CENTRAL BANKS

Monitoring ECB balance sheet expansion (July 2015)

Financial Scenarios / Europe Unit

- **In July, the purchase programme involving both public and private assets slightly surpassed the stated monthly target of EUR60bn, with EUR61.3bn of assets acquired and still a clear bias in favour of purchasing public bonds (80%). There was no let-up in purchasing in the month as a result of a summer lull in issuance, as some members of the ECB had been expecting.**
- **Developments in the Greek crisis have influenced the trend in interest rates and risk premiums on the European periphery. Even so, the contagion has been limited and no distortion of European treasury funding programmes has been discernible. On the other hand, inflation expectations have sagged marginally under pressure from commodity prices.**
- **The message from the ECB continues to be one of ample support, which is especially important in the current climate, where uncertainty is running high, not just on account of the Greek situation but also because of other risk factors of a global nature.**

ECB monetary expansion measures

a) Asset purchase programme: As happened in the two preceding months, the purchase programme for assets (both public and private) beat its stated monthly target of EUR60bn in July, although it did so to a lesser extent.

In the first five months of the programme, the ECB acquired EUR249.5bn of public sector bonds under its Public Sector Purchase Programme (PSPP), as well as EUR52.8bn in securities as part of its Covered Bond Purchase Programme (CBPP3) and EUR6.3bn via its Asset-Backed Securities Programme (ABSPP). Specifically, in July, as occurred in May and June, the ECB's purchases marginally exceeded the set target, though less so, as it bought assets worth EUR61.3bn, 80% of which was in sovereign bonds. The ECB is therefore on the way to achieving the expected balance sheet expansion of EUR1.1trn by September 2016.

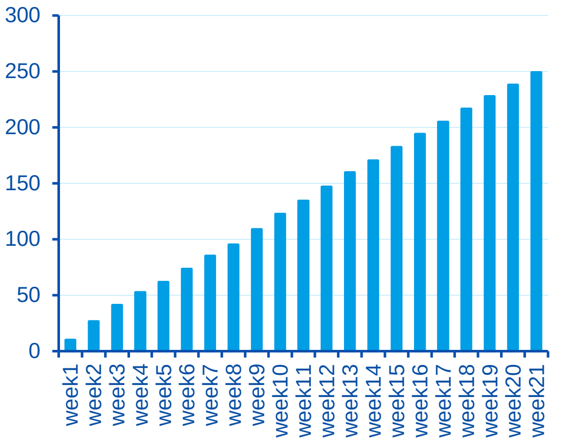
a.1) Public sector purchase programme

In July, the ECB purchased sovereign bonds to the value of EUR45.1bn, with a share by country that was practically in line with the ECB's capital key, although this takes account of a marginal adjustment to allow for it not purchasing bonds from Greece (this month, bonds from Cyprus were purchased, although the quantity involved was very small, at EUR0.098bn). 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 monthly buying in May and June (EUR45.4bn and EUR45.2bn respectively). Thus, contrary to what was announced, the purchasing in July was no lower as a result of any shortage of sovereign issues, just as there was no speeding up of buying in May and June (frontloading) either, which certain ECB members had been anticipating. In this context, in the minutes of their July meeting, the ECB members underlined the fact that the PSPP is flexible enough to be adapted, should the need arise.

With respect to the maturity of the debt securities acquired up to July, it is similar to those in the purchases over the first four months of the programme, with the average for the buying standing at eight years, which is below the average for euro area bonds that are eligible under QE (9.1 years). By country, the maturities in the sovereign bond purchasing were notably longer among those in the countries on the periphery, such as, for example, Portugal (10.6 years), Ireland (9.8 years) and Spain (9.7 years), with higher values compared to the maturities on their eligible debt (9.1 years in Spain, 8.0 years in Portugal and 8.9 in Ireland). This trend is partly due to the PSPP's own limitations, as, with respect to the periphery countries, the ECB has bonds that were acquired 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 towards the longer terms.

