CENTRAL BANKS

Monitoring ECB balance sheet expansion (May 2015)

Financial Scenarios / Europe Unit

- **The purchase programme, which involves both public and private sector assets, beat the declared monthly target of EUR60bn in May, with some EUR63.1bn of assets acquired and a clear bias towards public-sector bond purchases (80%).**
- **The tighter conditions in the credit markets have led the countries on the periphery to ease up slightly as regards their issuance rates. Even so, execution of the financing requirement in countries such as Spain has reached over 50% of that initially planned in terms of gross issuance of medium- and long-term bonds.**
- **In its latest monetary policy meeting, the ECB remained resolute about fully implementing the measures already set in train, actually commenting that further measures would be taken if called for. Given that the tightening of financial conditions has continued in May and that the recent inflation figures do not alter our medium-term outlook, we still think that opening the door to speculation over an early withdrawal of stimuli is very risky.**

ECB monetary expansion measures

a) **Asset purchase programme:** The purchase programme for assets (both public and private) surpassed its set target of EUR60bn a month in May.

In the first three months of the programme (March, April and May), the ECB bought EUR146.7bn of public sector bonds under the Public Sector Purchase Programme (PSPP), as well as EUR33.9bn in its Covered Bond Purchase Programme (CBPP3), and EUR3.7bn within its Asset-Backed Securities Purchase Programme (ABSPP). In May in particular, the ECB purchased a little more than the set target figure, specifically buying securities worth EUR63.1bn, 80% of this in sovereign bonds. The ECB thus remains on course to achieve an expected balance sheet expansion of EUR1.1trn by September 2016.

a.1) Public sector purchase programme

In May, the ECB purchased sovereign bonds to the value of EUR45.4bn, the share by country being practically in line with the ECB's capital key and featuring a slight adjustment for the non-purchase of bonds from Greece, Cyprus and Estonia[1]. This amount is more than was acquired in each of the first two months of the programme (EUR41.7bn in March and EUR42bn in April). This increase in the amount involved is likely to have been done in the first two weeks of the month when buying was stepped up. With regard to this, a member of the ECB's governing council, Benoît Cœuré, said that the bank would lift its buying levels in May and June to guard against lower issuance and therefore greater volatility, which is expected to emerge in the

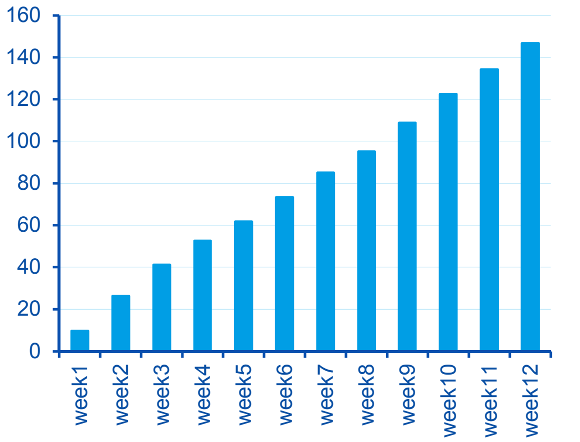
1: No Greek bonds were purchased so as not to exceed the limits imposed by the ECB (which can only buy bonds up to 25% of any issue and up to 33% of the debt securities of any single issuer). In the case of Cyprus no bonds have been acquired because the fifth review of the bailout programme has still not been finalised and, as regards Estonia, they have not been bought because Estonia has no bonds in circulation.

markets from mid-July and in August. In this context, in the minutes of their April meeting, the ECB members underlined the fact that the PSPP is not flexible enough to be adapted should the need arise.

With respect to the maturity of the debt securities acquired up to May, this is in line with the maturities associated with the purchases made in the first two months of the programme, with the average for the buying standing at 8.07 years, which is less than the average for eurozone bonds which are eligible under QE (9.1 years). By country, the maturities in the sovereign bond purchasing were notably long among the countries on the periphery, such as, for example, Portugal (10.8 years), Spain (9.71 years) and Ireland (9.61 years) with higher values compared to the maturities on their eligible debt (9.1 years in Spain, 8 years in Portugal and 8.9 years in Ireland). This trend is partly due to the PSPP's own limitations as, with respect to the peripheral countries, the ECB has acquired bonds under a previous securities purchase programme (SMP, or Securities Markets Programme) with shorter maturities (2-3 years) and thus the purchasing now has become skewed toward the longer terms.

