CENTRAL BANKS

Monitoring the expansion of the ECB's balance sheet (December 2015)

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- **In December, the asset purchasing programme (public- and private-sector) failed to reach its monthly target of EUR60bn, and came in at EUR50.2bn. In spite of this decline in purchases, this allowed the average since the programme began in March 2015 to reach EUR60bn, as in various months of the 10 months of the programme the ECB has exceeded its own monthly target.**

- **At the monetary policy meeting held on 21 January, and in spite of having announced new measures in December, the ECB opened the door to more measures in March. Although the ECB's room for manoeuvre is increasingly limited, the bank is indicating that is disposed to do the necessary to deal with the growing external risks (oil, market volatility and uncertainty in EMs).**

- **The increase in volatility and the tensions in the financial markets have favoured an increase in flows into safe-haven assets such as US, British and to a lesser extent, core Eurozone bonds. Meanwhile, idiosyncratic factors have favoured a degree of widening in the peripheral European risk premium, which the ECB's announcement of new measures failed to neutralise. The euro depreciated slightly vs. the USD after the ECB's January dovish statement, but to no lower than USD1.08.**

• ECB monetary expansion measures

a) Asset purchase programme. The asset purchase programme (public- and private-sector) failed to meet its objective of EUR50.2bn a month in December, similar to the situation in August, which was due to the reduced liquidity in the markets and to the fact that the central bank made no purchases between 22 December 2015 and 1 January 2016.

In the first ten months of the programme, the ECB acquired EUR491.2bn of public-sector bonds (*Public Sector Purchase Programme* (PSPP)), EUR93,1bn[1] through the guaranteed bond purchasing programme (CBPP3), and EUR12bn[2] through the asset-backed securitisation programme (ABSPP). In particular, in December the ECB bought less than its target, as it had done in August. More specifically, it bought EUR50.2bn, of which 88% was in sovereign bonds. In spite of this decline in purchases, it has achieved the average of EUR60bn a month since the programme began in March 2015, as in the first 10 months of the programme it purchased more than its monthly target in several months of the year.

1: EUR143.3bn since the programme started in October 2014.
2: EUR15.3bn since the programme started in November 2014.

a.1) Public-sector bond purchases

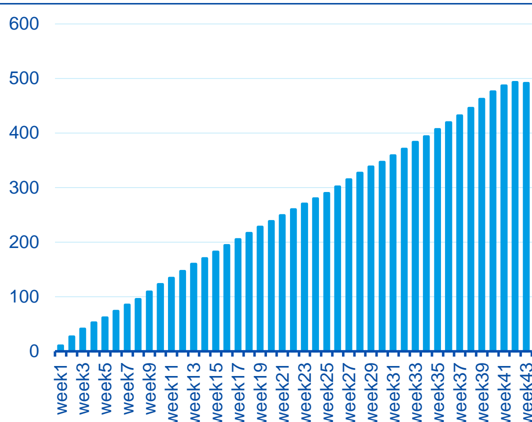
In December, the ECB bought sovereign bonds (including supranational and agency bonds) for a total of EUR44.3bn, with a country distribution practically in line with its capital key, although with a slight adjustment for not buying Greek bonds[3]. This was well below the monthly average since the programme began (EUR50bn).

The maturity of the debt acquired to November is similar to previous months. The average maturity of the purchases was 8 years, below that of the average of the euro area bonds eligible for the QE (9.1 years). By country, the longest maturities were in the peripheral sovereign bond purchases, for example in Portugal (10.3 years) and Spain (9.7 years), where maturities were higher than for the eligible debt (8 years in the case of Portugal and 9.1 years for Spain). This performance was partly due to the limitations of the PSPP itself, as for the peripheral countries the BCB holds bonds bought under an earlier asset purchasing programme (SMP), with shorter maturities (2-3 years, and thus the current purchases tend to have longer maturities. As regards purchases of supranational and agency bonds, in December the ECB acquired some EUR5.4bn's worth, or 12% of total bond purchases, and once again the ECB has accelerated the maximum established in the initial terms of the programme.