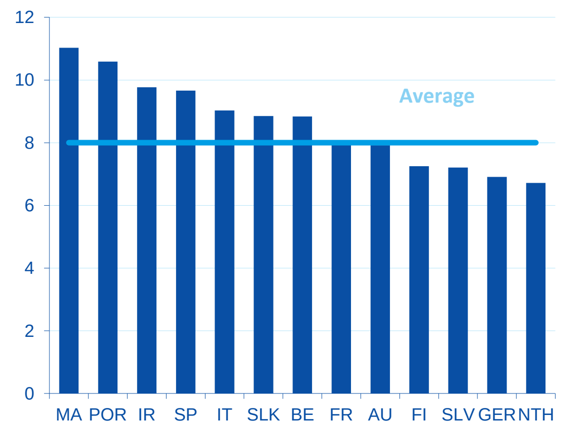
As regards buying of bonds issued by supra-national organisations and agencies, purchases last month were EUR6.3bn, which represents 12% of the total bonds acquired, meaning that the ECB has once again used up its maximum purchasing allowance established under the programme's initial conditions.

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)

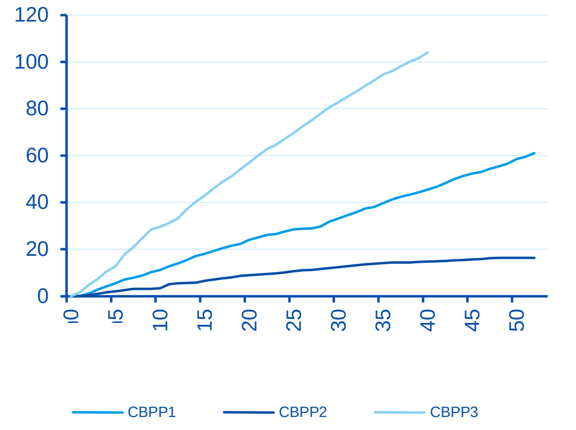


Source: ECB and BBVA Research

a.2) Private sector asset purchase programme

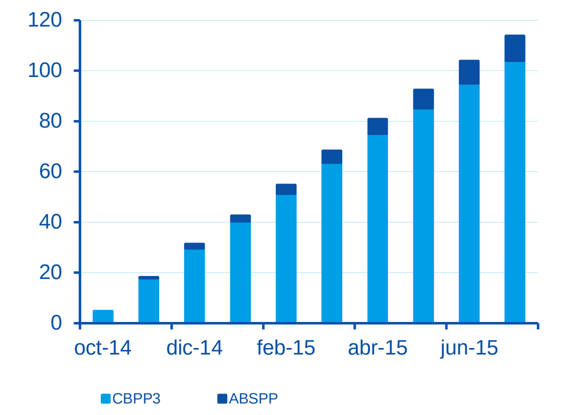
Under the private sector asset purchase programme, the ECB acquired securities worth EUR9.9bn in July, which is slightly below the average of EUR12bn for purchases since both programmes (ABSPP and CBPP3) have been in effect. July buying under CBPP3 amounted to EUR9bn, while purchases under ABSPP came to EUR0.9bn. Within the programme to date, covered bonds worth EUR104bn have been acquired (the programme began in October), along with EUR9.7bn in asset-backed bonds (the programme started in November). According to the way these programmes (ABSPP and CBPP3) were designed, the ECB can carry out its purchasing activity in both the primary and secondary markets, although the bulk of the purchasing (80%) under both programmes has taken place in the secondary market.

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

Table 1
QE measures (EUR bn)

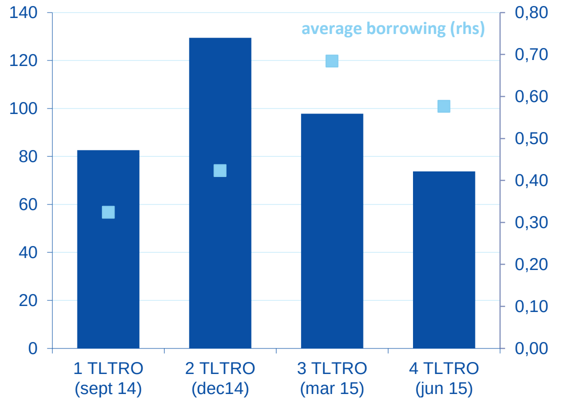
	Sept14	Oct14	Nov14	Dec14	Jan15	Feb15	Mar15	Apr15	May15	June15	July15
TLTROs	82.6			130.0			97.8			73.8	
CBPP3		4.8	13.0	11.8	10.6	11.0	12.4	11.5	10	9.9	9.0
ABSPP		0.0	0.4	1.0	0.6	1.1	1.2	1.2	1.4	1.6	0.9
PSPP							47.4	47.7	51.6	51.4	51.4

