CENTRAL BANKS

Monitoring ECB balance sheet expansion (June 2015)

Financial Scenarios / Europe Unit

- **In June, the asset purchase programme (which involves both public and private sector securities) was ahead of the set monthly target of EUR60bn, with some EUR62.9bn of assets acquired and still a clear bias towards public sector bond purchases (80%). That said, we have not yet detected any frontloading (bringing forward or speeding up of purchases) of the kind which some members of the ECB had anticipated ahead of the summer lull in issuance.**
- **The heightened uncertainty in Greece has been factored into the risk premiums of countries on the periphery, but the contagion is proving minimal given expectations that the ECB would take appropriate action if this were to be called for.**
- **We still think that inviting speculation over an early withdrawal of stimuli would be both premature and risky, especially in a context where risks deriving not only from the situation in Greece but also from China are giving rise to a high degree of uncertainty.**

ECB monetary expansion measures

a) **Asset purchase programme:** As was the case in May, the programme of purchases of assets (both public and private) exceeded its stated monthly target of EUR60bn in June.

In the first four months of the programme (March, April, May and June), the ECB bought EUR198.1bn of public-sector bonds under its Public Sector Purchase Programme (PSPP), as well as EUR43.8bn in securities as part of its Covered Bond Purchase Programme (CBPP3) and EUR5.3bn via its Asset-Backed Securities Purchase Programme (ABSPP). Specifically in June, as in May, ECB buying exceeded its set target as it acquired assets worth EUR62.9bn, 80% of which was invested in sovereign bonds. The ECB is therefore still on course to achieve an expected balance sheet expansion of EUR1.1trn by September 2016.

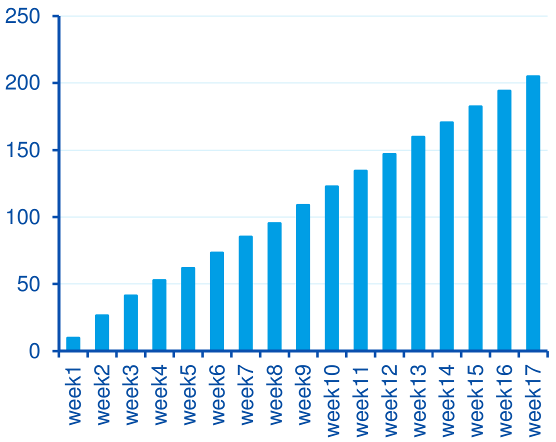
a.1) Public sector purchase programme

In June the ECB purchased sovereign bonds to the value of EUR45.2bn, where the share by country was practically in line with the ECB's capital key, though there was a marginal adjustment to allow for the non-purchase of bonds from Greece and Cyprus (in June bonds from Estonia were actually acquired, although this only involved a very small sum, amounting to EUR0.005bn). 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), yet slightly below the level of purchases made in May (EUR45.4bn), so for the moment there has not been any frontloading activity of the kind which certain members of the ECB had forecast. Against this backdrop, in the minutes of their June 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 June, although this is slightly shorter, it is in line with those in the purchasing over the first three months of the programme, with the average for the buying standing at eight years, which is less than the average for eurozone bonds that are eligible under QE (9.1 years). By country, the maturities in the sovereign bond purchasing were notably long among peripheral sovereign bonds acquired, such as, for example, Portugal (10.6 years), Spain (9.82 years) and Ireland (9.55 years), with higher values compared to the maturities on their eligible debt (9.1 years in Spain, eight years in Portugal and 8.9 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 current purchasing has become skewed toward the longer terms.

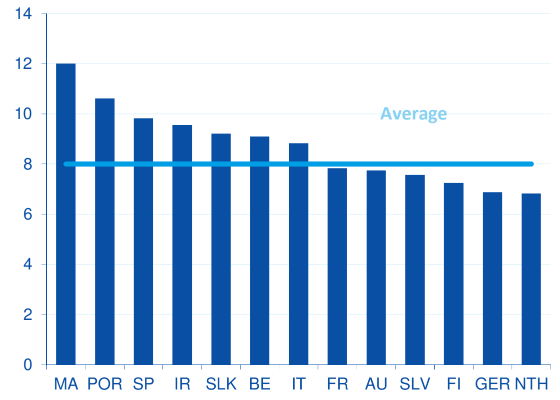
As regards buying of bonds issued by supra-national organisations and agencies, purchases last month were EUR6.3bn, which represents 12% of total bonds acquired, meaning that the ECB has once again used up its maximum purchasing allowance established under the initial conditions for the programme.