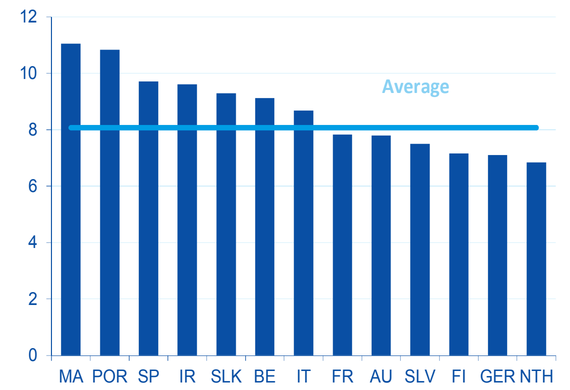
As regards buying of bonds issued by supra-national organisations and agencies, purchases last month were EUR6.2bn, which accounts for 12% of total bonds acquired, meaning that the ECB has once again bought up to the maximum established under the initial conditions for the programme.

Figure 1
PSPP: weekly bond purchasing, cumulative figure since 9 March 2015, (EUR bn).



Source: ECB and BBVA Research

Figure 2
PSPP: average maturity of bonds purchased (years)

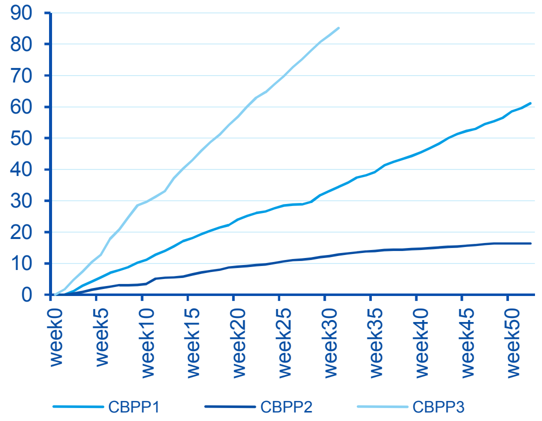


Source: ECB and BBVA Research

a.2) Private sector asset purchase programme

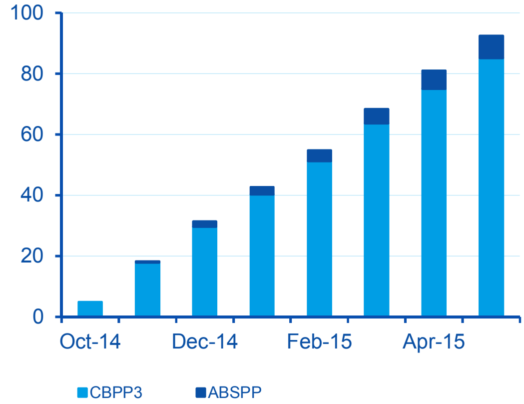
Under the private sector asset purchase programme, the ECB acquired securities worth EUR11.5bn in May, which is slightly below the average of EUR12.5bn for purchases since both programmes (ABSPP and CBPP3) have been in effect. May's buying under CBPP3 amounted to EUR10bn, while purchases under ABSPP came to EUR1.4bn. Within the programme to date, covered bonds worth EUR85.1bn have been acquired, along with EUR7.2bn in asset-backed bonds. The bulk of the purchasing has taken place in the secondary market (80%).

Figure 3
CBPPs
Cumulative weekly purchasing (EUR bn)



Source: ECB and BBVA Research

Figure 4
CBPP3 and ABSPP
Cumulative weekly purchasing (EUR bn)



Source: ECB and BBVA Research

b) Targeted longer-term refinancing operations (TLTROs, associated with lending)

Within the first three liquidity-providing operations with a four-year maturity (TLTROs), which are conditional upon developments in lending to the private sector (excluding mortgage loans for housing), EUR310bn has been taken up, of which around 60% is likely to have been bid for by institutions in the countries on the periphery. The next auction will take place on 18 June. Monitoring these auctions is important as a potential sign of a revival of lending to the real economy.

