CENTRAL BANKS

Monitoring ECB balance sheet expansion (September 2015)

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

- **In September, the purchase programme involving both public and private assets surpassed the stated monthly target of EUR60bn, with EUR63bn in assets acquired and still a clear bias in favour of purchasing public-sector bonds (80%).**
- **In an environment of an abundance of liquidity, the fifth TLTRO auction resulted in a very marginal take-up, of EUR15bn, which is far below both what had been expected and the levels of previous auctions.**
- **Interest rates on European debt are falling, on global cyclical uncertainty and lower inflation expectations. The percentage of European bonds with negative yields is on the rise. Periphery country risk premiums remain restrained.**
- **The ECB continues to underline its message of commitment to the present programme and emphasised its willingness to apply the flexibility which it provides, although it shows no signs of immediate action. Short-term inflation expectations have deteriorated in the past month, which adds bias towards a potential extension of QE. Even so, consistent with our forecasts for medium-term inflation, we are still expecting convergence towards the target in the next two years and we are standing by our central scenario of there being no changes to the ECB purchasing programme**

ECB monetary expansion measures

a) **Asset purchase programme:** The public and private asset purchase programme beat the set target with EUR63bn for the month in September, just as it had also surpassed the stated target between May and July, which served to make up for the lower purchases in August.

In the first seven months of the programme, the ECB acquired EUR340.9bn of public sector bonds under its Public Sector Purchase Programme (PSPP), EUR70.4bn[1] in securities as part of its Covered Bond Purchase Programme (CBPP3) and EUR9.6bn[2] via its Asset-Backed Securities Purchase Programme (ABSPP). Specifically, in September the ECB purchased slightly more than the set target, as it had done between May and July, buying EUR63bn of which 80% was in sovereign bonds. This step-up in purchases affords the ECB some margin in the coming months to buy a little less and still ensure that it meets its overall monthly target of EUR60bn. The ECB is therefore still on course to achieving the expected balance sheet expansion of some EUR1.1trn in September 2016.

In September, the ECB purchased sovereign bonds (including bonds of supra-national organisations and agencies) to the value of EUR51bn, with a share by country that was practically in line with the ECB's capital

1: EUR120.9bn since the programme came into effect in October 2014.
2: EUR13bn since the programme came into effect in November 2014.

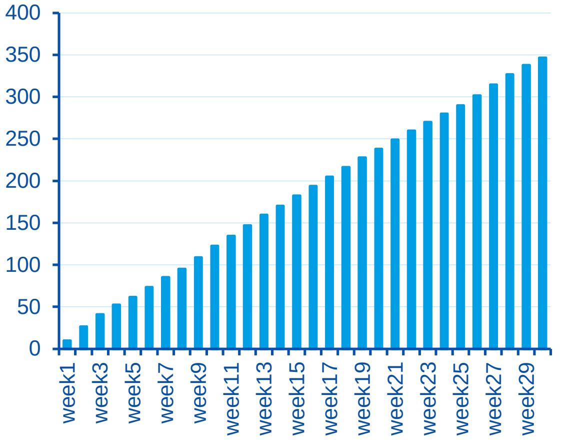
key, although this is taking account of a marginal adjustment to allow for the non-purchase of bonds from Greece[3]. This amount is in line with what was acquired over May to July (EUR51.5bn on average), when the monthly target was also topped.

In this situation, at the September monthly policy meeting and throughout the entire month the ECB Council members stressed and reiterated that the PSPP provides sufficient flexibility in terms of adjusting the scale, structure and duration of the programme to allow it to be adapted if this should be called for.

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 (10.9 years) and Spain (9.7 years), with longer maturities compared to those on their eligible debt (8 years in Portugal and 9.1 years in Spain). 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.

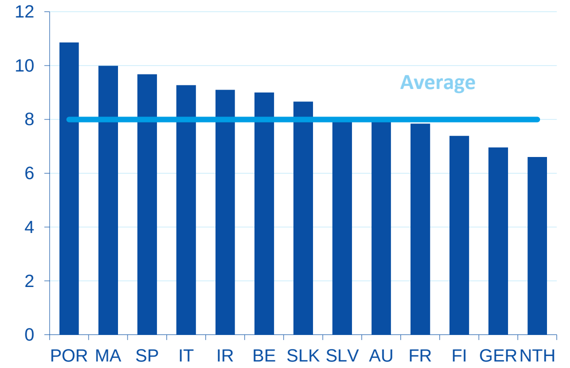
As regards buying of bonds issued by supra-national organisations and agencies, purchases last month were EUR6.3bn, which represents 12% of the total bonds acquired, meaning that the ECB has once again used up its maximum purchasing allowance established under the programme's initial conditions.