a.2) Private-sector asset purchase programme

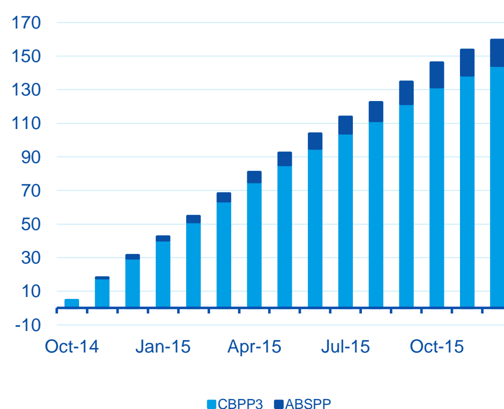
In December, under the private-sector asset purchase programme, the ECB acquired assets for EUR5.9bn, less that the average since the start of the two programmes (ABSPP and CBPP3) of EUR11bn. In December, purchases under CBPP3 amounted to EUR5.8bn, while those under the ABSPP amounted to EUR0.1bn. To date, the ECB has bought EUR143.3bn of guaranteed bonds (the programme began in October 2014) and EUR15.3bn of asset-backed securities (the programme started in November 2014). Under the design of these programmes (ABSPP and CBPP3), the ECB can make purchases in both the primary and secondary markets. Under both programmes, the purchases have been largely in the secondary market (80%).

Chart 1
PSPP: weekly bond purchases, cumulative since 9 March 2015, (EUR bn)



Source: ECB and BBVA Research

Chart 2
CBPP3 and ABSPP
Cumulative weekly purchases (EUR bn)



Source: ECB and BBVA Research

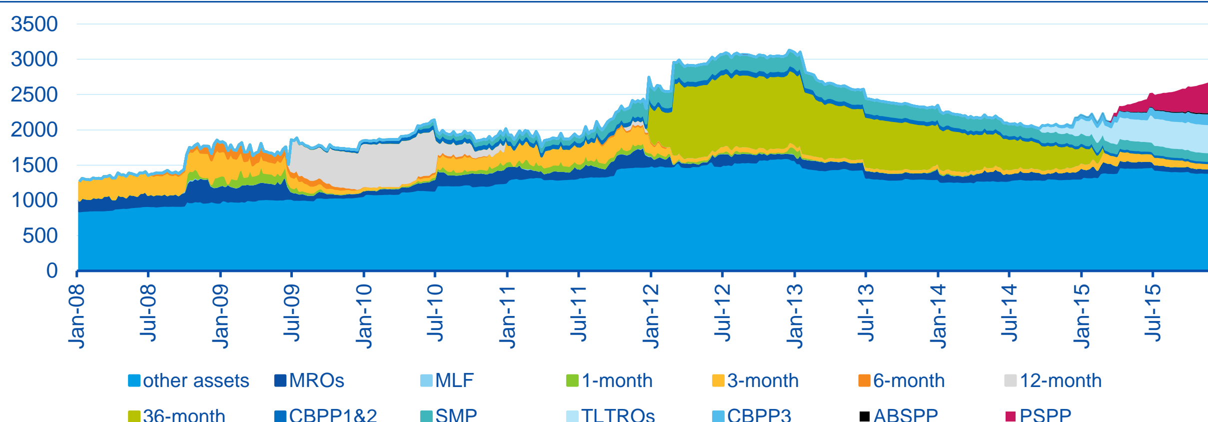
3: At present, as explained by Draghi in the July monetary policy meeting, Greece does not meet the criteria for asset purchases.

Table 1
Monetary expansion measures (EUR bn)

	Sep-14	Oct-14	Nov-14	Dec-14	Jan-15	Feb-15	Mar-15	Apr-15	May-15	Jun-15	Jul-15	Aug-15	Sep-15	Oct-15	Nov-15	Dec-15
TLTRO	82,6			130,0			97,8			73,8			15,5			18,3
CBPP3		4,8	13,0	11,8	10,6	11,0	12,4	11,5	10,0	9,9	9,0	7,5	10,1	10,0	6,9	5,8
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	1,6	0,6	0,1
PSPP							47,4	47,7	51,6	51,4	51,4	42,8	51,0	52,2	55,1	44,3

Source: ECB and BBVA Research

Chart 3
ECB balance sheet (EUR bn)



