CENTRAL BANKS

Monitoring ECB balance sheet expansion (August 2015)

Sonsoles Castillo / Agustín García / Miguel Jiménez / María Martínez / Cristina Varela

- **In August, the purchase programme involving both public and private financial assets failed to meet the stated monthly target of EUR60bn, with EUR51.6bn in assets acquired and still a clear bias in favour of purchasing public sector bonds (80%). There was less purchasing this month owing to a summer lull in issuance, as certain members of the ECB had anticipated which had been made up for by higher purchasing levels in previous months. Over the first six months of the programme, the stated target of EUR360bn was thus actually achieved.**
- **This month, the ECB made a technical adjustment to one of the programme parameters and raised the percentage upper limit that can be purchased in any single issue from 25% to 33%.**
- **Risk premiums on the European periphery have continued to show restraint and public debt issuance programmes have not been disrupted by the environment of volatility and risk aversion that developed in August.**
- **In this setting, the ECB has underlined its message of being committed to the present programme and emphasised its willingness to apply the flexibility which it provides for. Consistent with our inflation forecasts, which have been revised down a fraction on the lower oil price, we are still expecting convergence to the target in the next two years. We therefore do not anticipate any changes to the ECB's purchasing programme.**

ECB monetary expansion measures

a) **Asset purchase programme:** The public and private asset purchase programme failed to reach the stated monthly target of EUR60bn in August, in contrast to the previous three months, in which it topped the set target

In the first six months of the programme, the ECB acquired EUR291.7bn of public sector bonds under its Public Sector Purchase Programme (PSPP), EUR60.2bn[1] in securities as part of its Covered Bond Purchase Programme (CBPP3) and EUR7.6bn[2] via its Asset-Backed Securities Programme (ABSPP). Specifically in August, for the first time since the programme's inception, the ECB purchased securities to a value below its set target of EUR60bn. In exact terms it acquired EUR51.6bn, of which 80% was in sovereign bonds. This fall-off in the purchasing level had been anticipated by the ECB to allow for the drop in liquidity in the summer months, and so the August decrease was virtually offset by frontloading (speeding up of purchasing) over May to July. The ECB is therefore still on the way to achieving the expected balance sheet expansion of some EUR1.1trn in September 2016.

1: EUR111.5bn since the programme came into effect in October 2014.
2: EUR11.1bn since the programme came into effect in November 2014.

a.1) Public sector purchase programme

In August, the ECB purchased sovereign bonds (including bonds of supranational organisations and agencies) to the value of EUR42.8bn, 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 the non-purchase of bonds from Greece[3]. This amount is substantially less than was acquired over May to July (EUR51.5bn on average). As was mentioned previously, this was because of the summer holiday period, as in August there are fewer issues and there is greater market volatility.

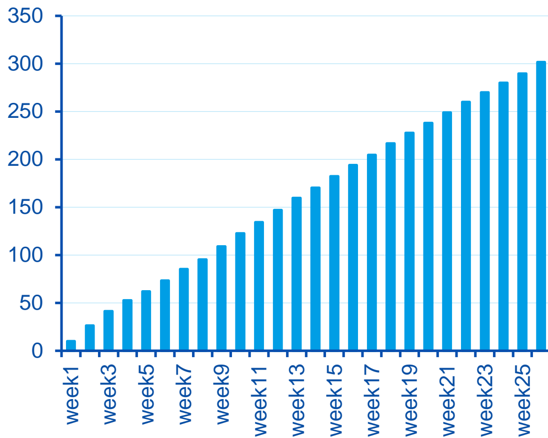
Against this backdrop, at their September monetary policy meeting the ECB members stressed and reiterated that the PSPP provides sufficient flexibility, in terms of adjusting the scale, structure and duration of the programme, to be able to adapt it if this is called for. In connection with this, the central bank announced a slight change to the asset purchase programme at the meeting. The modification allows it to buy a larger amount of any single bond issue and raises the initial limit from 25% to 33% (subject to verification on a case by case basis that this increase does not create a situation in which the Eurosystem might represent a blocking minority). The ECB said that this measure is for the purposes of implementing the current programme without causing any alarm so as to achieve its target of EUR60bn. Besides giving the ECB more room to find liquidity in its current purchasing and greater flexibility to take advantage of more liquid bonds, this shows a commitment by the central bank to maintaining an accommodative monetary policy.

With respect to the maturity of the debt securities acquired up to August, this is similar to that in purchasing over previous months, with the average standing at 8 years, which is below the average for euro area bonds that are eligible under QE (9.1 years). By country, maturities were still noticeably longer in the sovereign bond purchasing in the periphery countries, such as, for example, Portugal (10.7 years), Ireland (9.7 years) and Spain (9.7 years), with longer terms compared to the maturities on their eligible debt (9.1 years in Spain, 8 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 Market Programme), with shorter maturities (2-3 years) and thus the current purchasing has become skewed towards the longer terms.

As regards the buying of bonds issued by supra-national organisations and agencies, purchases last month were EUR5.4bn, 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.