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

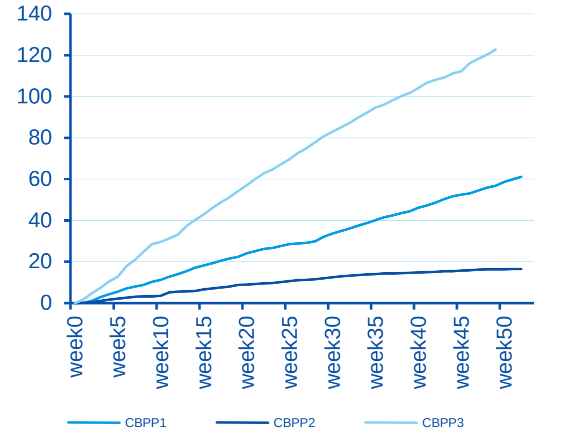
a.2) Private sector asset purchase programmes

In September, under the private sector asset purchase programme, the ECB acquired securities worth EUR12bn, which is in line with the average of EUR12bn since both programmes have been in effect (ABSPP and CBPP3). September buying under CBPP3 amounted to EUR10.1bn, while purchases under ABSPP came to EUR1.9bn. Within the programme to date, covered bonds worth EUR120.9bn have been acquired (the programme began in October), and EUR13bn in asset-backed bonds (the programme started in November). According to the way these programmes were designed (ABSPP and CBPP3), the ECB can

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

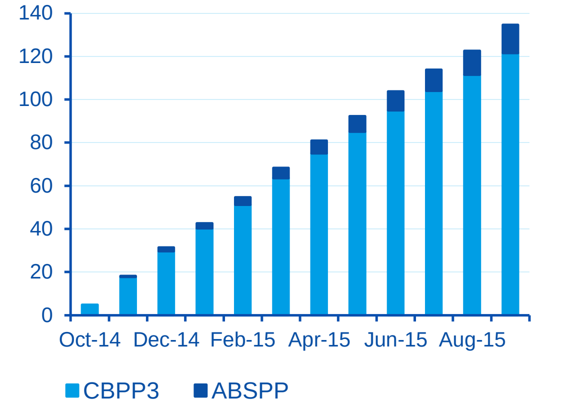
carry out its purchasing activity in both the primary and secondary markets, although the bulk of the purchasing (80%) under both programmes has taken place in the secondary market.

Figure 3
CBPPs
Cumulative weekly purchasing (EUR bn)



Source: ECB and BBVA Research

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



Source: ECB and BBVA Research

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

In the fifth TLTRO held on 24 September, demand was EUR15.5bn from 88 institutions (an average amount of EUR0.2bn each). This figure represents 4% of the potential maximum amount that could have been taken up according to our estimates (EUR400bn), which is substantially lower than analysts were predicting (an average range of EUR50-60bn). No information is yet available on the liquidity take-up by country, although an initial idea can be formed based on the release of the figures for borrowing from the central bank in September, which is expected from mid-October. This low take-up appears to be linked to an excess of liquidity in the system, although it could also suggest modest expectations of increasing credit in the future on the part of the banks. In the first five liquidity-providing operations, that are conditional upon developments in lending to the private sector excluding mortgage loans for housing purchases (TLTROs), a figure of EUR400bn 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 11 December. Monitoring these auctions is important, as they are a potential indicator of a recovery

Table 1
QE measures (EUR bn)

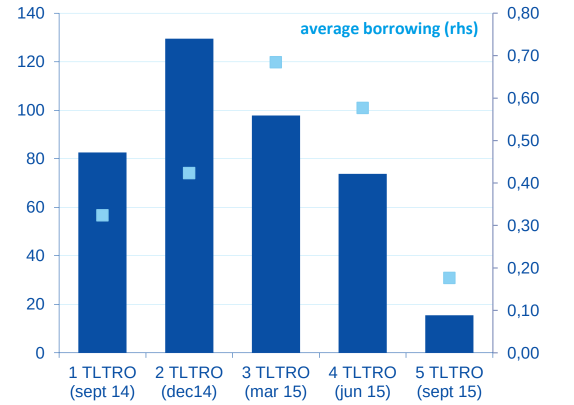
	Sep14	Oct14	Nov14	Dic14	Ene15	Feb15	Mar15	Abr15	May15	Jun15	Jul-15	Ago-15	Sep-15
TLTRO	82,6			130,0			97,8			73,8			15,5
CBPP3		4,8	13,0	11,8	10,6	11,0	12,4	11,5	10	9,9	9,0	7,5	10,1
ABSPP		0,0	0,4	1,0	0,6	1,1	1,2	1,2	1,4	1,6	0,9	1,3	1,9
PSPP							47,4	47,7	51,6	51,4	51,4	42,8	51