Source: ECB and BBVA Research

c) The Eurosystem's regular open market operations

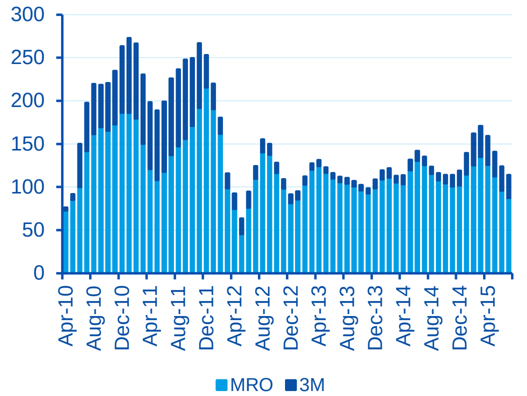
In July, as in the last three months, the liquidity allotted in the weekly main refinancing operations (MROs) and monthly auctions (3M LTROs) has fallen off. This currently stands at around EUR115bn, which is a shade below the 2014 average (EUR120bn), after the rise experienced in January and February on account of LTROs with a three-year maturity falling due (banks switched to regular operations).

Figure 5
TLTROs (EUR bn)



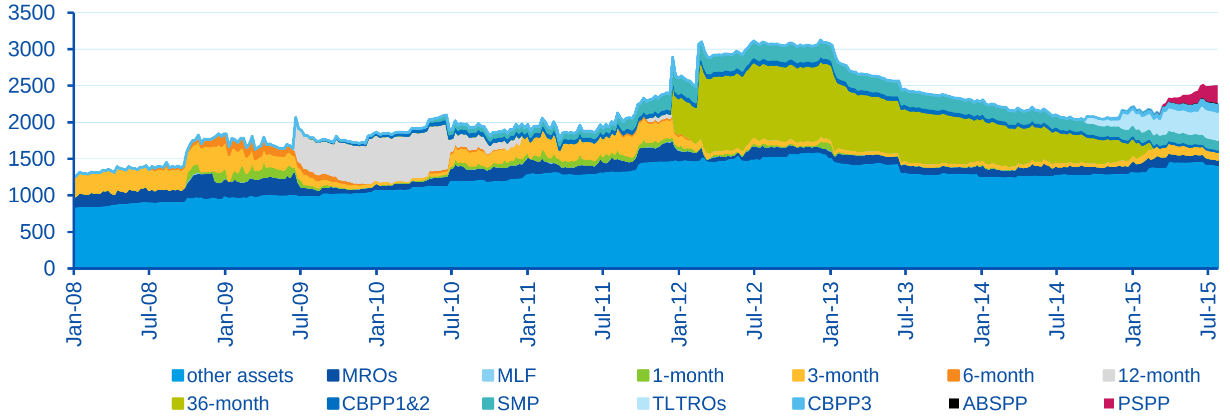
Source: ECB and BBVA Research

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

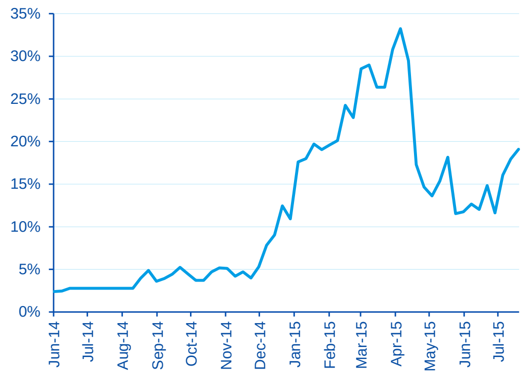
a.1) Impact on sovereign bond interest rates

Developments in the Greek crisis represent the factor which has continued to influence trends in interest rates in the euro area. July has thus been a volatile month for rates on Europe's periphery. The increased likelihood of Grexit caused interest rates and risk premiums on the periphery to continue to rise in the first part of the month. Nonetheless, this movement was limited. We still think that following this moderate spillover from Greece there is clear underlying belief that the ECB will use all the tools at its disposal to head off an escalation of fragmentation in markets in the euro area. Even though, for the time being, the ECB has not significantly speeded up its purchasing programme, the markets are confident that the monetary authority would either use it more flexibly (by increasing the amount involved or even by redistributing purchases across the various countries) or employ other available means