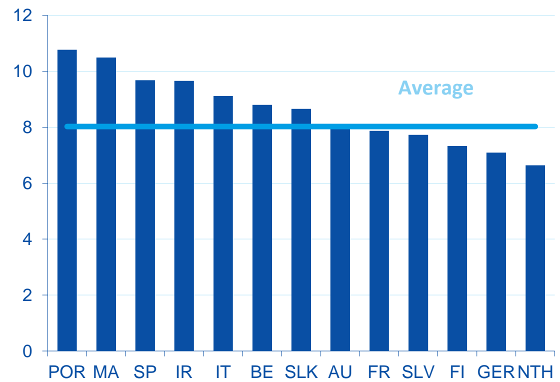
3: According to what Mr. Draghi said at the last press conference, Greece does not meet the criteria for starting bond purchases.

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)

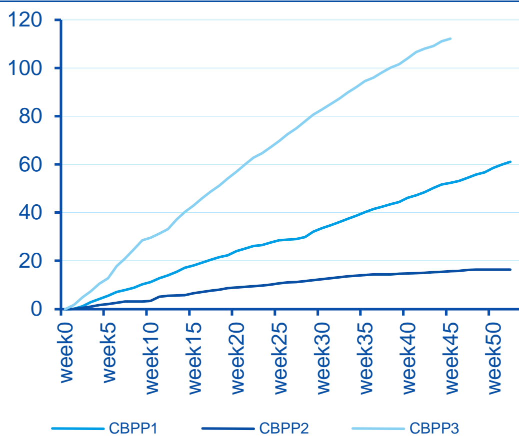


Source: ECB and BBVA Research

a.2) Private sector asset purchase programme

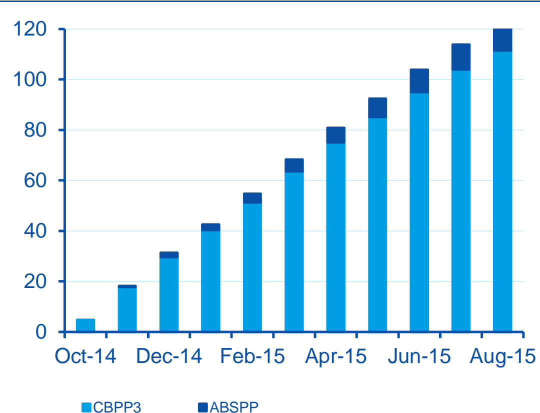
In August, under the private sector asset purchase programme, the ECB acquired securities worth EUR8.8bn, which is far below the average of EUR12bn for purchases since both programmes (ABSPP and CBPP3) have been in effect. August buying under CBPP3 amounted to EUR7.46bn, while purchases under ABSPP came to EUR1.35bn. Within the programme to date, covered bonds worth EUR111.5bn have been acquired (the programme began in October), along with EUR11.1bn 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% is thought to have been bid for by periphery country institutions. The next auction is due to be held on 24 September. An influential factor in the take-up of liquidity at this auction might be the recent tightening in the financial markets, as was recently suggested by Peter Praet, member of the Executive Board of the ECB. 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)

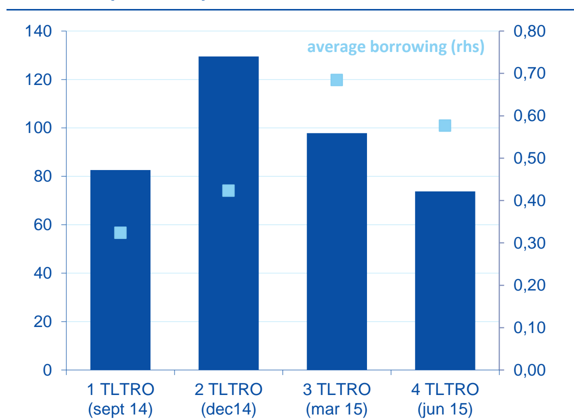
	Sept14	Oct14	Nov14	Dec14	Jan15	Feb15	Mar15	Apr15	May15	June15	July15	Aug15
TLTROs	82.6			130.0			97.8			73.8		
CBPP3		4.8	13.0	11.8	10.6	11.0	12.4	11.5	10	9.9	9.0	7.5
ABSPP		0.0	0.4	1.0	0.6	1.1	1.2	1.2	1.4	1.6	0.9	1.3
PSPP							47.4	47.7	51.6	51.4	51.4	42.8