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



Source: ECB and BBVA Research

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

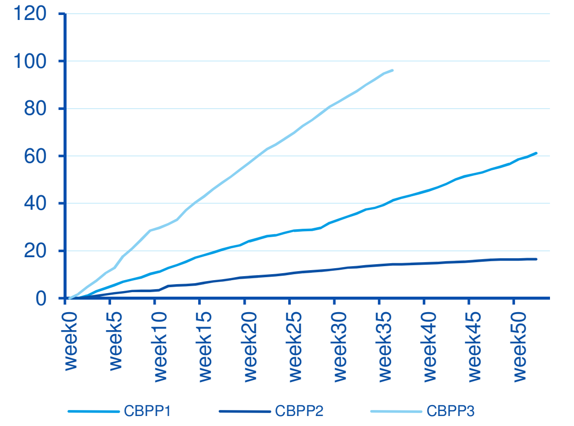


Source: ECB and BBVA Research

a.2) Private sector asset purchase programme

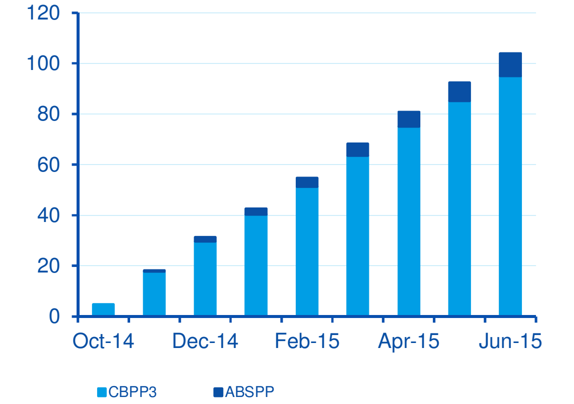
Under the private sector asset purchase programme, the ECB acquired securities worth EUR11.5bn in June, which is slightly below the average of EUR12.4bn for purchases since both programmes (ABSPP and CBPP3) have been in effect. June buying under CBPP3 amounted to EUR9.9bn, while purchases under the ABSPP came to EUR1.6bn. Within the programme to date (up to 3 July), covered bonds worth EUR96.1bn have been acquired, along with EUR8.9bn in asset-backed bonds. According to the way these programmes (ABSPP and CBPP3) were conceived, the ECB can carry out its purchasing activity both in the primary and in the secondary markets. The bulk of the purchasing under both programmes 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

In the fourth TLTRO conducted on 18 June, EUR73.8bn was taken by 128 banks (an average amount per bank of EUR0.6bn). This amount represents 21.5% of the potential upper limit that could have been bid for according to our estimates (EUR345bn). This amount is very much in line with what analysts were forecasting (EUR75bn on average). Official information on the take-up of liquidity by country is not available yet, although an initial idea can be gathered from the publication of June figures for bank borrowing from the central bank for June, i.e. from mid-July.

In the first four liquidity-providing operations which are conditional upon developments in lending to the private sector (excluding mortgage loans for housing), known as TLTROs, EUR384.2bn has been taken up, of which around 60% is thought to have been bid for by institutions in countries on the periphery. The next auction is due to be held on 24 September. Monitoring these auctions is important as they are potential indicators of a revival of lending to the real economy.

Table 1
QE measures **(EUR bn)**

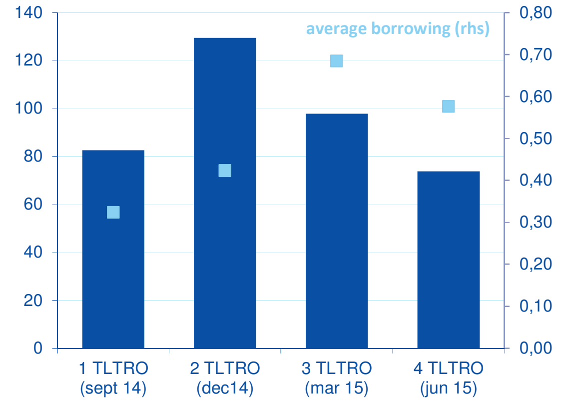
	Sep14	Oct14	Nov14	Dec14	Jan15	Feb15	Mar15	Apr15	May15	Jun15
TLTROs	82.6			130.0			97.8			73.8
CBPP3		4.8	13.0	11.8	10.6	11.0	12.4	11.5	10	9.9
ABSPP		0.0	0.4	1.0	0.6	1.1	1.2	1.2	1.4	1.6
PSPP							47.4	47.7	51.6	51.4

