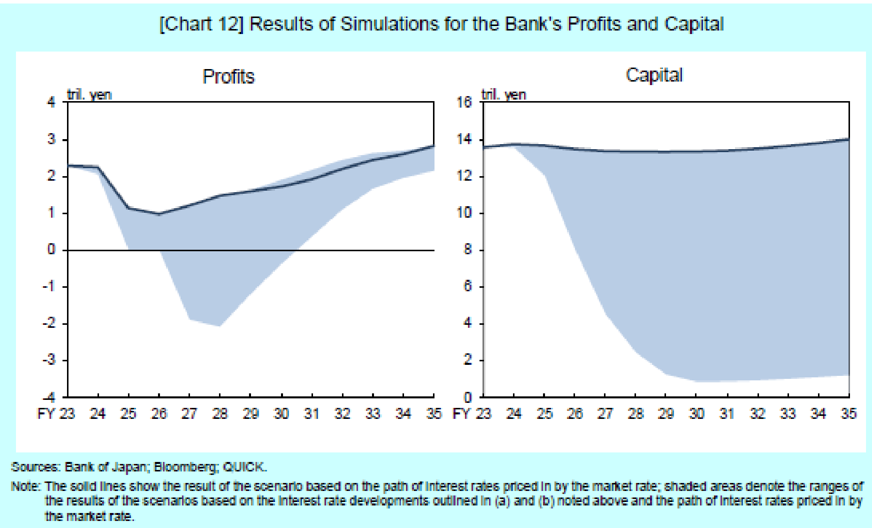
hike executed in June of FY26, one or two additional rate hikes are now expected. Due to quantitative tightening developments, the balance for current account deposits continues to decline. So, assuming an average current account balance of Y420tn and an average IOER of 94bp for FY26, interest payments totaling Y3.9tn would be incurred. Even though this represents a deterioration in FY26 earnings of roughly Y1.2tn compared to FY25, the BOJ recorded a surplus of Y1.9tn in FY25, driven by interest income from JGBs and ETFs. So, it appears to have a certain financial buffer.

Chart 1: BOJ's Profits/Losses and Main Factors



Source: BOJ; compiled by Daiwa.

Chart 2: BOJ's Simulations for Its Profits and Capital



Source: Reprinted from Bank of Japan Review: The Bank of Japan's Finances and Simulations for Profits and Capital.

Focusing on ECB's response as a precedent

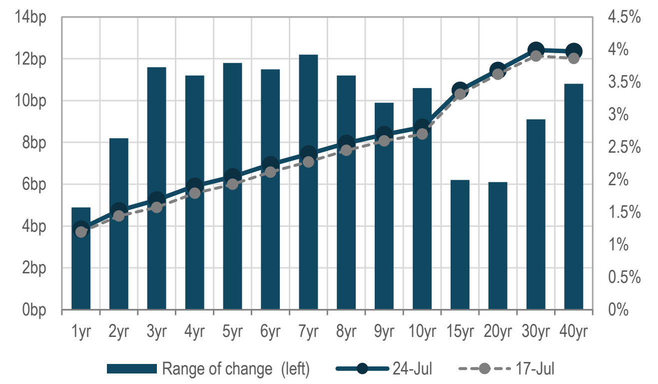
The argument at the ECB over raising the minimum reserve requirement is a topic that is relevant to Japan as well, given the financial implications for central banks and the burden of paying interest on reserve deposits following quantitative easing. Meanwhile, given that Japan has not adjusted its reserve requirement since 1991 and that the BOJ is currently running a surplus, it would be premature to apply the ECB's discussions directly to Japan at this time. However, if interest rate hikes continue in the future, the BOJ's earnings environment could change as a result of rising interest expenses. As major central banks explore institutional designs for the era of massive reserve balances, the ECB's actions will continue to draw attention as reference examples for future discussions.

Last week's JGB market and outlook for this week

Last week, yields continued to rise on the JGB market amid persistent concerns about fiscal policy, compounded by rising yields overseas. On 22 July, there were speculative media reports (citing those in the know) that the rate-hiking pace could accelerate. As a result, market expectations for interest rate hikes through October reached 80% and short/medium-term yields rose notably. While the acceleration of interest rate hikes is expected to alleviate concerns about the BOJ "falling behind the curve," the 10-year/2-year and 30-year/10-year JGB yield spreads have remained virtually unchanged. Amid growing expectations for interest rate hikes, overseas as well, this indicates that considerable concerns about "falling behind the curve" and fiscal issues remain.

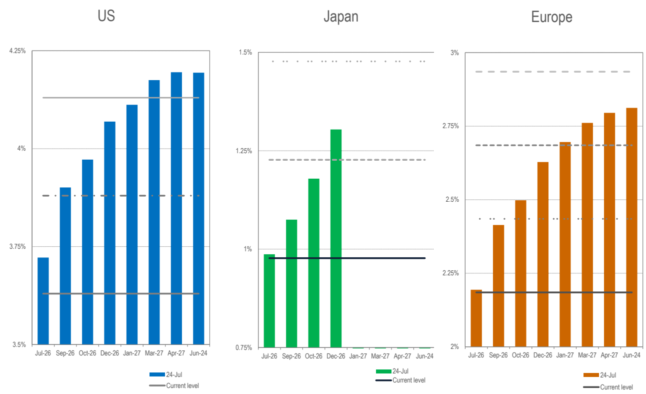
Meanwhile, over the weekend, it was reported that US President Donald Trump had ordered that Iran not be further attacked. As a result, US airstrikes have been halted and it appears that Iran is refraining from retaliation. The deterioration of the situation in the Middle East has been a factor driving up yields across the globe, fueled by rising energy prices and a shift toward a more hawkish stance by central banks. The main focus this week will be on the 28-29 July FOMC meeting and the 30-31 July BOJ Monetary Policy Meeting. However, we expect JGB yields to level off for the time being after the recent rise paused.

Chart 3: Change in JGB Yield Curve (compound yield basis) (17 Jul → 24 Jul)



Source: Bloomberg; compiled by Daiwa.

Chart 4: Rate-hike Pricing in US, Japan, and Europe



Source: Bloomberg; compiled by Daiwa.

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