Source: ECB and BBVA Research

c) The Eurosystem's regular open market operations

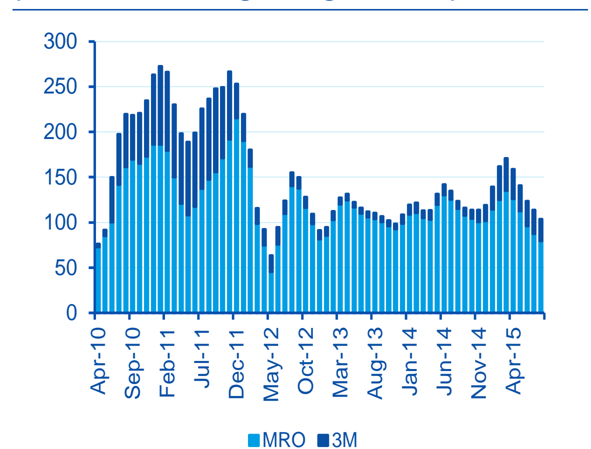
In August, as in the last four months, the liquidity allotted in the weekly main refinancing operations (MROs) and monthly auctions (3M LTROs) has fallen off. On average over last month, bidding in the weekly auctions came down to around EUR75bn, which is significantly below the average for the year (EUR110bn). On the other hand, bids in three-month auctions, 3M LTROs, also dropped off. The stock in auctions of this type is EUR70bn and has also fallen below the average for the year (EUR90bn). Liquidity in such auctions has diminished considerably in the second and third quarters of the year, following the rise experienced in mainly January and February, due to the falling due of the three-year LTROs (institutions switched to regular operations).

Figure 5
TLTROs (EUR bn)



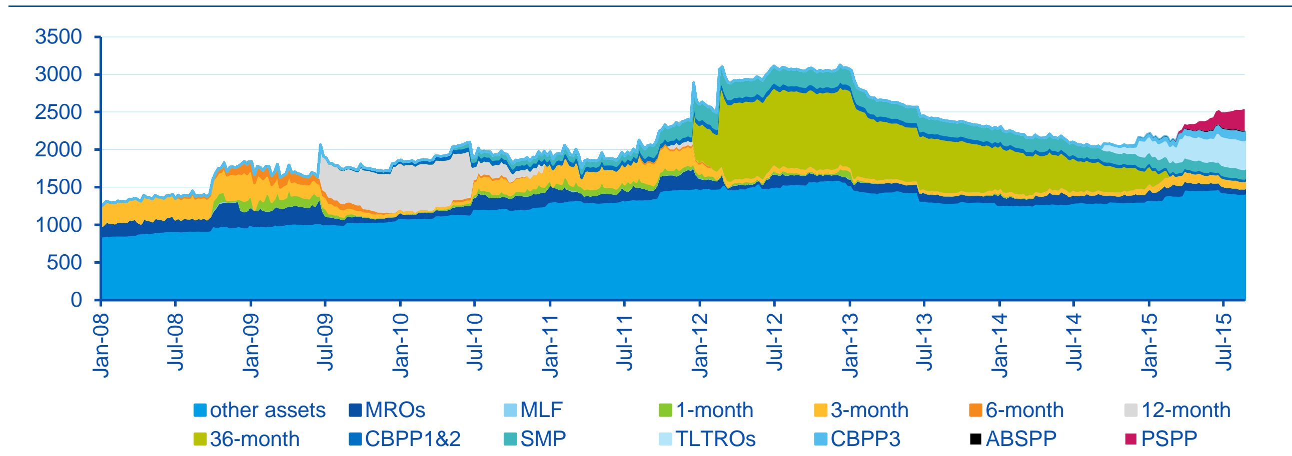
Source: ECB and BBVA Research

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



Source: Bloomberg and BBVA Research

Figure 7
ECB balance sheet (EUR bn)



Source: ECB, Bloomberg and BBVA Research

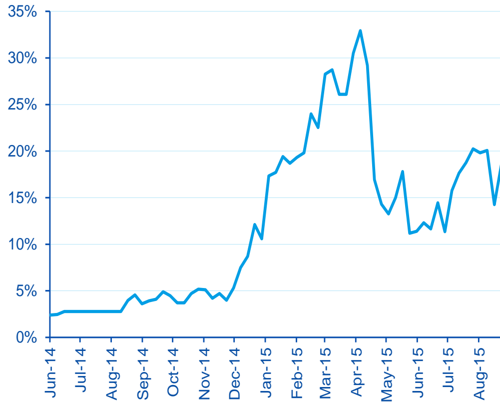
Impact on assets

a.1) Impact on sovereign bond interest rates

In August, and especially in the second half of the month, the markets (mainly emerging) saw wild volatility, triggered by concerns over growth in China. This behaviour was magnified due to the imminence of the potential hike in rates by the Federal Reserve (Fed), after over six years at historical lows, and plunging commodity prices, notably that of oil. These factors were conducive to increased risk aversion and greater switching into safe-haven assets, which applied moderate downward pressure on debt interest rates worldwide. The emerging markets have been the area most affected, although European markets were also hit by potential spill-over from a slowdown in the EMs. With respect to interest rates in Europe and within this context, the Bund held at an average of around 0.65% over August, exhibiting a fair amount of volatility (0.8-0.56%). On the other hand, interest rates on the European periphery rose, although not significantly, during the latter part of the month, owing to the rise in risk aversion, although these movements eased in the last week, especially in Italy and not so much in Spain.