Source: ECB and BBVA Research

c) The Eurosystem's regular open market operations

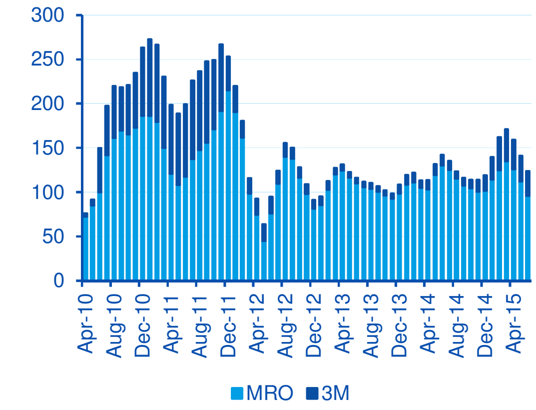
In June, as in April and May, the liquidity allotted in the weekly main refinancing operations (MROs) and monthly auctions (3M LTROs) diminished. This currently stands at around EUR125bn, which is closer to the 2014 average (EUR120bn), after the rise experienced mainly in January and February due to the falling due of LTROs with a 3-year maturity (banks which switched to regular operations).

Figure 5
TLTROs (EUR bn)



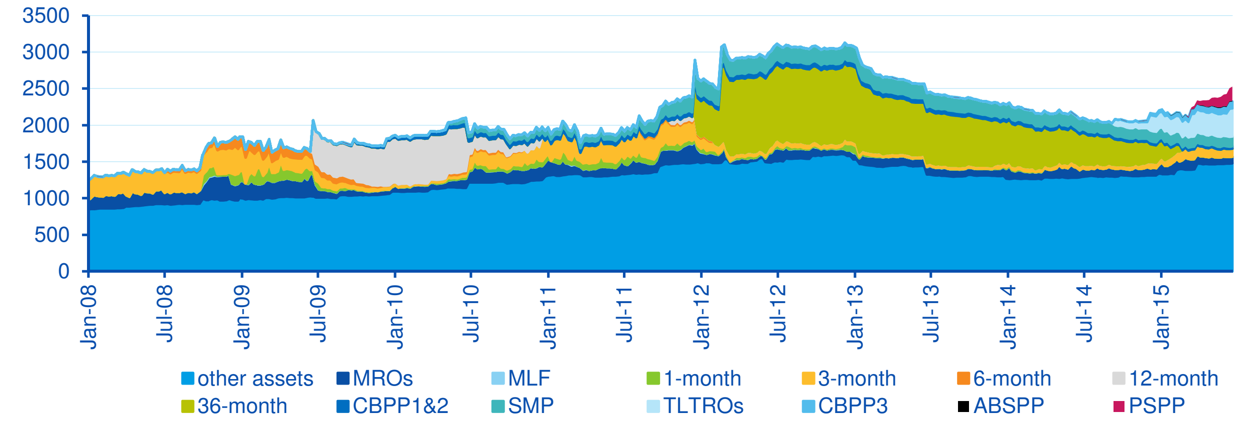
Source: ECB and BBVA Research

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

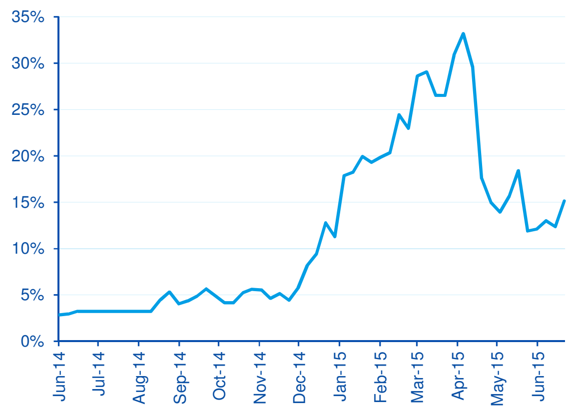
Impact on assets

a) Impact on sovereign bond interest rates

The deepening of the Greek crisis has continued to push interest rates on bonds in the periphery upwards, while it has supported falls in German rates, which have benefited from flows seeking a safe haven. This divergence has caused risk premiums among the countries on the periphery to widen in the last month (20bp in Spain and Italy and 30bp in Portugal). Nonetheless, although the situation in Greece has escalated to very serious levels and the likelihood of Grexit has increased, the spill-over to the peripheral countries is proving a great deal more bearable than in