(OMTs) should the need arise. Nonetheless, in the second part of the month, interest rates on the periphery shrank back significantly (the 10-year rate came down by over 40bp in Spain and Ireland, and by 50bp in Italy), while risk premiums narrowed by slightly less (between 25 and 35bp). Two factors lie behind this behaviour. First, there has been a decrease in the risk of Grexit after the Greek parliament gave its blessing to the measures stipulated by the European creditors, which paved the way for Europe to grant a bridging loan to Greece, that averted a default on the debt, and also for negotiations on a new bailout to get underway. Second, the fresh signs that point to the slowdown in the Chinese economy being potentially more severe than was forecast have prompted heightened risk aversion and a flight to safe-haven assets, which has exerted downward pressure on interest rates on debt worldwide.

The easing of interest rates, which was brought about by both the calming of the Greek crisis and the rise in the global risk premium, has encouraged a slight increase in the number of bonds showing negative yields (upward of 19% vs. 12%). Nonetheless, unlike in the opening months of implementation of the bond purchase programme, it is now only the bonds with higher credit standings and, fundamentally, those at the shorter end, which are exhibiting negative yields, for which reason the ECB can be relatively comfortable with the present pace of programme execution.

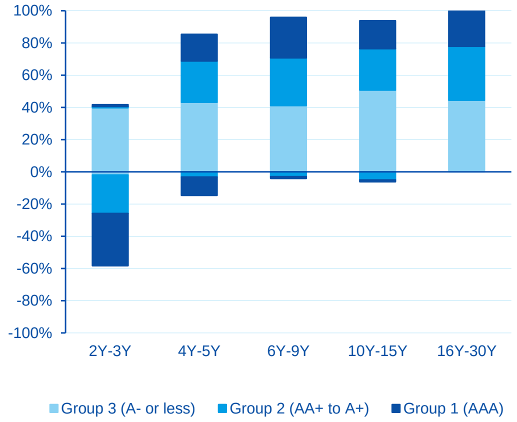
Figure 8
% of sovereign bonds* (euro area) with negative interest rates out of total debt



*Eligible under the PSPP

Source: Bloomberg and BBVA Research

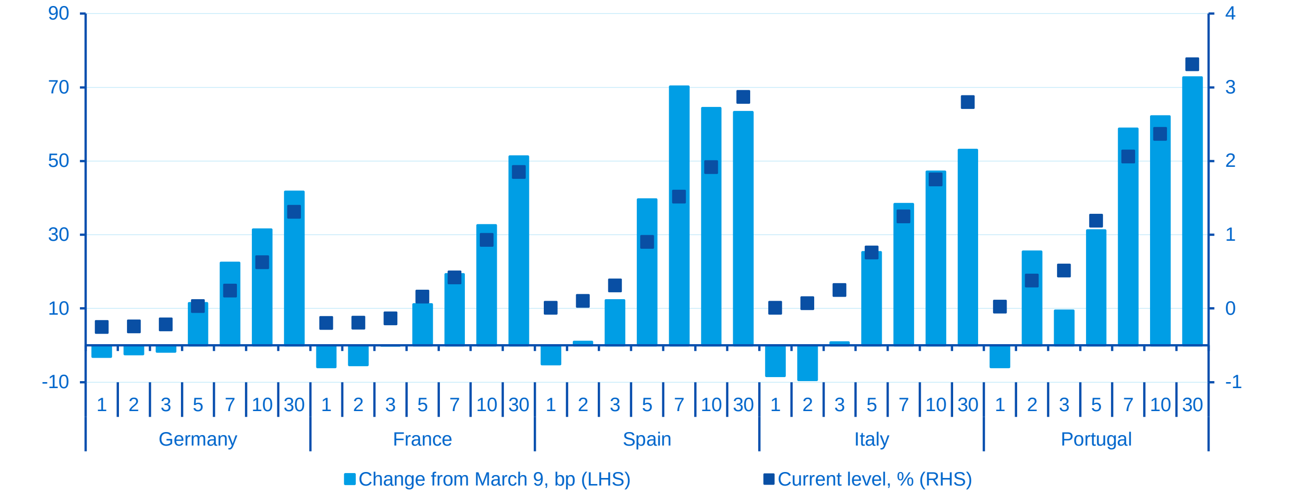
Figure 9
% of sovereign bonds* (euro area) with positive/negative interest rates by country rating.