With these developments, the number of bonds with negative yields held stable at around 20% in August. Even so, in contrast to the opening months of the bond-purchasing programme, it is now only the bonds with a higher credit rating, and essentially those at the shorter end, which are displaying these negative yields. The ECB can therefore rest relatively easy, given the current pace of execution of the programme.

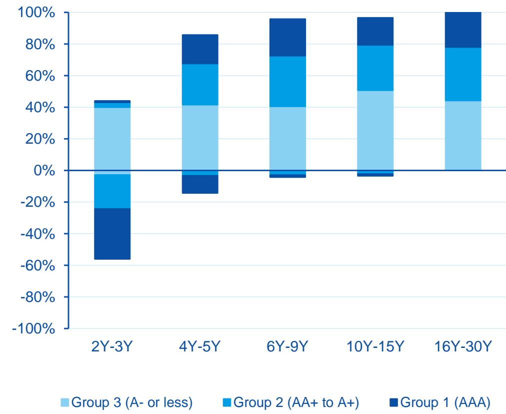
Figure 8
% of sovereign bonds* (euro area) with negative interest rates out of total debt



*Eligible under the PSPP

Source: Bloomberg and BBVA Research

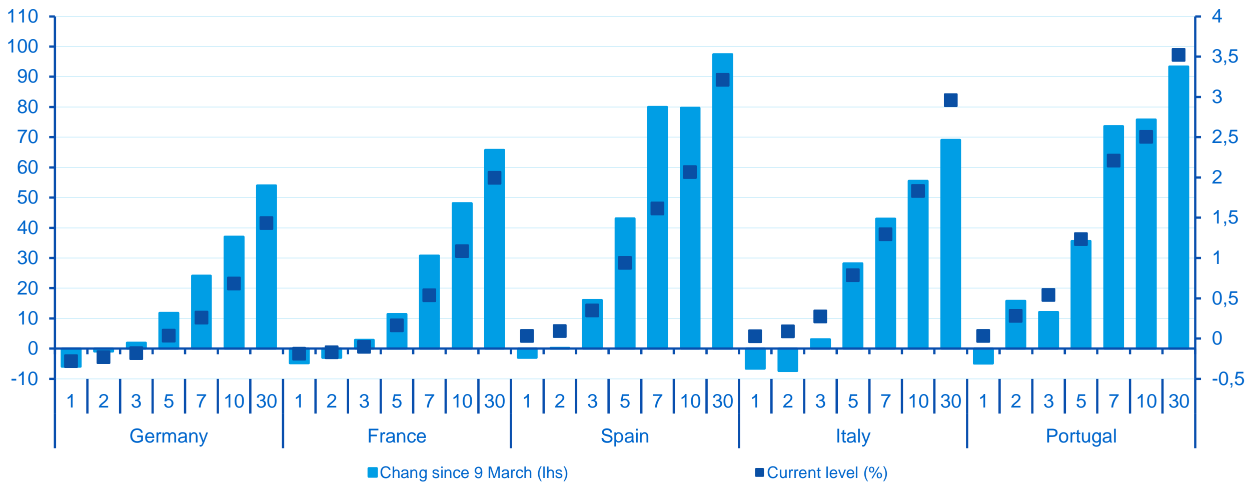
Figure 9
% of sovereign bonds* (euro area) with positive/negative rates by country rating.



*Eligible under the PSPP

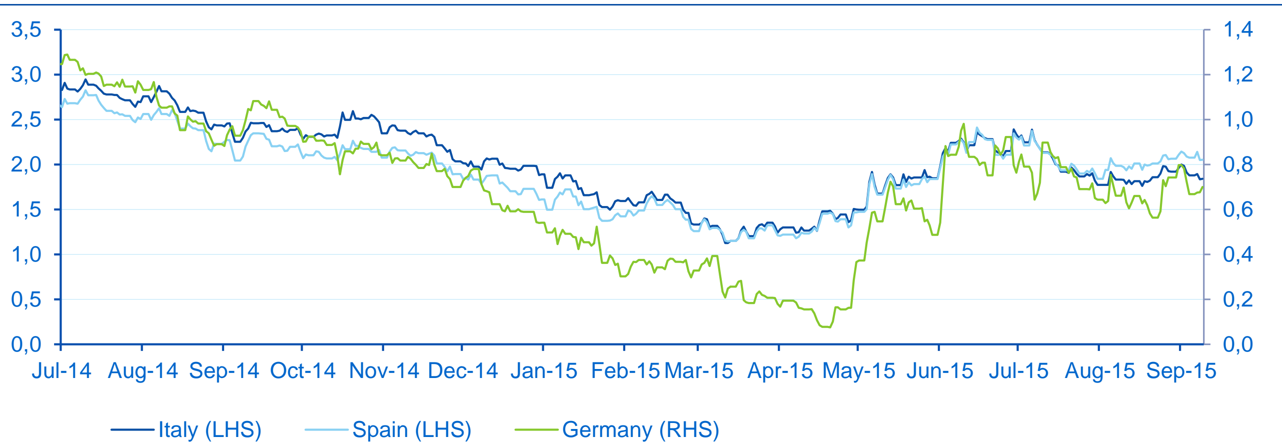
Source: Bloomberg and BBVA Research

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 (%)