previous disruptive episodes. In fact, in the past month the risk premium in core countries such as France or Belgium has widened to almost the same degree (18bp for Belgium, 16bp in France, and 14bp for the Netherlands). Behind this behaviour there lies clear confidence that the ECB will use all the tools at its disposal to head off further fragmentation in eurozone markets. Even though for the time being the ECB has not speeded up its purchasing programme, the markets are confident that the monetary authority would use the latter more flexibly (by upping the amount involved or even redistributing purchases across the various countries) or employ other available means (OMTs) should the need arise.

After the rise in interest rates, above all as regards core-country bonds, since May, the percentage of bonds priced in the market at negative rates has come down considerably (from 33% to 12%). This percentage rose marginally in June (to 15%) as a result of a certain flight-to-safety effect.

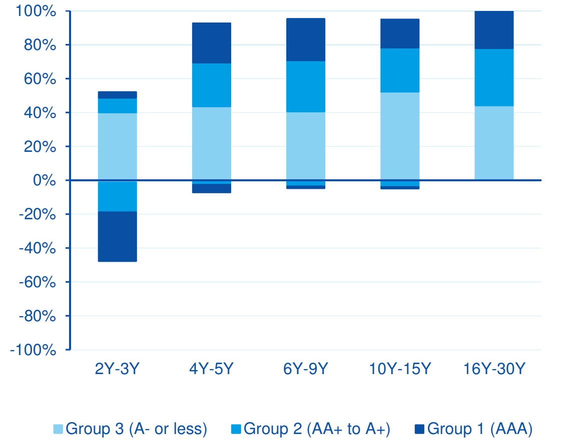
Figure 8
% of sovereign bonds* (eurozone) with negative interest rates over total debt



*Eligible under the PSPP

Source: Bloomberg and BBVA Research

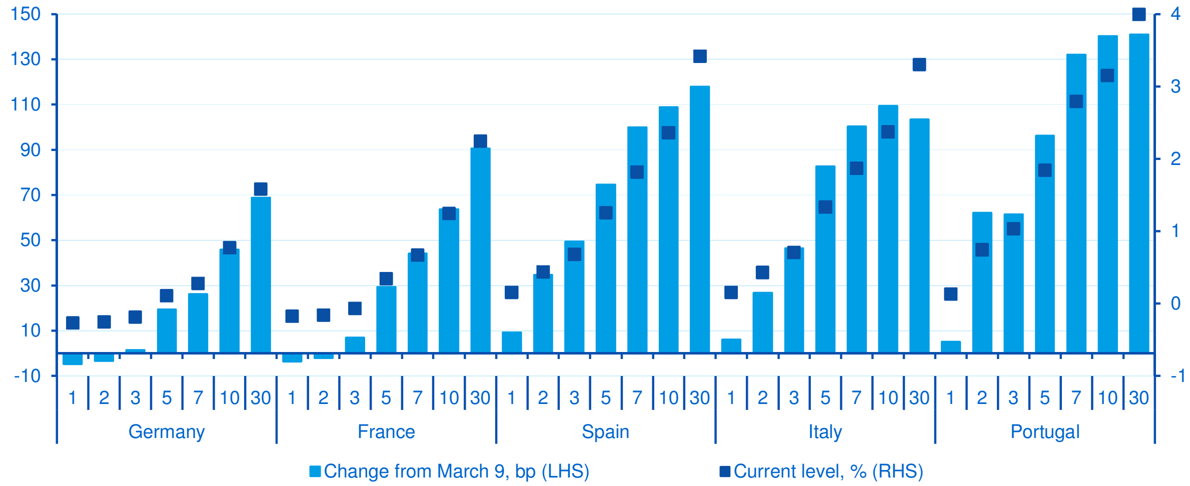
Figure 9
% of sovereign debt securities* (eurozone) with positive/negative interest rates, by country rating