Source: ECB, Bloomberg and BBVA Research

Impact on the assets

a.1) Impact on sovereign debt yields

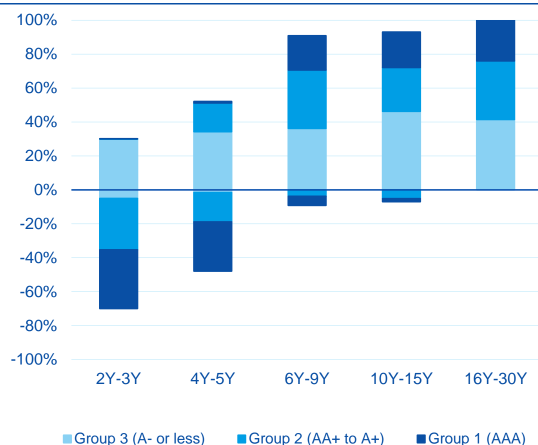
The start of the interest-rate normalisation cycle in the USA in December did not wreak havoc in the international financial markets, although the American curve flattened by 10bp and widened by an average of 14bp during the month. Meanwhile, the ECB's decision to extend its non-standard measures by slightly less than the market had been expecting, and without giving any clear signal of taking further additional measures, supported an upward correction in European rates. However, in January, the situation in the financial markets changed completely, due to increased risk aversion. Increased uncertainties over the degree of economic slowdown in China and also regarding its exchange-rate policy, as well as the continuation of oil-price declines (which had reached levels below USD30/bbl) unleashed another episode of financial turbulence which affected the EMs particularly badly. In this environment, investors intensified their portfolio rebalancing, underweighting risk assets and increasing the weight of safe-haven assets. Thus, together with strong outflows from EMs (although to a lesser extent than in the summer of 2015, as portfolios had already been adjusted), there were strong flows into safe-haven assets, principally US, UK and 'core Europe' public debt. Meanwhile, idiosyncratic factors led to an increase in the risk premium in peripheral countries. Thus, even though the ECB has opened the door to the possibility of taking measures in March, the 10Y bund spread widened by 11bp in Spain to 125bp, 63bp in Portugal to 254bp, favoured by the political uncertainty, and by 12bp in Italy to 106bp. Altogether, in this risk environment and with limited

inflationary pressures, total debt in circulation in the Eurozone at negative interest rates increased in the first two weeks of January. However, this movement has been driven by the higher-quality debt.

Chart 4
% of sovereign debt* (Eurozone) at negative rates over total debt

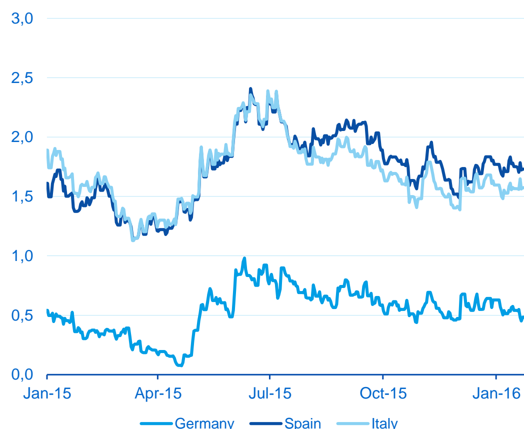
*Eligible under the PSPP
Source: Bloomberg and BBVA Research

Chart 5
% of sovereign debt* (Eurozone) at positive/negative rates, by country rating



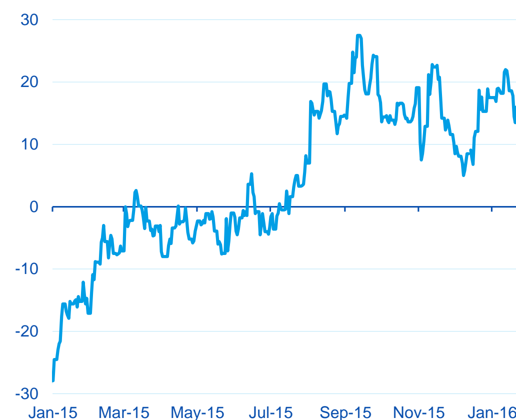
*Eligible under the PSPP
Source: Bloomberg and BBVA Research

Chart 6
10Y interest rates (%)



Source: Bloomberg and BBVA Research

Chart 7
Spread on 10Y bond Spain vs. Italy (bp)