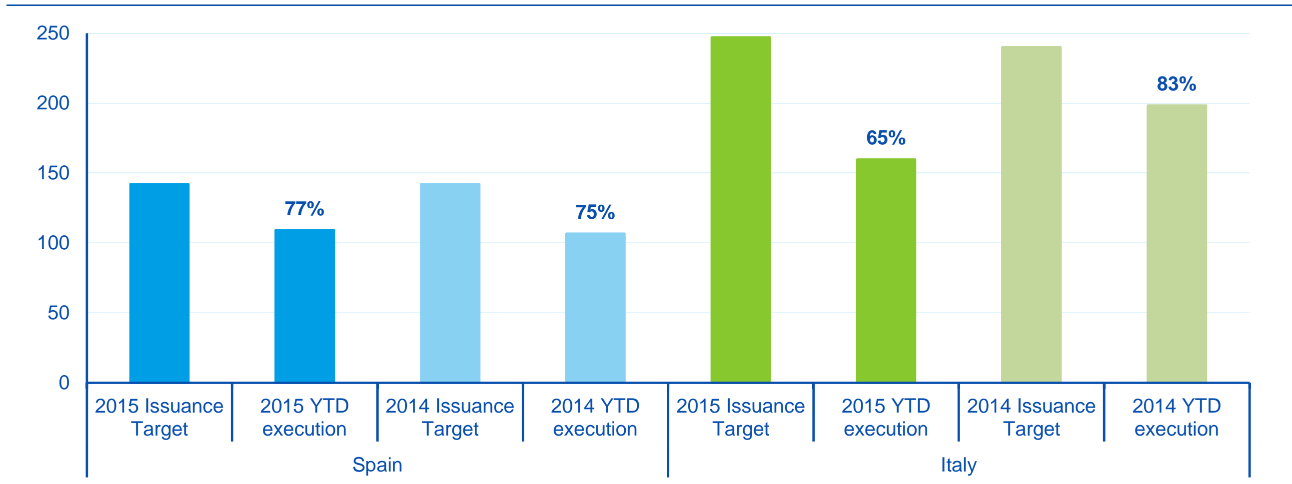


Source: Bloomberg and BBVA Research

a.2) Sovereign bond issuance: The rate of sovereign bond issuance remained positive in August

Spain picked up the pace of its Treasury bond issues in August. The Treasury carried out the two bond auctions scheduled for August. This was in contrast to patterns in previous years, when the Treasury would opt to call off one of the two planned auctions due to the low volume of trading that was typically recorded in August. So far this year, the Treasury has issued USD109bn in medium- and long-term bonds, which represents 77% of gross issuance of medium- and long-term bonds envisaged for 2015 (EUR142bn, which has recently come down to EUR140bn). Thus, despite the new bouts of risk in Greece and the uncertainty prior to the Autumn elections, in 2015 execution of the long-term financing requirements has surpassed levels seen in the same period in 2014 (75%). In general, the rate of execution of issuance targets is positive among the periphery countries. As regards Portugal, the Treasury has already achieved the issuance target planned for this year of EUR14bn, whereas in Ireland the execution rate for forecast issues stands at 69%. However, Italy has provided the note of discord, with an issue execution rate that is still below the level of last year (65% vs. 83% in 2014) and short of the European average of 71%. Whatever the case, the low extent of execution does not owe itself to any lack of demand, but instead could be a result of the financing strategy chosen by the Italian Treasury, given that Italy slowed down its rate of issuance in May after the sharp upturn in yields to wait for borrowing costs to remit again. We can therefore expect it to step up its issue rate again in the next few months. To conclude, we can say that neither the Greek crisis nor the increased risk aversion arising over the extent of the slowdown in China's economy have significantly affected the funding programmes of Treasuries.