Table 1
QE measures (EUR bn)

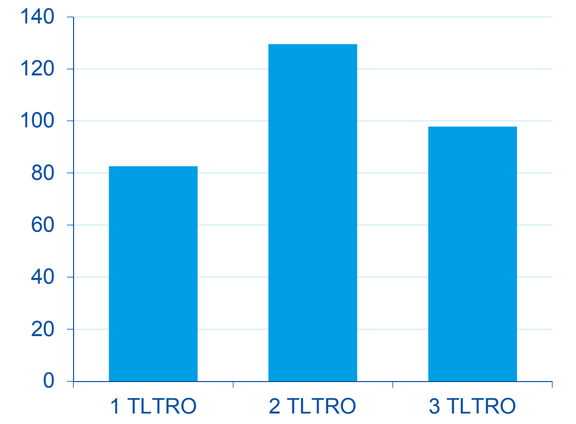
	Sept14	Oct14	Nov14	Dec14	Jan15	Feb15	Mar15	Apr15	May15
TLTROs	82.6			130.0			97.8		
CBPP3		4.8	13.0	11.8	10.6	11.0	12.4	11.5	10
ABSPP		0.0	0.4	1.0	0.6	1.1	1.2	1.2	1.4
PSPP							47.4	47.7	51.6

Source: ECB and BBVA Research

c) The Eurosystem's regular open market operations

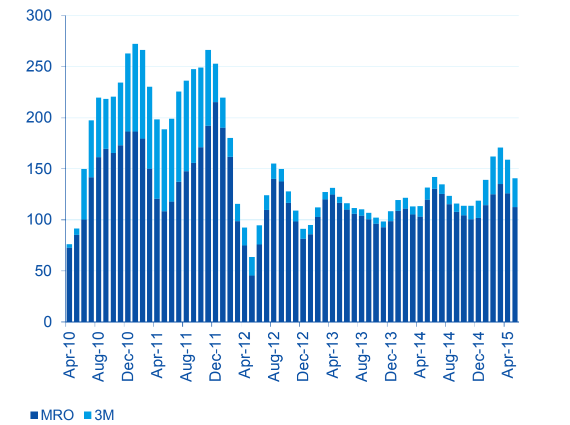
In May the liquidity allotted in the weekly main refinancing operations (MROs) and monthly auctions (3M LTROs) diminished to around EUR135bn, which was closer to the 2014 average of EUR120bn, in the wake of the rise that took place mainly in January and February as a result of the LTROs with a three-year maturity falling due (the institutions used these regular operations to replace part of the liquidity in the latter).

Figure 5
TLTROs (EUR bn)



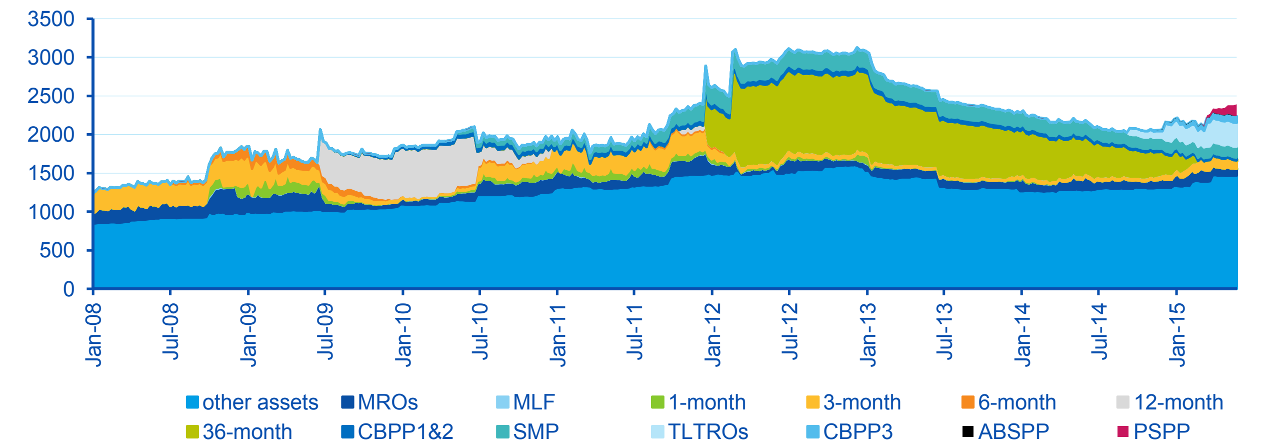
Source: ECB and BBVA Research

Figure 6
3M LTROs and MROs
(3-month moving average, EUR bn)



Source: Bloomberg and BBVA Research

Figure 7
ECB balance sheet (EUR bn)