*Eligible under the PSPP

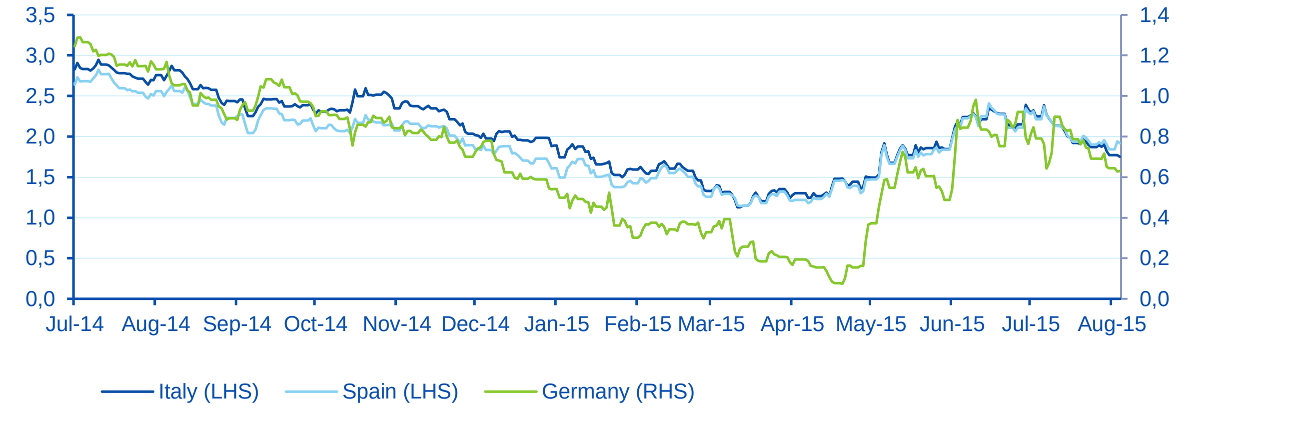
Fuente: Bloomberg and BBVA Research

Figure 10
Euro area: sovereign bond curves: current level (%) and change since the start of QE



Source: Bloomberg and BBVA Research

Figure 11
10-year bond yields (%)



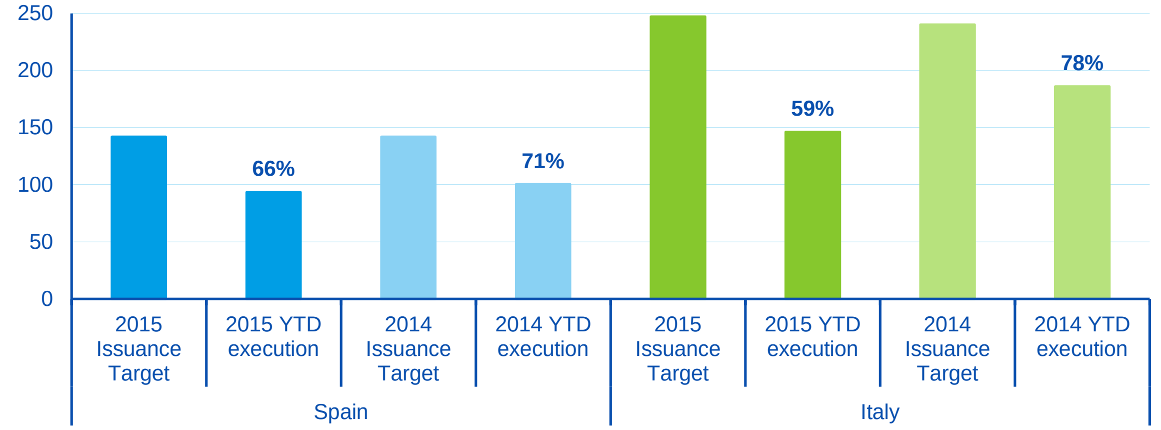
Source: Bloomberg and BBVA Research

a.2) Sovereign bond issuance: the rate of issuance came down in July, in line with the lower volume in the summer months

The rate of medium- and long -term debt issuance in Spain and Italy came down slightly in July, in line with the lull in activity typical of sovereign issuance over these summer months. In Spain's case, the Treasury has already issued 69% of its initially planned total gross bond issuance within the medium to long maturity category (EUR142bn). We can report that the rate of issuance is high and very similar to last year (71%). Moreover, the Spanish government has scaled down its net issuance requirement by EUR2bn, and so the total amount of issuance executed could be close to 70% of the final issuance requirement. In Italy's case, the rate of execution of medium- and long-term bond issuance is lower than it was last year (59% in 2015 vs. 78% in 2014).