Source: ECB and BBVA Research

c) The Eurosystem's regular open market operations

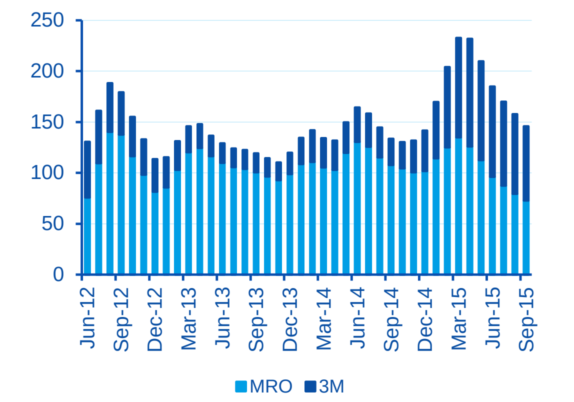
In September, as in the last five months, the liquidity allocated in the weekly main refinancing operations (MROs) and monthly auctions (3M LTROs) has fallen off. On average over the last month, bidding in the weekly auctions came down to around EUR75bn, which is significantly below the average for the year (EUR110bn). On the other hand, bids in the 3-month auctions, 3M LTROs, also dropped off. The stock in auctions of this type is EUR67bn and has also fallen below the average for the year (EUR90bn). Liquidity in such auctions diminished considerably in the second and third quarters of the year, following the rise experienced (mainly in January and February) owing to the falling due of the 3-year LTROs (institutions switched to regular operations).

Figure 5
TLTROs (EUR bn)



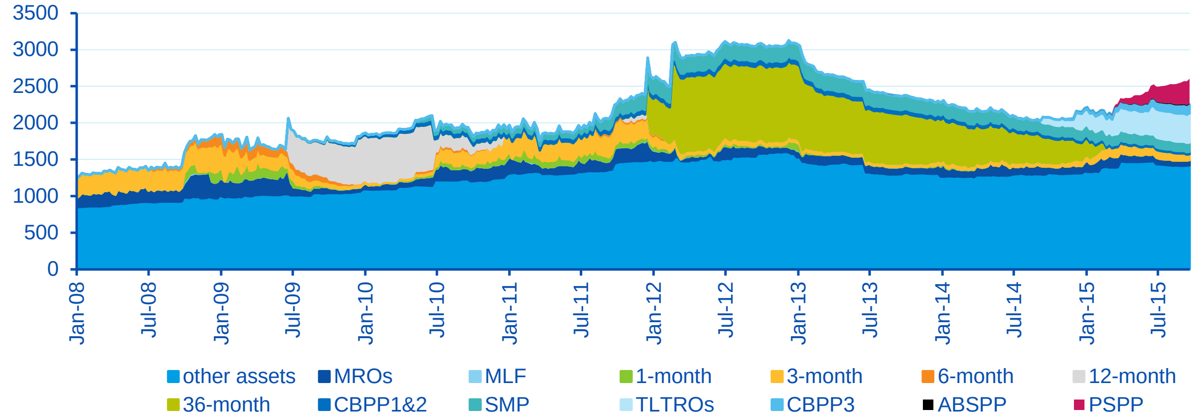
Source: ECB and BBVA Research

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



Source: ECB 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

Interest rates on European debt and risk premiums held relatively stable in the first part of September, in spite of the high volatility in markets given the uncertainty over the global cycle (the impact of China's slowdown), normalisation of the Fed's interest rates and election processes (Greece, Catalonia and Portugal). In the second part of the month and in the opening week of October, volatility abated and European interest rates generally came down following the Fed's decision to defer the first rate hike because of the drop in inflation expectations and the growing expectation in the market of an extension of quantitative easing by the ECB. The fall in interest rates was apparent all along the European curve and in all countries, more notably among those on the periphery. In Spain's case, the uncertainty prior to the Catalan elections gave rise to a poorer performance by its sovereign bonds compared to the others. In this situation the spread between Spain and Italy opened up to 24bp, a level not seen since mid-2013, but then closed the month at around the 14bp mark.

Over September, the percentage of bonds with negative yields rose considerably, to 25%. Nonetheless, unlike in the first few months of implementation of the bond-purchasing programme, it is currently only the bonds with a higher credit rating, and fundamentally at the shorter end, where these negative yields are being observed, for which reason the ECB can rest relatively easy about the present pace of the programme's execution.

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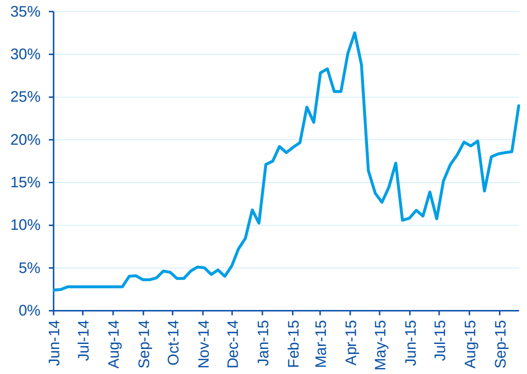
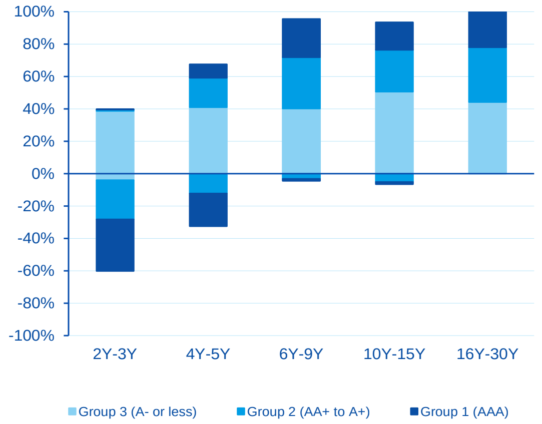
Figure 8
% of sovereign bonds* (euro area) with negative interest rates out of total debt