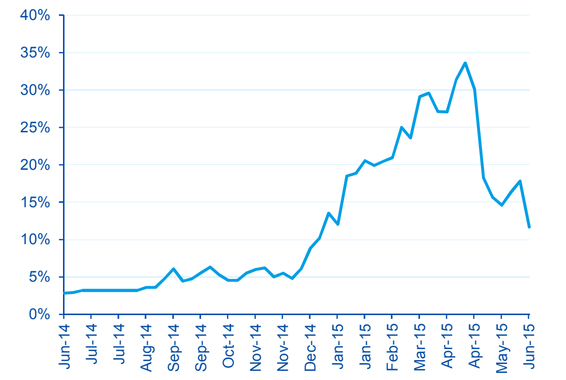
Source: ECB, Bloomberg and BBVA Research

Impact on assets

a) Impact on sovereign bond interest rates

Last month, the rise in interest rates which began in late April continued and even became sharper. In most eurozone countries, long-term interest rates (over 10 years) reached 40 basis points above the level seen prior to the programme's announcement. Specifically, the German 10-year bond has climbed past 0.85% (something not seen since October 2014). On the other hand, 10-year bond rates in Italy and Spain have topped 2%. As a result, the percentage of European bonds priced at negative corresponding rates has continued to shrink considerably, and currently stands at under 15%. Several factors could be behind this upturn in yields: i) first, the uptick could be due to a correction of very low levels as well as straying increasingly further from fundamentals: ii) inflation shocks are beginning to take on an upside rather than a downside hue; iii) the very fading of expectations of negative interest rates is becoming loaded towards the long end of the curve, and iv) market distortion, since, when there is an abrupt movement, liquidity is withdrawn from markets.

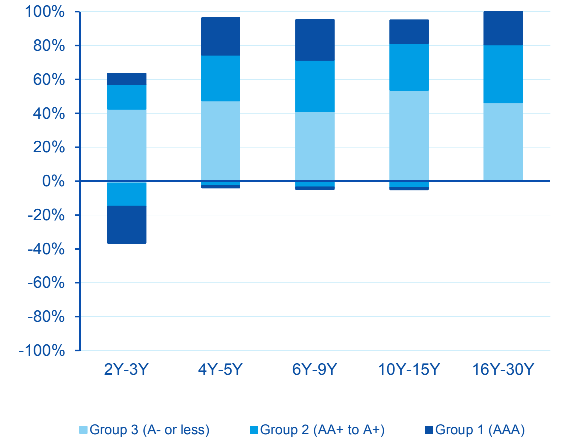
Figure 8
% of sovereign bonds* (eurozone) with negative interest rates out of total debt



*Eligible under the PSPP

Source: Bloomberg and BBVA Research

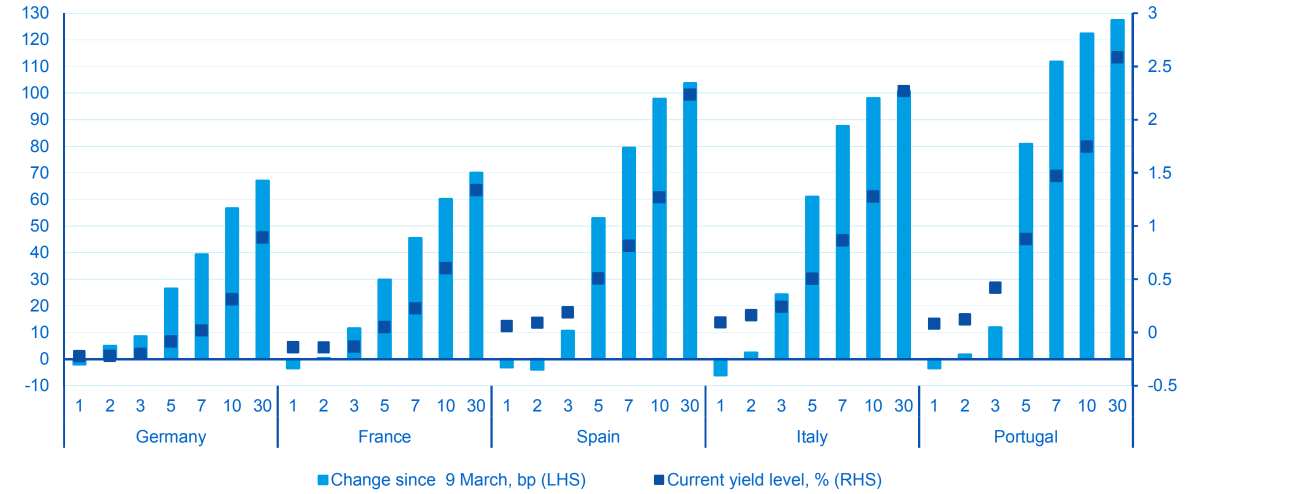
Figure 9
% of sovereign debt securities* (eurozone) with positive/negative rates, by country rating