We can thus claim that the Greek crisis is not having a significant effect on the issuance rate among the periphery countries.

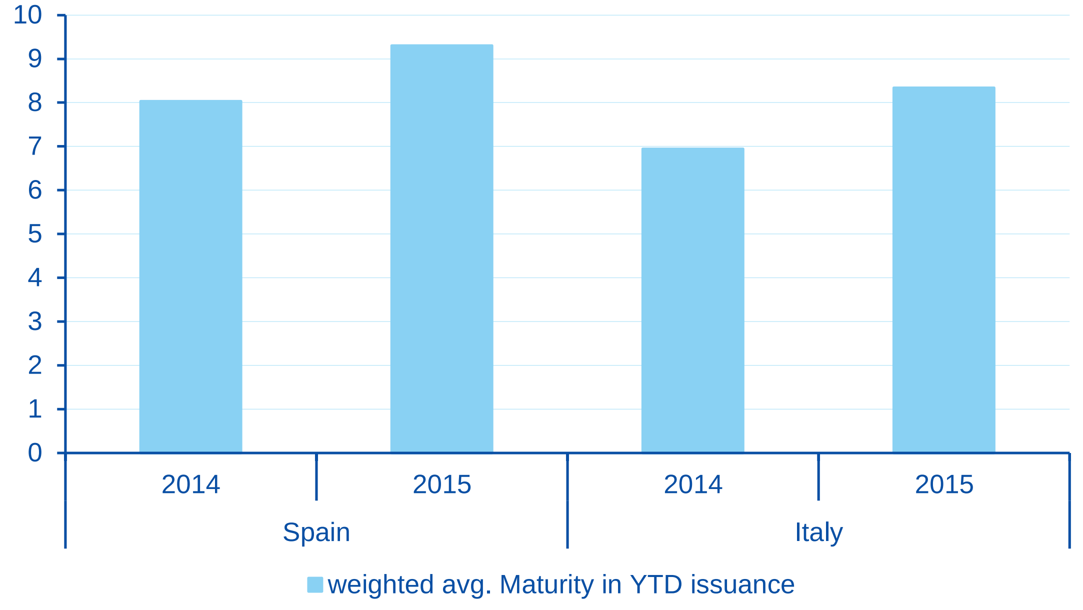
Figure 12
Spain and Italy: gross sovereign bond issuance as of 31 July (EUR bn and % of annual gross issuance target)



Source: National treasuries and BBVA Research

Both Spain and Italy continue to raise the average maturity of their new issues. In cumulative terms, the average life of new medium and long term debt issued in 2015 is above the level in 2014 (see Figure) at 9.2 years in Spain and 8.2 years in Italy.