*Elegible under the PSPP

Source: Bloomberg and BBVA Research

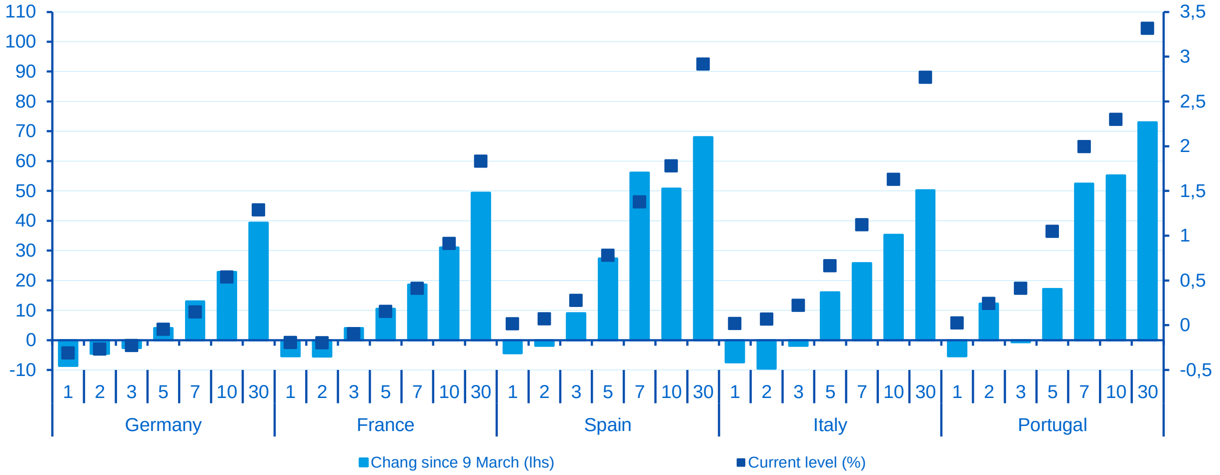
Figure 9
% of sovereign bonds* (euro area) with positive/negative rates by country rating.



*Elegible under the PSPP

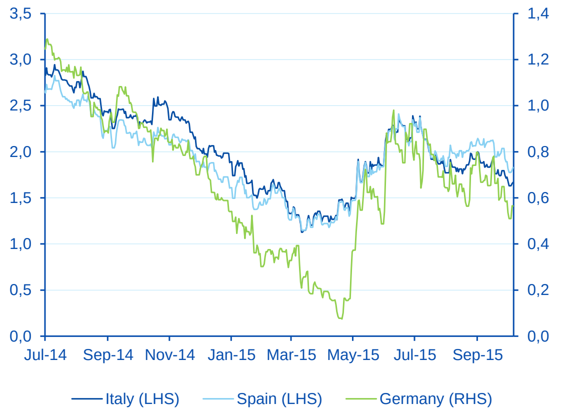
Source: Bloomberg and BBVA Research

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



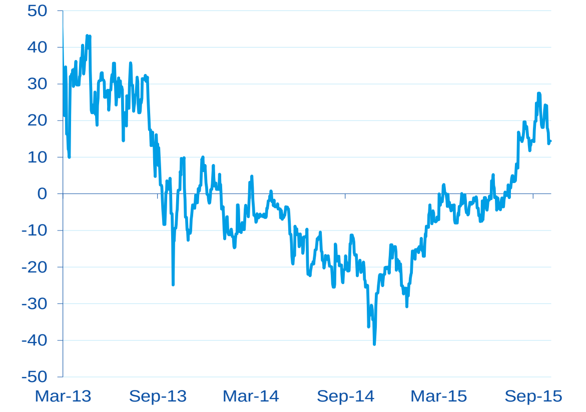
Source: Bloomberg and BBVA Research

Figure 11
10-year interest rates (%)



Source: Bloomberg and BBVA Research

Figure 12
10-year Spain/Italy bond spread (bp)