*Eligible under the PSPP

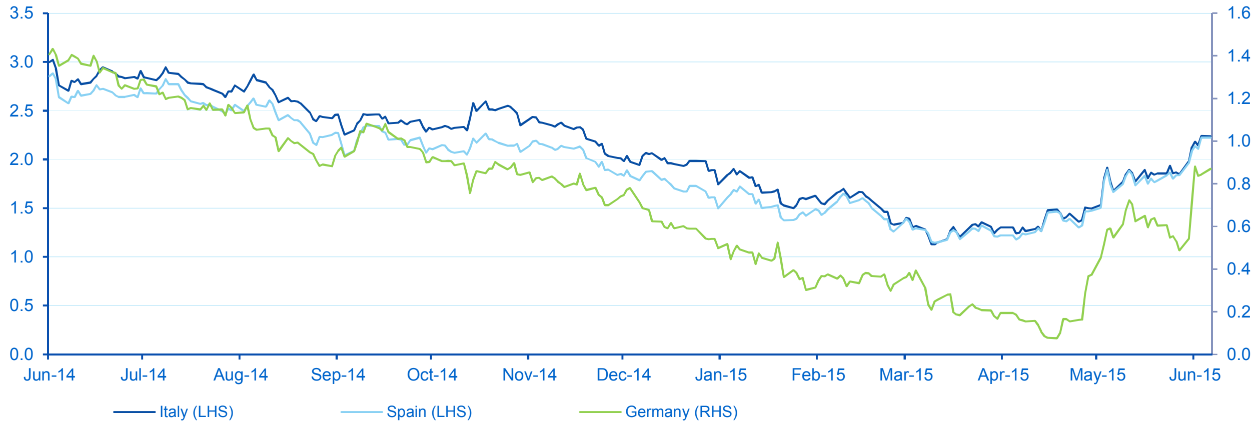
Source: Bloomberg and BBVA Research

Figure 10
Eurozone: sovereign bond curves: Current level (%) and change since the start of QE



Source: Bloomberg and BBVA Research

Figure 11
10-year bond yields (%)



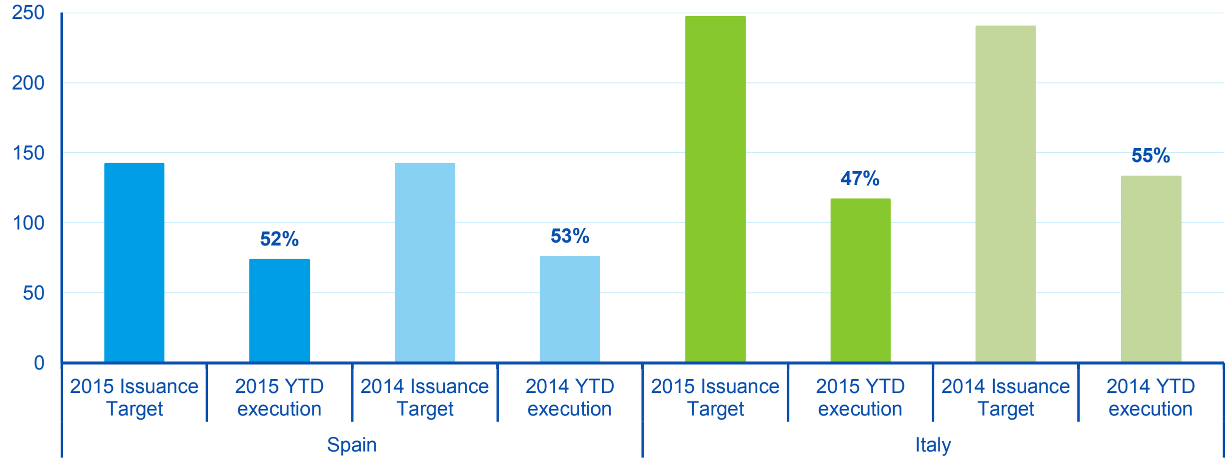
Source: Bloomberg and BBVA Research

a.2) Sovereign bond issuance: The pace of medium- and long-term issuance is easing up