Figure 13
Spain and Italy: average maturity of new issues as of 31 July 2015

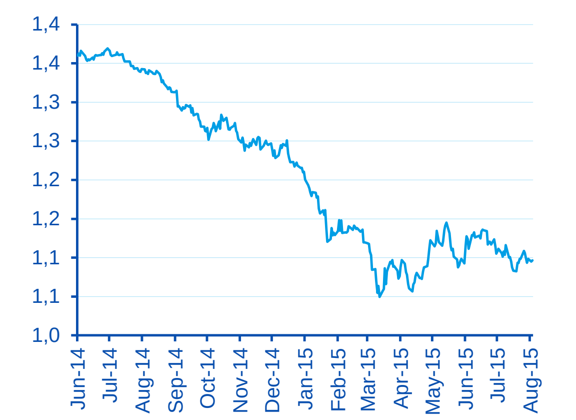


Source: National treasuries and BBVA Research

b) Impact on the exchange rate

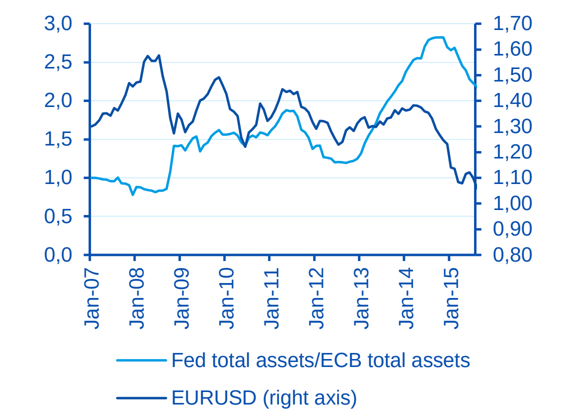
The euro has held within a narrow band in the past month of July (1.08-1.11), being somewhat weaker than in June. It has stuck to the same script with respect to the Greek crisis, where it has appreciated with strained situations in Greece and depreciated when these have calmed a bit. The euro's current status as a funding currency could be behind this pattern whereby, when there are bouts of jitters, flows towards the euro accelerate, whereas a fall in risk aversion encourages investors to finance themselves in euros at low rates and invest in higher-return currencies, which causes the euro to depreciate.

Figure 14
EUR/USD



Source: Bloomberg and BBVA Research

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

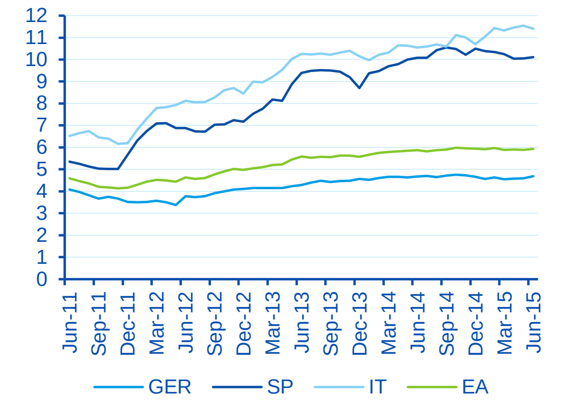


Source: Bloomberg and BBVA Research

c) Holdings of sovereign bonds by financial institutions

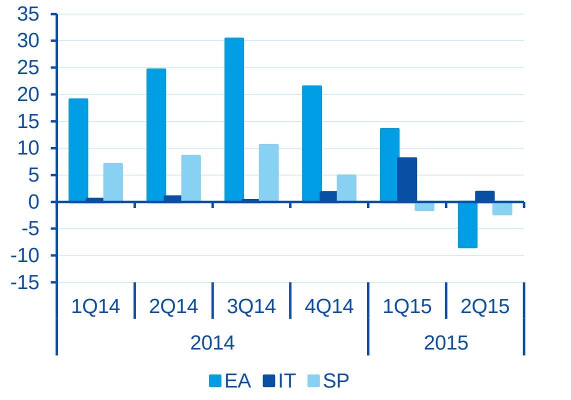
According to data published by the ECB on holdings of euro area sovereign bonds by financial institutions, euro area institutions (with the exception of Spain and Belgium) continued to offload sovereign bonds in June. Thus, for the euro area as a whole, financial institutions shed EUR12.7bn of their sovereign bond holdings, in line with the figure of the previous month, when they cut their holdings by EUR10.3bn. The drop in June was mainly instigated by French institutions, which reduced their holdings by EUR13.5bn, followed by Italian and German entities. The Italian institutions trimmed their holdings by EUR3.2bn, while their Spanish counterparts lifted their bond holdings by EUR3.1bn. On average over Q2, Spanish institutions scaled down their holdings by EUR2.3bn and Italian entities raised theirs by EUR1.8bn.

Figure 16
Sovereign bonds held by financial institutions out of total banking assets (%)



Source: ECB and BBVA Research

Figure 17
Sovereign bonds held by financial institutions (quarterly average, EUR bn)



Source: ECB and BBVA Research

Are the ECB's measures working?