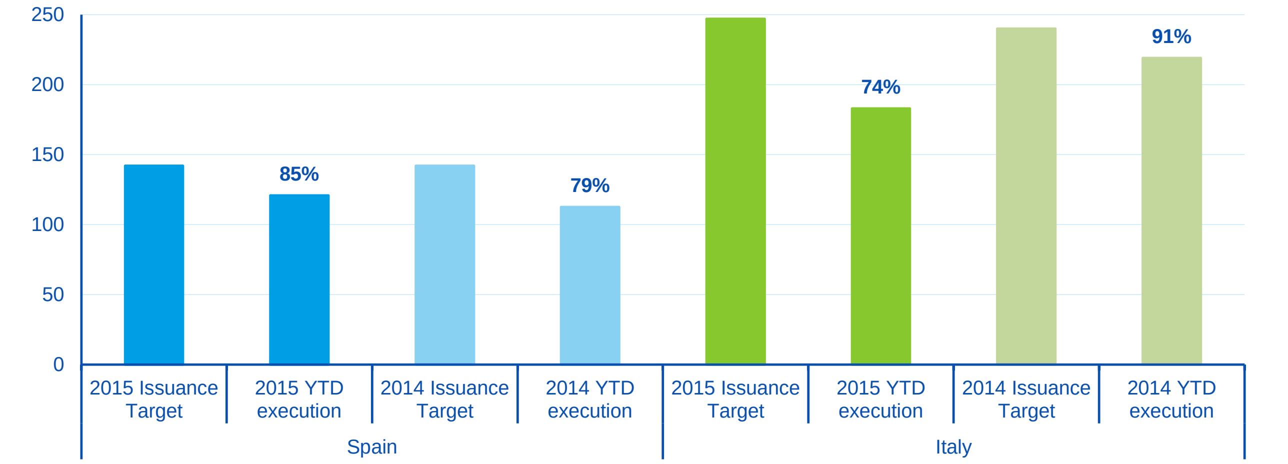
Source: Bloomberg and BBVA Research

a.2) Sovereign bond issuance: the rate of sovereign bond issuance remained positive, but the average life of issues has shortened, both in Italy and in Spain.

Over September and the first few days of October, Spain has issued EUR12bn in medium- and long-term debt, which is around the average for issuance since April. On the other hand, Italy has issued EUR13bn, which is below the average for the past few months (EUR15bn). Of the periphery countries, Italy continues to be the one which is falling behind the most in terms of the percentage of execution of required gross issuance for medium- and long-term debt (74% vs. 91% the previous year), while Spain shows execution which is ahead of the previous year (85% vs. 79%[4]), and in Ireland and Portugal execution stands at 100% of expected levels. The delay in execution of target issuance in Italy is not due to problems of demand for Italian paper but instead, in our opinion, because the Italian treasury has responded differently from everyone else in managing the interest rate tightening that took place among the periphery countries as a result of the Greek crisis and the risks deriving from the imminence of the normalisation of rates by the Fed (which has still not materialised). In this respect, while countries such as Spain decided to keep up the volume of issues and shorten terms to contain the cost of borrowing, Italy chose to cut back the volume of issues and also kept this at a modest level in September

4: Calculated on the basis of initially planned gross medium and long term debt issuance of EUR142bn, which has currently been reduced to EUR140bn.

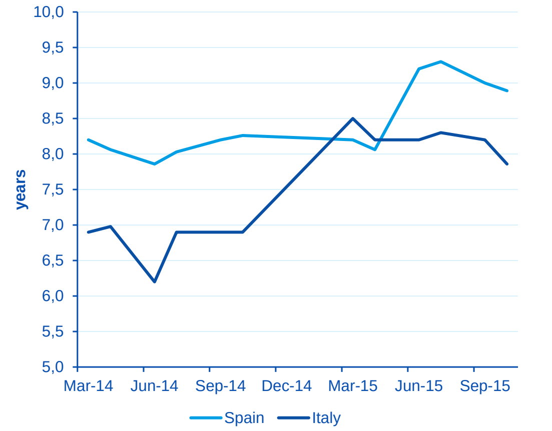
Figure 13
Spain and Italy: Gross sovereign bond issuance as of October 2 (EUR bn and % of annual gross issuance target)



Source: National treasuries, Bloomberg and BBVA Research

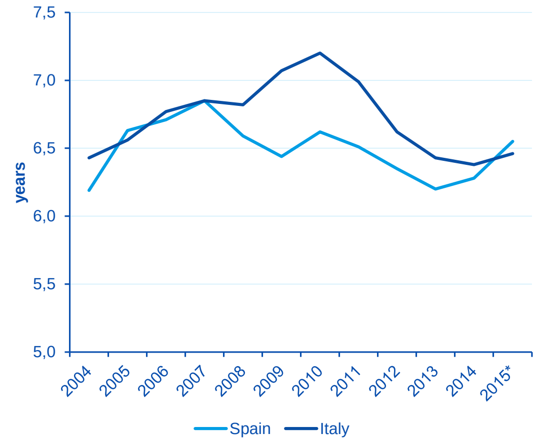
In this respect, Figure 8 illustrates how in Spain the average life of new issues has reduced slightly for the second month in a row, while in Italy it came down for the first time this month. Nevertheless, in both countries the average life of total debt in circulation remains above the level of the previous year.