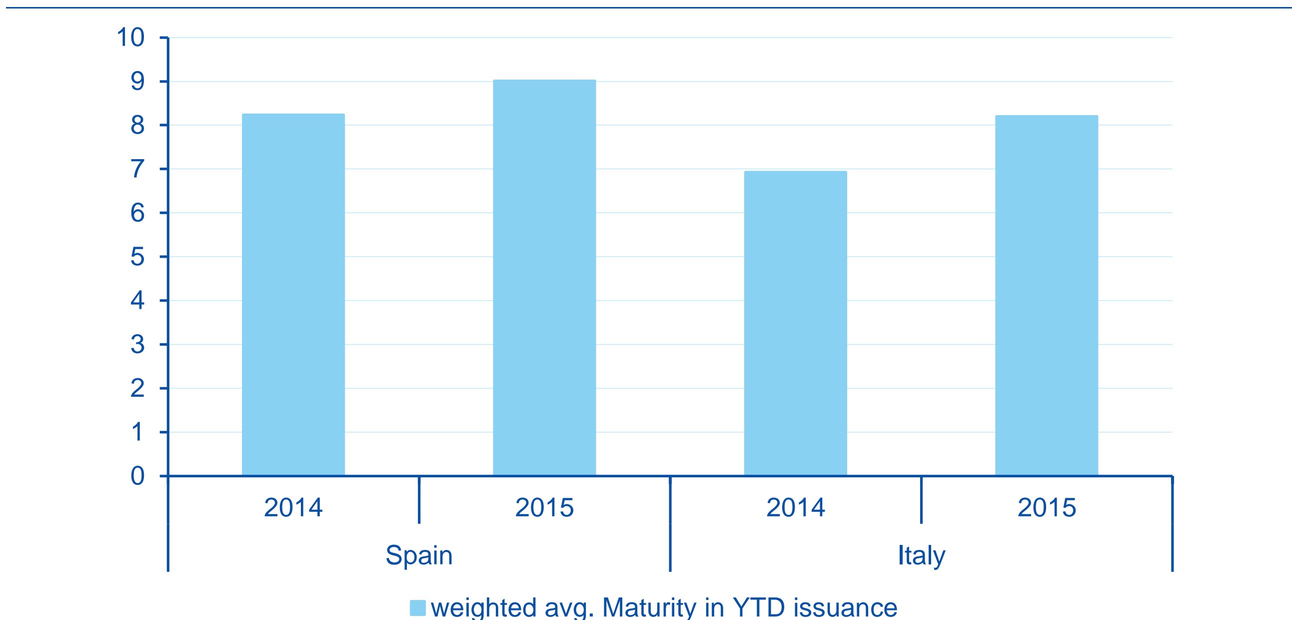
Figure 12
Spain and Italy: Gross sovereign bond issuance as of September 9 (EUR bn and % of annual gross issuance target)



Source: National treasuries and BBVA Research

For both Spain and Italy the average maturity of new issues is longer than in 2014. In cumulative terms, the average maturity of new medium- and long-term debt issued in 2015 is longer than for 2014 (see Figure 13) at 9.0 years in Spain and 8.2 years in Italy, and only slightly below the average maturity for debt issued up to July of 9.3 years in Spain and 8.3 years in Italy.

Figure 13
Spain and Italy: Average maturity of new issues as of September 9 2015

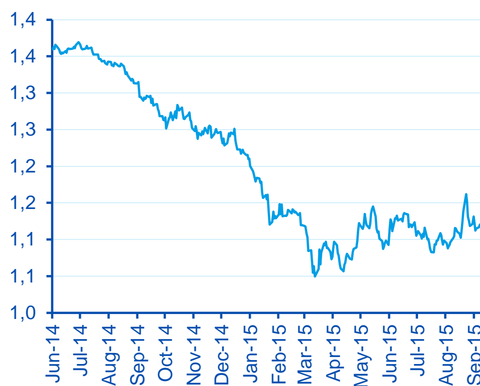


Source: National treasuries and BBVA Research

b) Impact on the euro exchange rate

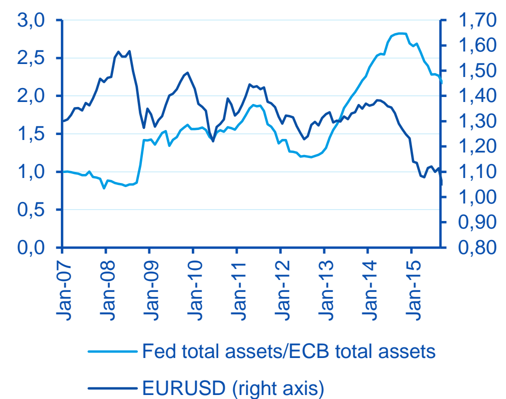
In August the euro seems to have consolidated at a level above USD1.11. Moreover, with the afore-mentioned episode of risk aversion, the euro has gained in strength, hitting market levels of over USD1.16. The recent moderation of inflation expectations has not managed to dent the trend of greater euro strength either. This pattern could be due to two reasons: i) a lag in market expectations about the Fed hike, given that the correction of China's economy adds uncertainty over the global growth scenario, and ii) the euro's current status as a funding currency means that at times of tension inward flows increase, or long-term positions in investment currencies are closed, while a drop in risk aversion prompts investors to borrow at low rates in euros and invest in currencies offering higher returns, which depreciates the euro.