The tightening of credit conditions in wholesale markets, following the upturn in yields over the last two months, has had a mild braking effect on the rate of medium- and long-term bond issuance among the countries on the periphery. Nonetheless, in the case of Spain up to May the execution of the 2015 regular medium and long-term gross issuance target remains in high rates, on a par with levels last year. Meanwhile, in Italy the execution rate was slightly below last yeary (Figure 12). Moreover, in May net bond issues were positive in Spain and Italy, which leaves net issues over the first five months at positive levels (EUR17bn in Spain and EUR65.7bn in Italy).

In June, Spain does not have to deal with any bonds falling due. This should imply that the supply of Spanish bonds will grow this month, for which reason any increase in risk aversion aimed at the periphery countries (uncertainty over Greece) could tighten financing conditions for Spain’s sovereign debt. Nonetheless, the pick-up in sovereign bond purchasing by the ECB should be a factor which cushions this effect. As proof of this, one could point to the fact that, at the beginning of June, Spain placed EUR5bn in a 10-year bond which was very well received by the market in spite of the rise in risk aversion. In May, the ECB purchased Spanish bonds worth EUR5.9bn and the Spanish Treasury issued EUR10bn. It seems reasonable to expect issuance to climb slightly in June to EUR15bn, and for ECB purchasing to be over EUR6bn. On the other hand, Italy faces bond maturities worth EUR17bn (excluding short-dated discount bonds), which could result in a net supply of bonds that is virtually negligible or low.

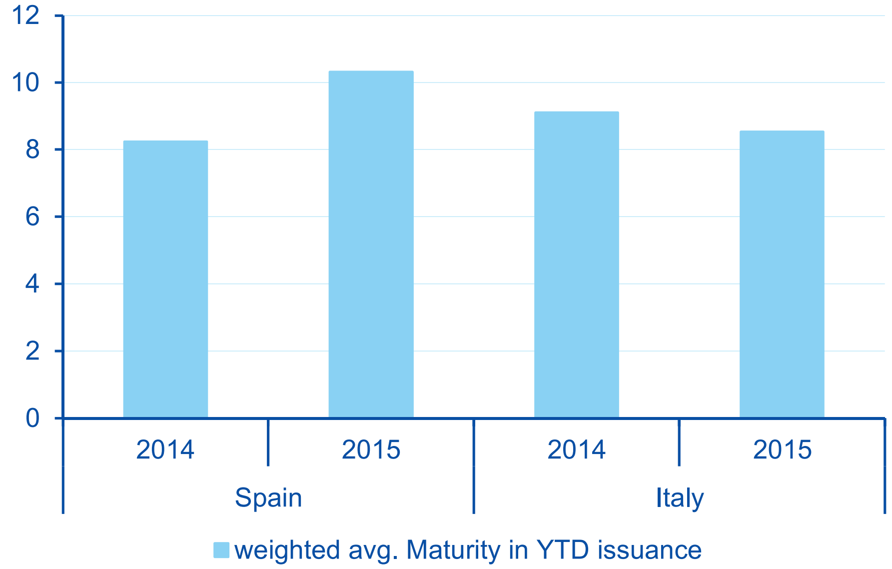
Figure 12
Spain and Italy: gross sovereign bond issuance as of May (EUR bn and % of annual gross issuance target)



Source: National treasuries and BBVA Research

The weighted average maturity of new bond issues came down significantly in May compared to April (Spain: 5 years vs. 11 years in April). For the year as a whole, however, the average maturity for new medium- and long-term debt issued in Spain stands at above the 2014 level, while in Italy this remains in line with 2014 (see Figure below).