Figure 14
Average life of the new Lt and Mt sovereign debt issuances



Source: National treasuries and BBVA Research

Figure 15
Average life of the new sovereign debt issuance outstanding

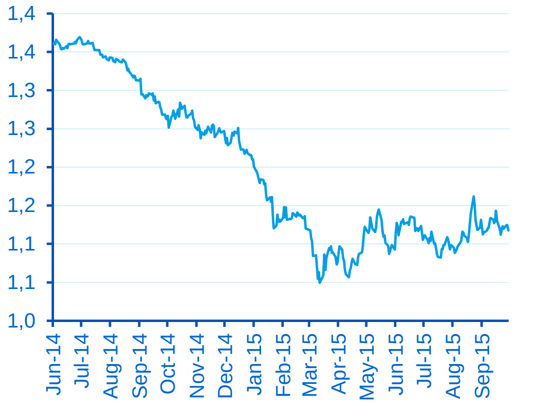


Source: National treasuries, Bloomberg and BBVA Research

b) Impacto en tipo de cambio

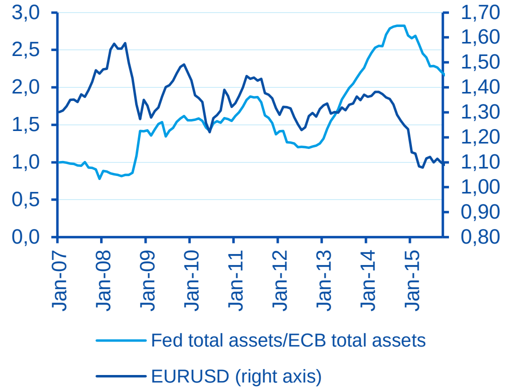
The euro has kept within a range of USD1.115-1.144. In general it has been observed that the euro is still performing a role as a safe-haven currency in times of uncertainty, although also this month, unlike last month, the euro's responsiveness to the deterioration of inflation indicators (both the CPI and inflation indicators based on market indicators) has increased. Thus, although US economic data and the global cyclical environment have meant that there is a reduced likelihood of a rate hike in the United States this year, which would work to the advantage of the euro, its appreciation has been limited. Added to this, the sit-and-wait posture adopted by the ECB has sustained the floor for the euro, in spite of increased expectations of greater stimulus by the central bank. At the end of the month, the euro depreciated against all the G-10 currencies except the Swiss franc and the Danish krone. With respect to the emerging markets, there has been a mixed performance, with depreciation against the Russian rouble (+3.25%) and the Mexican peso (+1.5%), while the euro strengthened against the Brazilian real (-5%) and the Turkish lira (-1.94%). In terms of the nominal effective exchange rate, the euro held practically stable (+0.3%).

Figure 16
EURUSD



Source: Bloomberg and BBVA Research

Figure 17
EURUSD y políticas monetarias (Fed/BCE)

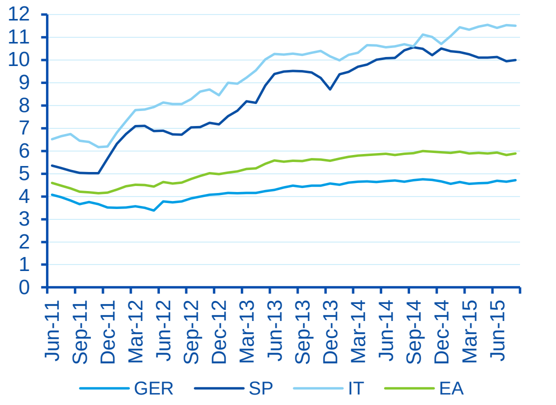


Source: Bloomberg and BBVA Research

c) Holdings of sovereign bonds by financial institutions

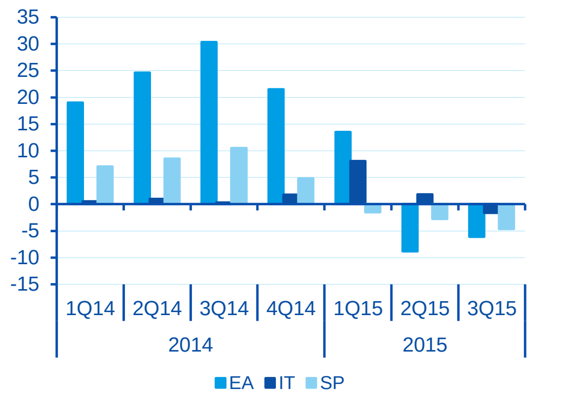
According to data published by the ECB, euro area financial institutions, mostly, bought sovereign bonds in August. Thus, for the euro area as a whole, financial institutions lifted their holdings of sovereign bonds by EUR15.6bn, unlike in June and July when they substantially cut their books in these, by EUR14bn and EUR27.7bn respectively. The rise in August was in the main from French institutions, which lifted their holdings by EUR11bn, whereas Spanish institutions held their holdings unchanged in August, while Italian entities brought theirs down by a very small amount (EUR1bn).