Figure 14
EUR/USD



Source: Bloomberg and BBVA Research

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

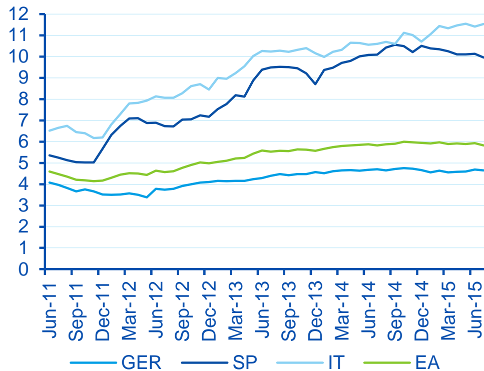


Source: Bloomberg and BBVA Research

c) Holdings of sovereign bonds by financial institutions

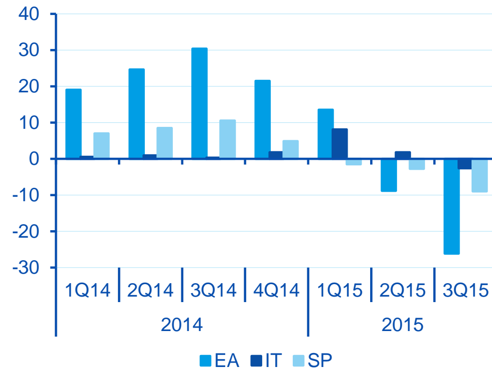
According to data published by the ECB on holdings of euro area sovereign bonds by financial institutions, euro area institutions (with the exception of Portugal) continued to offload sovereign bonds in July. Thus, for the euro area as a whole, financial institutions shed EUR26.1bn of their sovereign bond holdings, almost double the figure for the previous month, when they cut their holdings by EUR14.1bn. The drop in July was mainly instigated by Spanish institutions, which brought down their holdings by EUR9bn, followed by French and Italian entities. The French institutions trimmed their holdings by EUR7.1bn, while those from Italy scaled down their bond holdings by EUR2.6bn.

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) *3Q15 (July data)



Source: ECB and BBVA Research

The adjustment of their sovereign bond portfolios by Spanish institutions could run on over the next few months, given that the supply of Spanish paper should shrink over the rest of the year, unless the Treasury brings forward to 2015 the funding from issues planned for 2016 (as it has already done in the past two years). In line with Spain's gross issuance target in 2015 (EUR140bn), for the remainder of this year medium- and long-term debt issues should amount to EUR31bn. On the other hand, maturities that will fall due on debt are EUR14.5bn, which implies that net issuance will be EUR16.5bn. If the ECB keeps up its rate of purchasing, the monetary institution would have to buy up EUR22bn of Spanish debt, for which reason the supply of Spanish paper should fall off slightly over the rest of the year.

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 latest activity figures suggest that recovery is progressing at a relatively sound and steady pace in spite of the slowdown in global demand and the heightened uncertainty over how the emerging economies will fare in the coming quarters, given the doubts over China's economy, monetary policy decisions (mainly by the Fed) and lower commodity prices. In particular, the plunging oil price is behind the low inflation rate, which could even turn slightly negative in the coming months, although core inflation has ticked marginally upwards recently due to the recovery of domestic demand and depreciation of the euro.

The data from the National Accounts showed that GDP over the euro area as a whole grew 0.4% QoQ in 2Q15 after 0.5% in 1Q15, 0.1pp more in either quarter than was initially published, which was brought about by the solidity of private consumption and something of a recovery in exports, while the rate of import growth eased up. The latter could be associated with the poorer performance by investment, which contracted slightly and fuels doubts over the whether the recovery will gain traction over the remainder of the year. The few figures available for the third quarter (from confidence surveys) point to relative stability over the past three months or even something of an improvement, with a better performance by expectations in the services segment, which in part relates to the strength of domestic fundamentals. This improved showing has offset a mild deterioration in confidence in the industrial sector, although at the moment it seems that the doubts over China and the emerging economies are weighing down on expectations with respect to

production in the coming quarters. Using this information, the MICA-BBVA model estimates that GDP growth in the euro area should be about 0.4% QoQ for 3Q15.

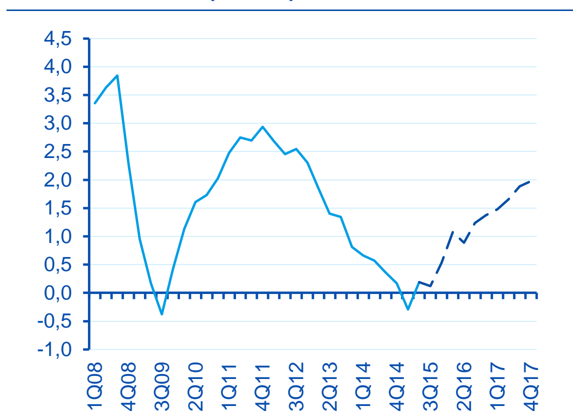
Despite such relative stability, last week the ECB revised its growth forecasts for the euro area as a whole down by 0.1pp for 2015 and 0.2pp in both 2016 and 2017 to 1.4%, 1.7% and 1.8% respectively. This revision was partly due to slightly lower growth than had been expected in June (with a carry-over effect of around 0.1pp by our calculations) and lower global demand (which should pare growth down by a further 0.1pp in the next two years). Given that the National Accounts revision shows slightly higher growth than was initially published in 1H15, and in line with our forecasts, we still expect growth of 1.5% for 2015 overall, although now recovery could stabilise at current levels of 0.4% QoQ, compared to our initial forecast of a pick-up in the second half, and this also increases risks to the downside regarding our growth forecast of 1.9% in 2016.