Figure 13
Spain and Italy: average maturity of new issues

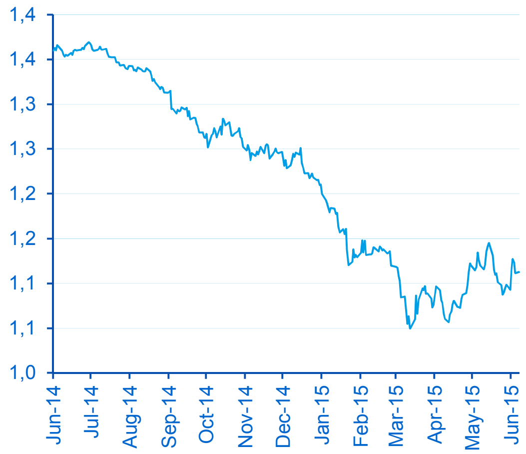


Source: National treasuries and BBVA Research

b) Impact on the exchange rate

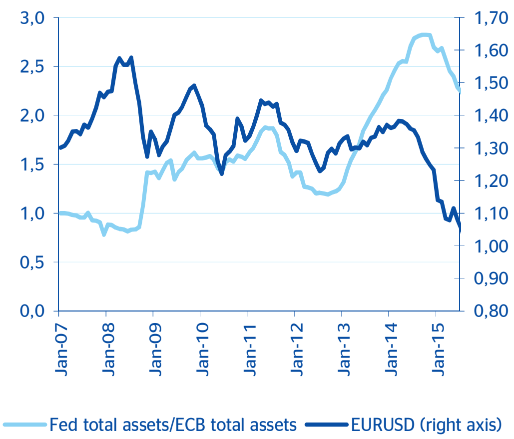
In line with the rise of rates at the long end, the EUR firmed in May to over the USD1.14 level. More significant, though, was the high volatility in this market: after its rise, the EUR dropped back to below USD1.09 (closing the month at USD1.12 on average). The volatility has persisted so far in June and is marked by the uncertainty that predominates over the impact of monetary policy on long assets.

Figure 14
EUR/USD



Source: Bloomberg and BBVA Research

Figure 15
EUR/USD and monetary policy stances (Fed/ECB)

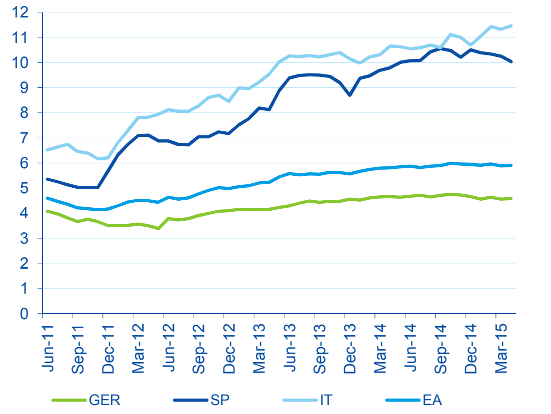


Source: Bloomberg and BBVA Research

c) Holdings of sovereign bonds by financial institutions

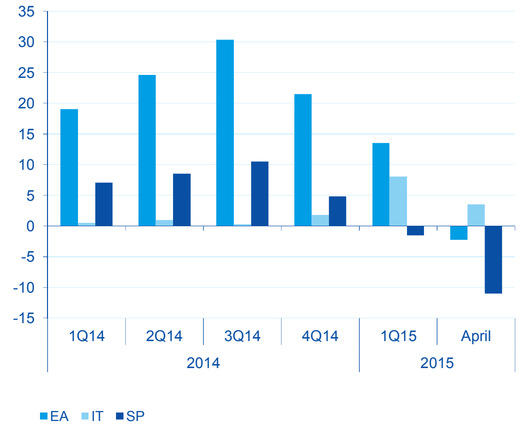
According to ECB figures on eurozone sovereign bond holdings by financial institutions for April (the ECB began buying sovereign bonds in March), institutions are continuing to move out of sovereign bonds in quantities that are of little significance, except in the case of the Spanish institutions. In greater detail, for the eurozone as a whole, financial institutions scaled down their holdings of sovereign bonds by EUR2.3bn, a figure which is substantially lower than its counterpart the previous month, when they cut their holdings by EUR10.8bn. The drop in April was mainly by Spanish institutions, which trimmed their holdings by EUR11bn, followed by Dutch, Irish and German institutions. The decline in holdings by Spanish institutions in April might have been on account of EUR18bn falling due on a Spanish Treasury bond on the last day of the month (30 April). On the other hand, Italian institutions stepped up their bond holdings by EUR3.5bn in April. In their case, although some EUR17bn in bonds fell due in Italy, they matured in the middle of the month and so the institutions might have had time to reinvest this money in some other bond being auctioned.

Figure 16
Sovereign bond holdings by financial institutions out of total banking assets (%)



Source: ECB and BBVA Research

Figure 17
Sovereign bond holdings by financial institutions (quarterly average, EUR bn)



Source: ECB and BBVA Research

Are the ECB measures working?