*Eligible under the PSPP

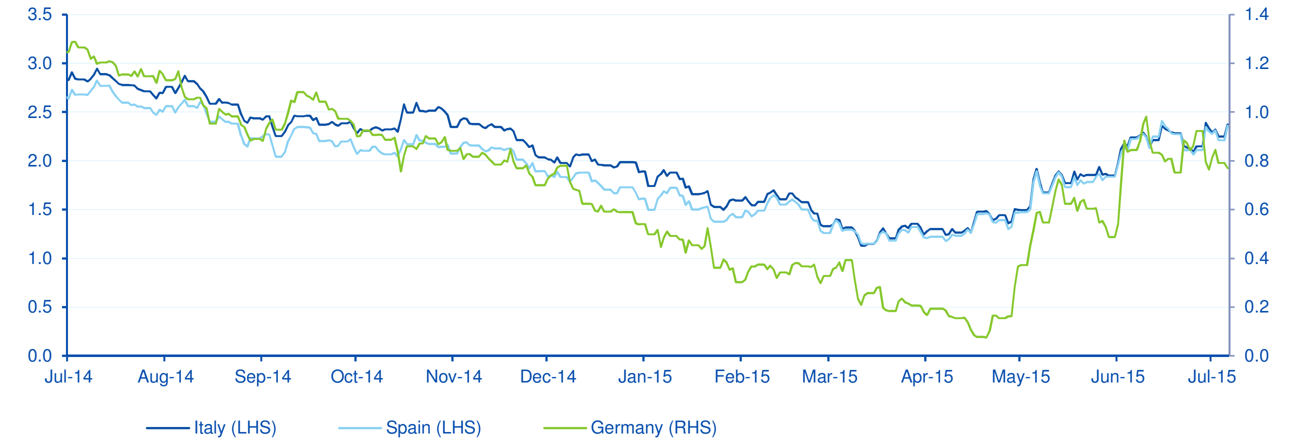
Source: Bloomberg and BBVA Research

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 rate is stabilising

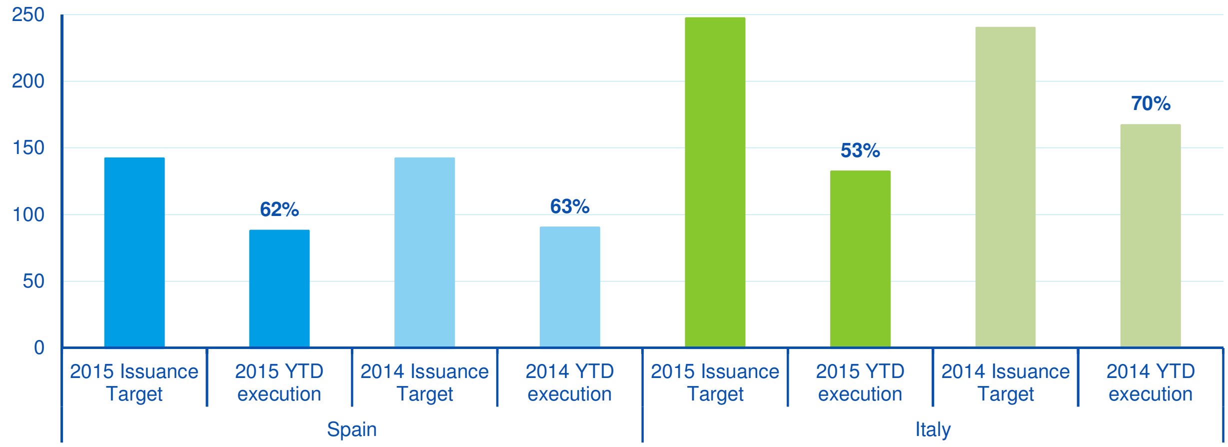
The rate of medium and long term sovereign debt issuance in Spain and Italy held or accelerated slightly in June with respect to May, despite the deterioration in the risk premiums of those countries on the periphery in the past month. We should recall that in May issuance had already slowed with respect to the first quarter of the year. So far this year, the rate of execution of gross issuance requirements is on a par with what was seen a year ago in Spain (62% in 2015 vs. 63%[1] in 2014), and has fallen well behind in Italy (53% in 2015 vs. 70% in 2014).

In July, bond maturities (EUR19.5bn in Spain and EUR16bn in Italy), together with the ongoing ECB purchase programme, should facilitate coverage of issuance, provided that the Greek crisis does not end messily. Beyond issuing debt at higher interest rates, there are no signs of difficulties in placing it.

Over the rest of the year, net issuance will increase in Spain by around EUR22bn. Even so, we believe that the market will easily soak up the new stock of debt, given that, if the ECB keeps up its rate of purchasing for the rest of the year, it will provide demand for EUR33.6bn in Spanish sovereign bonds on the secondary market. In the case of Italy, the outlook is better, as net issuance over the remainder of the year will be virtually negligible (+EUR2bn) and the ECB should demand securities worth EUR52bn.