With respect to prices, both headline and core inflation held stable at 0.2% YoY and 0.9% YoY respectively in August, since the greater fall in energy product prices, together with the plunging oil price, was offset by a rise in food and non-energy industrial goods prices. Although, in general, inflation up to August has performed in line with forecasts, with certain surprises by components offsetting each other, we now expect oil prices to stand at around USD50/bbl at the end of 2015, USD60/bbl in 2016 and USD67/bbl in 2017 (a little more than 12% lower than our estimates three months ago), for which reason mildly negative inflation in the next two months cannot be ruled out, while we also now predict a smaller upturn in year-end inflation from a base effect for energy prices (after the sharp fall recorded in 4Q14). We are therefore revising our inflation estimates down by around 0.2pp for both 2015 and 2016, to 0.1% and 1.1% respectively, with a further 0.1pp for the forecast for 2017, to 1.7%, which are practically the same as those presented by the ECB last week (although their forecast was higher for next year, up from 1.5% in June). Despite this downward revision, which is basically due to the adjustment from the new developments in the oil price, we continue to expect inflation to move back towards the target in the next two years as does the ECB.

With respect to inflation expectations priced in by the market, indicators such as the 5y5y inflation swap were especially volatile in August, coming under pressure from the recent uncertainty surrounding commodity prices. They nonetheless stand at around 1.7%.

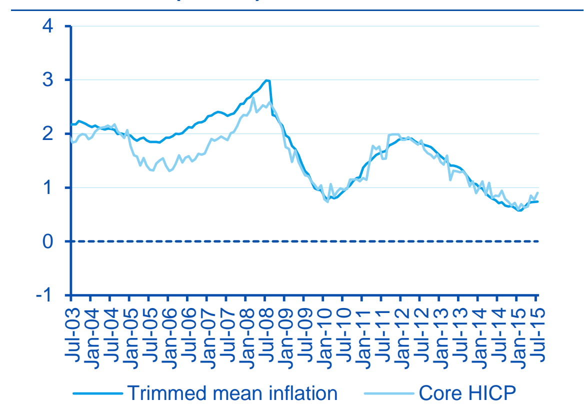
On the other hand, financial conditions have toughened in the last two months, especially last month. The rise in commodity prices, particularly oil, and a stronger euro, as well as higher real interest rates, have increased the risks to achieving a sustainable path for inflation towards 2%.

Figure 18
Inflation forecast (% YoY)



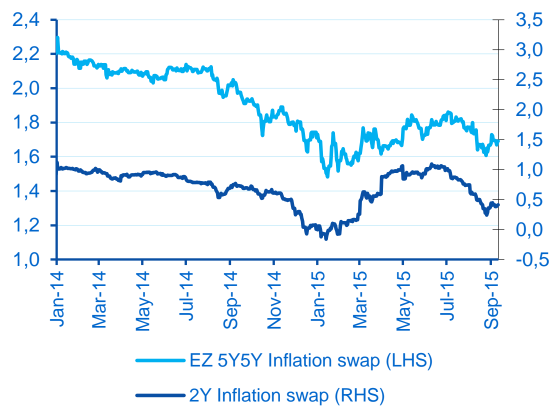
Source: Bloomberg and BBVA Research

Figure 19
Core inflation (% YoY)



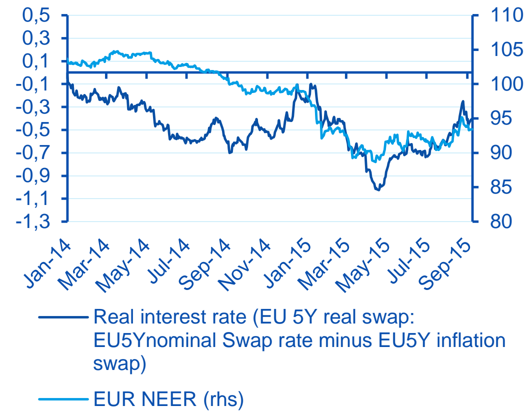
Source: Bloomberg and BBVA Research

Figure 20
Euro area: Implied expectations in the markets



Source: Bloomberg and BBVA Research

Figure 21
Tightening of financial conditions



Source: Bloomberg and BBVA Research

Conclusion: taken together, the first six months of the implementation of the ECB's programme as a whole are in line with forecasts, despite the isolated case of August when the monthly target was not reached. At its September monetary policy meeting, the ECB reinforced its message of being strongly committed to the current programme in the face of a climate of greater global uncertainty. It again insisted that it intends to see the asset purchase programme through to the end of September 2016, or indeed beyond this date if this is called for, and it stressed that adjustments can be made to it if this should prove necessary. Although the level of uncertainty is high and the risks remain to the downside, provided that growth stabilises in China and the major emerging markets (our central scenario), as well as in the financial markets, we think that the most likely scenario is that the ECB will wait and see, and therefore not alter its current purchase programme.

DISCLAIMER

This document has been prepared by BBVA Research Department, it is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

In regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions in the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. It is forbidden its reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process, except in cases where it is legally permitted or expressly authorized by BBVA.