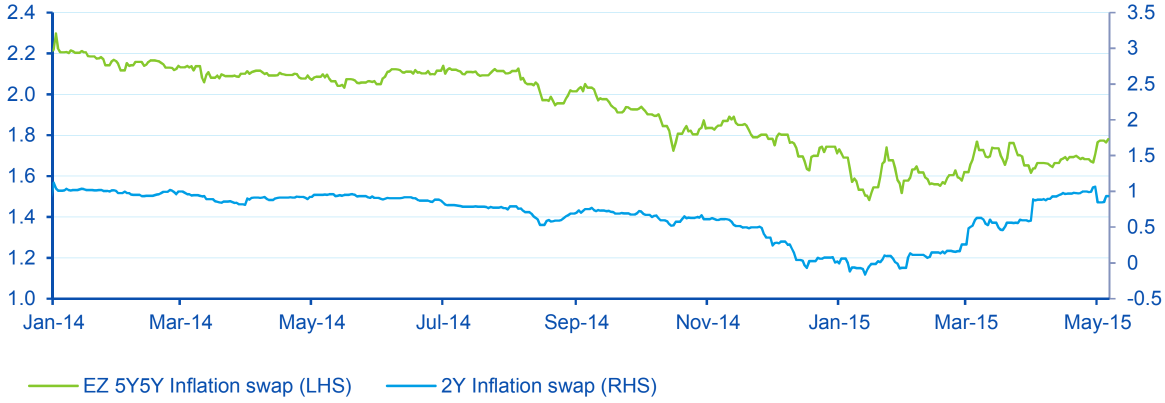
The ultimate aim of the ECB's unconventional measures (TLTROs and ABS, CB and public sector security purchases) is to bring inflation back onto a course compatible with its target level.

The flash estimate for May inflation shows eurozone prices accelerating to 0.3% YoY after 0% YoY in April compared to the expected 0.2% YoY, owing to a pick-up in core inflation from 0.7% to 0.9% YoY. This might reflect the recovery of domestic demand, though seasonal technical aspects too (variations in flight fares and accommodation rates) which have added volatility to the index recently. The inflationary pressures are in any case still very restrained. With respect to the inflation expectations discounted in the market, indicators such as the 5y5y inflation swap rate still stand at over 1.75%, although this was with a certain degree of volatility throughout the whole of May.

On the other hand, the activity data out for Q2, mainly confidence, point to a consolidation of growth for the eurozone economy (between 0.4% and 0.5% QoQ), in line with forecasts. Both the PMI indicator and the European Commission's ESI paint a relatively bright picture, in the manufacturing as well as the services sectors. In the case of manufactures, the figures reveal something of an acceleration with respect to Q1, whereas for services they point to stable growth. On the other hand, household confidence has fallen in the first two months of 2Q15, though it is still holding at a high level.

Given all the above, and as we were expecting, the ECB's macroeconomic forecasts presented last Wednesday are being maintained with few changes. The only difference is the upward revision of the inflation forecast for 2015, which is now 0.3% YoY (March forecast: 0%, BBVA: 0.1% YoY), taking into account the recent trends in inflation and the oil price, which indicate higher-than-expected inflation for this year, while the projections for 2016 and 2017 remain unchanged at 1.5% and 1.8% respectively. With regard to GDP, forecasts are unaltered (1.5% in 2015, 1.9% in 2016 and 2.1% in 2017; BBVA: 1.5% in 2015 and 2.2% in 2016), although the risks are still on the downside, they are more balanced than they were three months ago.

Figure 18
Eurozone: implied inflation expectations in the markets



Source: Bloomberg and BBVA Research

Conclusion: the interpretation of the last month of sovereign bond purchasing by the ECB remains upbeat. In May, the central bank surpassed its monthly buying target (achieving EUR63.1bn). This, together with the recent statements by the central bank about remaining determined to implement the measures set in motion to the full extent (at its June meeting it even actually said that further steps might be taken if this becomes necessary), continues to sustain the programme's success. Therefore, given that the tightening of funding conditions has continued in May, we still think that opening the door to speculation over an early withdrawal of stimuli is highly risky. With regard to this, at last week's monetary policy meeting the ECB president, Mario Draghi, said that the governing council has not discussed any QE exit plan and he added that there is still "a long way to go" with respect to inflation, in other words, before the central bank achieves its target rate of around 2%.

DISCLAIMER