1: Compared with net issues at the end of 2014 of EUR142bn.

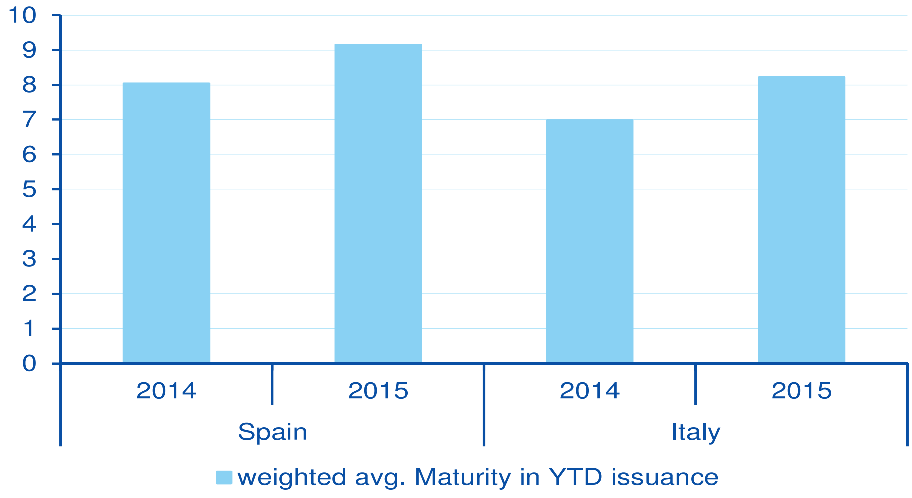
Figure 12
Spain and Italy: Gross sovereign bond issuance as of 3 July (EUR bn, % of annual gross issuance target)



Source: National treasuries and BBVA Research

The weighted average maturity of new bond issues was a little higher in June than in May (Spain: 7.5 years vs. 5 years in May, and Italy 11.7 years in June). Yet for the year as a whole, the average maturity of new medium and long-term debt issued is above the 2014 level (see Figure).

Figure 13
Spain and Italy: Average maturity of new issues as of 3 July 2015

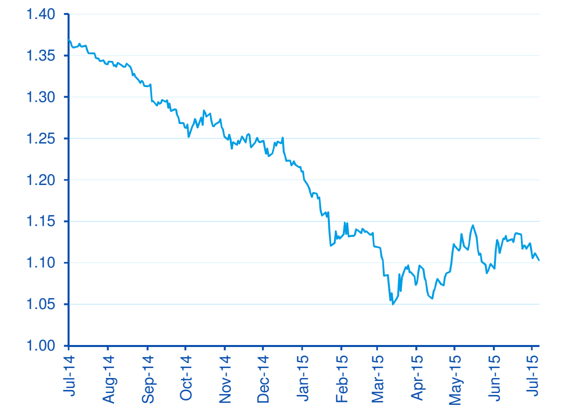


Source: National treasuries and BBVA Research

b) Impact on the exchange rate

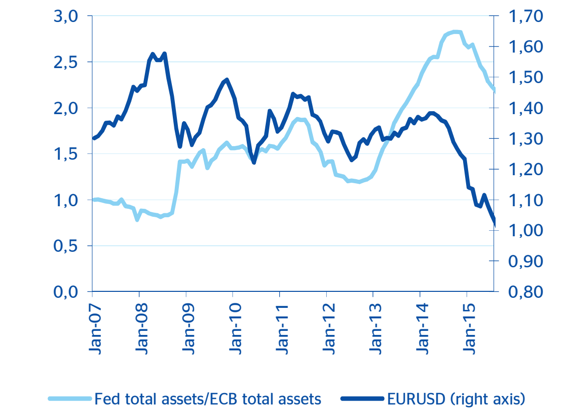
The euro has held within a narrow band in the past month (1.10-1.13). The greater emphasis on gradualism in the Fed's cycle of rate hikes has supported the euro somewhat, despite the intensification of the Greek crisis.