Figure 18
Sovereign bonds held by financial institutions with respect to total bank assets (%)



Source: ECB and BBVA Research

Figure 19
Sovereign bonds held by financial institutions (quarterly average) (EUR bn) ***3Q15 (data for July and August)**



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.

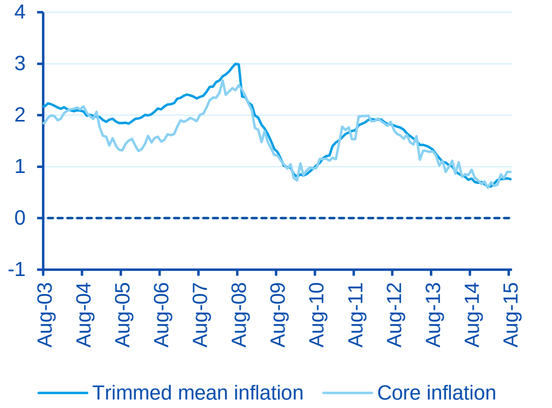
The latest activity figures suggest that recovery is likely to have continued to progress at a sound and relatively stable pace over the third quarter as a whole. The September confidence indicators were mixed, though, with an improvement generally for those of the European Commission that contrasts with the fall for the PMIs, although they are still clearly in expansive territory. Both surveys indicate a limited impact from the slowdown in the emerging economies, even though new orders from abroad advanced at a more sluggish pace and doubts have increased over year-end growth. This slowdown in global demand might offset the positive effects of a weaker euro (over the past year) and of lower energy prices. The real activity figures to July have been confirming the pointers from the confidence surveys, with something of a recovery in both industrial production and retail sales, which makes for a larger contribution to growth from domestic demand, above all from private consumption. Despite the drop in exports in July, the level of sales abroad remains virtually stable with respect to the second quarter, while imports fell considerably, which suggests that net exports should not hold back growth. Taking on board all of this information, the MICA-BBVA model estimates that euro area GDP growth is likely to be around 0.4% QoQ for 3Q15. Following the ECB's quantitative easing measures, household lending continued to show signs of improving up to August (0.6% 3M/3M), although business credit has still not incontestably got off the ground (0.2% 3M/3M having stagnated in 2Q15) and fuels doubt about the upturn in investment.

With respect to prices, the 0.2pp slip back in euro area headline inflation to -0.1% YoY in September was basically on the back of the fall in energy product prices, while inflation for the other components held relatively steady. All in all, core inflation stayed at 0.9% YoY, and has been unchanged since the middle of the year. For the moment, no hint of second-round effects from the oil price collapse has been visible, although it could be that they are being stopped in their tracks by the pick-up in domestic demand and a bit of pass-through from the euro's depreciation over the past year. Looking ahead, inflation ought to perk up in November and December (to around 0.8% YoY), owing to the disappearance of the base effects from energy prices (after the heavy fall in late 2014), later reaching an annual average of around 0.1% for the whole of 2015. Nonetheless, recent commodity price movements, especially oil, as well as the euro exchange rate (bound in with the decisions made by other central banks) adds a risk to the downside to short-term inflation forecasts which would materialise if energy price falls spread to other components. For 2016, inflation will hold clearly below the ECB's target rate, and we expect it to show an annual average of 1.1%.

For the first time, we have included a set of composite indicators in this report to take our inflation monitoring a step further (see Figure 22). According to these indicators, which take in inflation measurements from the current figure to expectations ten years out, since the start of the year (coinciding with the QE announcement) inflation has begun to converge on the mean. Nevertheless, the latest data show that this converging movement has come to a halt and has even seen a partial turnaround with respect to the most long-term component. In principle, this hold-up has come about in line with the correction in commodity prices, yet monitoring how this situation develops could be key to assessing the likelihood of an extension of QE.

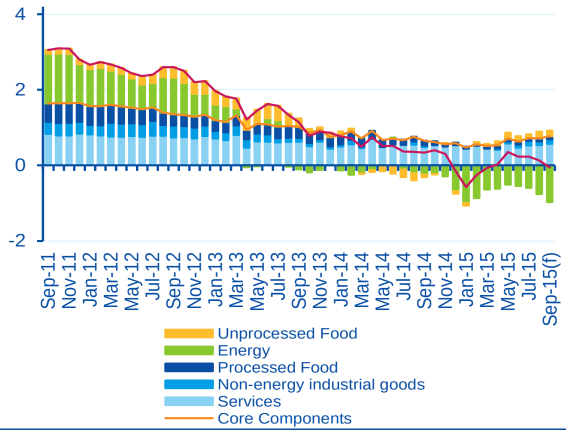
On the other hand, financial conditions eased last month (due to lower real interest rates and a stable euro) in comparison with the tightening which occurred over the summer months.