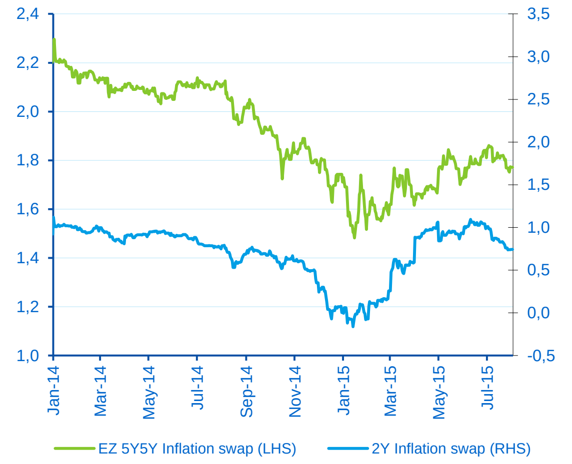
The ultimate aim of the ECB's unconventional measures (TLTROs and ABS, CB and public sector bond purchases) is to bring inflation back on target.

The latest activity figures suggest that internal components should have continued to support recovery in Q2, though somewhat less effectively than they had in Q1. Nonetheless, the external sector should be back to contributing positively to growth following the disappointing performance by exports at the start of the year. All things considered, our short-term MICA-BBVA model estimates quarterly GDP growth of 0.4% QoQ in 2Q15 for the euro area. For Q3 we only have the July confidence figures so far, both those from the European commission and the PMIs, which looked relatively stable and indicate a very minimal impact from the escalation of the Greek crisis in June and July and a degree of stabilisation in the GDP growth rate early on in 3Q15. That said, unlike the gentle rise in the economic sentiment indicator, which was buoyed by improved services sector and industry expectations, the composite PMI edged back and could be conveying doubts over the slowdown in global demand, especially from the emerging economies. This impact of lower demand from outside could vary in the region's different countries. Germany could have lost a bit of traction (above all because of the fall in orders from outside) whereas France still shows signs of weakness, although the pace of growth seems to be holding up on the periphery.

With respect to price movements, inflation remained stable in July at 0.2% YoY, in line with expectations, since the fall in energy product prices and the easing of those of foodstuffs, especially in the non-processed component, was offset by the slight rise in inflation experienced by services and non-energy industrial goods. Core inflation thus picked up by 0.1pp to 0.9% YoY, which could be a partial reflection of healthier domestic demand and some pass-through from the euro depreciation over the past year. Going forward, we still expect inflation to stay relatively stable or rise gently in Q3, and it will not be until Q4 when a greater upturn becomes noticeable, up to a rate of around 1%, due to the fading out of the base effects from energy prices (after the plunge in the latter part of 2014), thereafter arriving at an annual average of about 0.3% for 2015 as a whole. Even so, recent trends in commodity prices, and oil in particular, give a downward bias to inflation trends in the short term. For 2016, inflation will remain clearly below the ECB's target rate and we expect it to show an annual average reading of 1.3%.

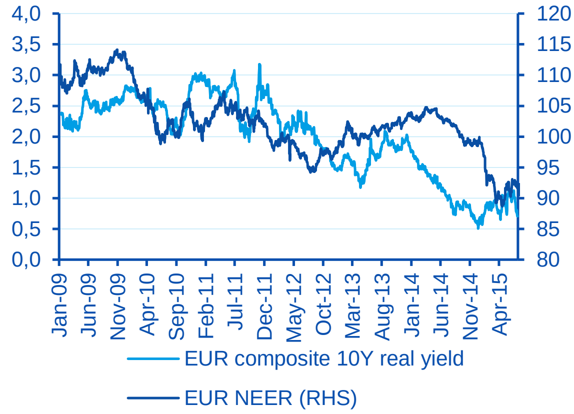
With respect to inflation expectations factored in by the market, indicators such as the 5y5y inflation swap have stuck to a mildly downward trend in July, under pressure from the new uncertainty surrounding commodity prices. They nonetheless stand at around the 1.74% mark, which is higher than the level in early May.

Figure 18
Euro area: implied expectations in the markets



Source: Bloomberg and BBVA Research

Figure 19
Tightening of financial conditions



Source: Bloomberg and BBVA Research

Conclusion: the take on the past month of ECB sovereign bond purchases continues to be a positive one. The central bank beat its monthly purchasing target in July (EUR61.3bn), as it did in May and June, so there has been no drop in buying levels over the month, owing to a lack of issuance of the kind that had been envisaged by certain ECB members. In the July monetary policy meeting, Mr Draghi was adamant about fully implementing the QE plan. In our opinion, the ECB's message remains one of adequate support, which is especially important in the present climate in which uncertainty is riding high, not just because of the Greek situation but also due to other risk factors of a global nature.