Figure 14
EUR/USD



Source: Bloomberg and BBVA Research

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

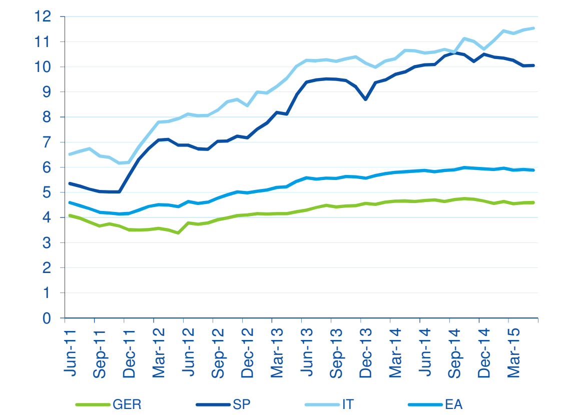


Source: Bloomberg and BBVA Research

c) Holdings of sovereign bonds by financial institutions

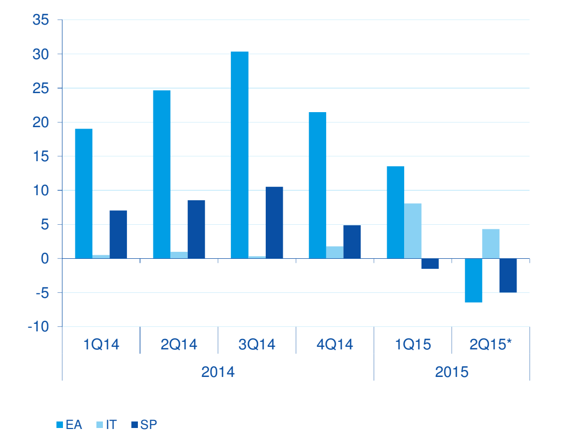
According to the data published by the ECB on holdings of eurozone sovereign bonds by financial institutions, eurozone institutions (with the exception of Spain and above all Italy) continued to offload sovereign bonds in May. Thus, for the eurozone as a whole, financial institutions shed EUR10.9bn of their sovereign bond holdings, which was significantly more than in the previous month, when they cut their holdings by EUR2.1bn. The fall in May was mainly instigated by French institutions, which brought down their holdings by EUR11.6bn, followed by German and Irish entities. For their part, Italian and Spanish institutions lifted their bond-holdings by EUR5.1bn and EUR0.9bn respectively.

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) * April and May data



Source: ECB and BBVA Research

Are the ECB's measures working?

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

The economic climate continues to improve, despite the resurgence of the Greek crisis. The confidence and activity indicators suggest that the growth rate will have consolidated in 2Q15, shored up by both domestic and external factors. On the one hand, private consumption remains robust, although growth could ease off a little after its fine performance since mid-2014, whereas exports seem to be recovering after a poor start to the year, in April standing at 3.3% above 1Q15 and with orders from abroad still on the rise, possibly lured by euro depreciation.

Based on the information available to date, the MICA-BBVA short-term model estimates quarterly GDP growth of 0.4%/0.5% QoQ for 2Q15, in line with our baseline scenario of growth of 1.6% for 2015 as a whole. Uncertainty has nonetheless increased significantly after the latest developments in the Greek crisis, which could finally hit the confidence of economic agents, primarily as regards short-term investment decisions.

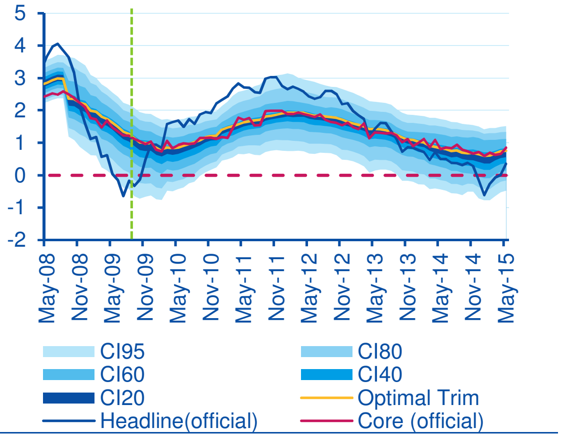
With respect to movements in prices, inflation slipped back by 0.1pp to 0.2% YoY in June, owing to the fall of energy prices and the slowdown in services inflation. This was visible in lower core inflation (-0.1pp) which came down to 0.8% YoY, which implies that the higher than expected increase in May could have been due to seasonal factors (tourist packages, above all in Germany).

Meanwhile, the risk of deflation continues to wane, as indicated by the fall in the percentage of the consumption basket that shows negative monthly rates (swda) lasting over a period of 6-12 months, which is now at under 3.4% relative to a historical average of 2.4%.