Figure 20
UEM: inflacion (% YoY)



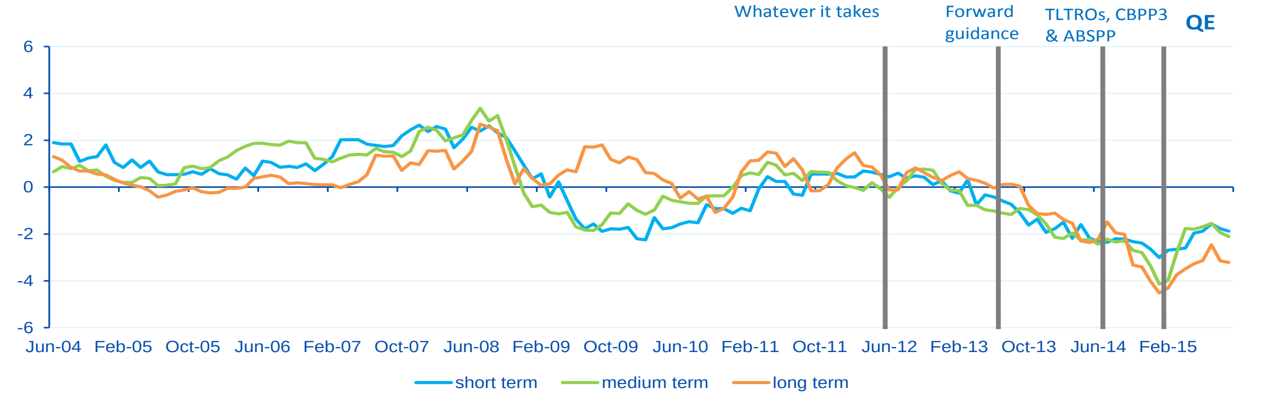
Source: Bloomberg and BBVA Research

Figure 21
EMU: inflation (% YoY) and contribution by component (pp)



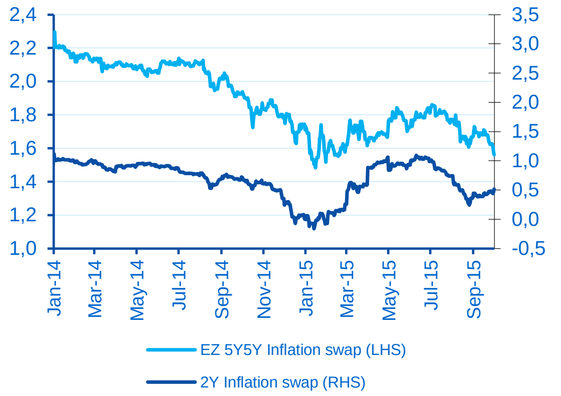
Source: Bloomberg and BBVA Research

Figure 22
Composite inflation-monitoring indicators*
Standard deviations from the mean



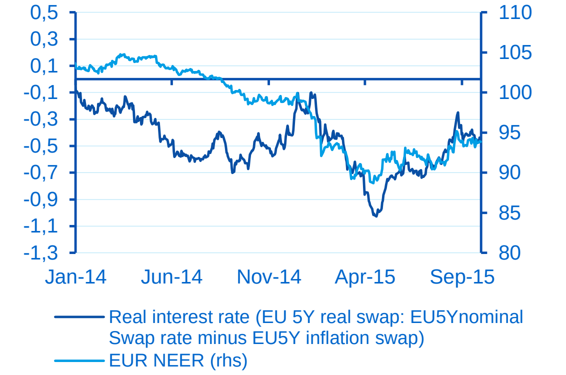
*These indicators are constructed using principal component analysis. To combine these diverse variables in each sub-index, a Z-score is calculated for each one and then the first principal component for the Z-scores. The variables included for the short term are: headline and core inflation and the GDP deflator. For the medium term: ECB inflation forecasts two years out, the two-year inflation swap and inflation two years out published by the *Survey of Professional Forecasters*. For the long term: the five-year inflation swap, long-term inflation published by the *Survey of Professional Forecasters* and the 5y5y forward inflation swap. An economic watch will be posted on the website that explains the indicators.
Source: Bloomberg and BBVA Research

Figure 23
Euro area: implied inflation expectations in the markets



Source: Bloomberg and BBVA Research

Figure 24
Tightening of financial conditions



Source: Bloomberg and BBVA Research

Conclusion: the interpretation regarding the ECB's sovereign bond purchases last month remains positive. In September, the central bank beat its monthly purchasing target (buying EUR63bn), as it did from May to July. This increased buying allows the ECB both a degree of margin in the coming months (to reduce purchasing) and to be sure of hitting its monthly target of EUR60bn. In a climate of heightened uncertainty on a global dimension, the members of the ECB's governing council have stepped up their rhetoric in expressing a firm commitment to the current programme, as well as their intention to extend it if this becomes necessary, while at the same time making it very clear that it is still too early to make any decisions in this regard. Although uncertainty is running high and the risks to the downside remain, as long as growth in China and the key emerging markets stabilises (our central scenario), we think that the most likely scenario is that the ECB will sit this out and therefore choose not to alter its purchase programme in its present form.

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