Going forward, we are standing by our scenario of a very gradual rise in headline inflation over the next few months, while core will remain relatively stable. This is in line with our trimmed means model for the EMU as a whole (using data up to May), as it shows an improvement in trend inflation, which stands at 0.8% YoY, in step with core inflation. Our models suggest that inflation could rise slightly to around 0.5% YoY during 3Q15, while core will hold relatively stable at around 0.8% YoY. The disappearance of base effects in connection with energy prices at the end of the year could be reflected in a greater upturn in inflation of over 1% in December. The economy's recovery is modest though, while free of inflation pressure too, which means that we expect annual average inflation to be a little shy of 1.5% in 2016, after marking just over 0% this year.

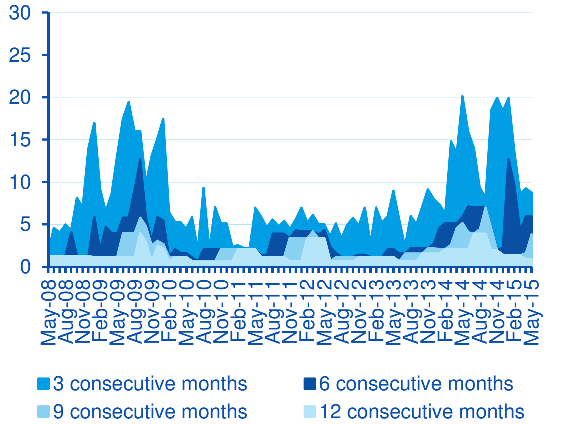
With regard to the inflation expectations discounted in the market, measures such as the 5Y5Y inflation swap spent the whole of June at over 1.75%, although this has shown quite a bit of volatility, and in the last few weeks it has topped 1.8%.

Figure 18
Headline, core and trend inflation (% YoY)



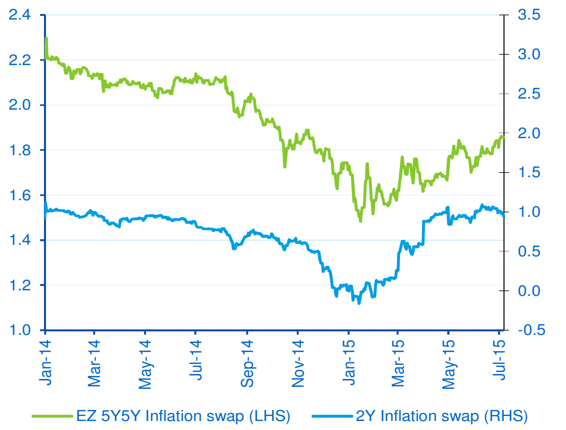
Source: Bloomberg and BBVA Research

Figure 19
Percentage of HICP goods with negative monthly rates (swda)



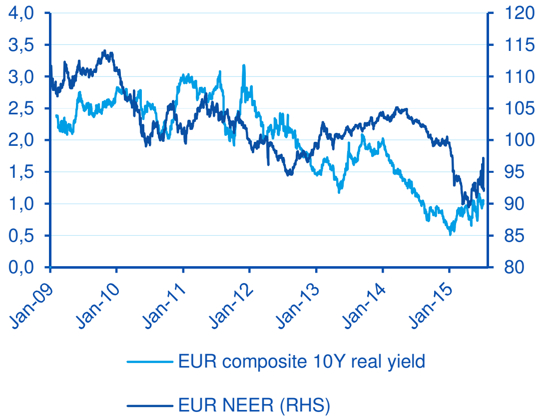
Source: Bloomberg and BBVA Research

Figure 20
Eurozone: Implied inflation expectations in the markets



Source: Bloomberg and BBVA Research

Figure 21
Tightening of financial conditions



Source: Bloomberg and BBVA Research

Conclusion: our take on the past month of sovereign bond purchases by the ECB remains positive. The central bank achieved its monthly purchasing target (EUR62.9bn) and more in June, as it did in May, but thus far there has been no pick-up in buying. The recent statements by the central bank maintain its firm commitment to full implementation of the measures and at its June meeting it even reminded us of the possibility of taking further measures if necessary. In the current climate of heightened uncertainty, not just because of the Greek situation and its possible impact on the rest of the eurozone, but also on account of other global risk factors, it is important to dispel any expectations of an early withdrawal of stimuli. More than this, the ECB should stress that the bias is instead in the other direction, i.e. it will take matters further if required.

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