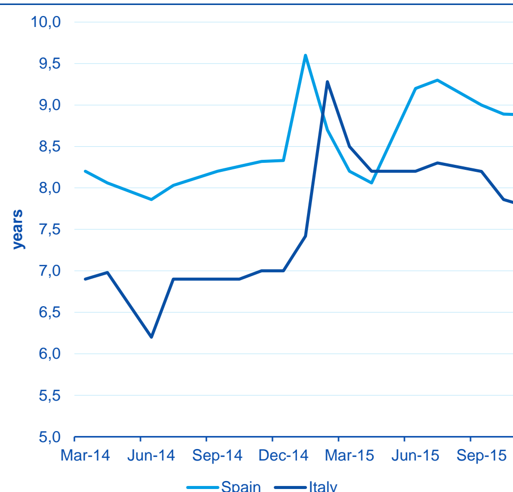
Source: Bloomberg and BBVA Research

a.2) Sovereign debt issuance: net issuance of EUR194bn in 2016

In 2015, all governments managed to reach their issuance targets and even the peripheral countries managed to increase the average maturity of their new medium- and long-term issuance in 2015 (from 8.3 years to 9.1 years in the case of Spain, and from 7 to 7.7 years in Italy), in spite of the increased volatility in both global and local financial markets (third bail-out of Greece, elections in Portugal and Spain). In addition, the increase in the average maturity of the new issuance also slightly extended the average maturity of the total debt in circulation in Spain (from 6.28 years in 2014 to 6.42 years in 2015) and Italy (from 6.38 years in 2014 to 6.52 years in 2015).

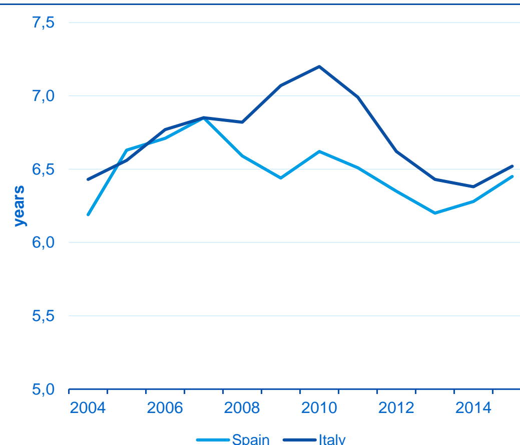
The cost of financing the medium- and long-term debt also fell over the course of 2015 (-21bp to 0.84% in Spain and -37bp in Italy to 1.08%). Also, in the case of Spain, the total cost of the debt in circulation fell (from 3.47% in 2014 to 3.14% in 2015).

Chart 8
Average maturity new medium- and long-term debt issuance* (to 30 December 2015)



Source: National Treasuries, Bloomberg and BBVA Research

Chart 9
Average debt maturities, Spain vs. Italy



Source: National Treasuries, Bloomberg and BBVA Research

In terms of the issuance programmes in 2016, the Treasuries of the EU member states are facing a scenario in which: i) their financing needs will be less; ii) the rise in Eurozone interest rates will be limited, in spite of the likely recovery in the area and the interest-rate normalisation process in the USA, given the ECB's purchasing programme in the 2-30 year areas (now extended to March 2017), and iii) an environment of higher market volatility due to the global uncertainty. In this scenario, all the Treasuries want to lengthen the average maturity of their debt, although also taking advantage of the opportunity to reduce their interest expenses offered by the negative rates at the shorter end of the curve. In general terms, net medium- and long-term bond issuance will be positive in the Eurozone (EUR194.4bn), and practically all countries will have net positive issuance, except Germany (if we include the inflation-linked bonds) where issuance will be net negative EUR2.5bn. Nonetheless, excluding the inflation-linked bonds, Germany's net bond issuance would be zero, although Germany has net positive issuance in the 10-30 year area. As a result, the supply of bonds in 2016 should not cause much distortion in the market.

Based on data to June 2015, the principal sellers of German and French public debt were non-residents, while in the case of Italy and Spain it was the domestic banks that met the ECB's demand for paper.

Chart 10
Debt holders in 2Q15 (debt holdings as % of total debt)

Countries	Non-residents		Domestic banks	
	2014	2015	2014	2015
Germany	61,8%	59,6%	23,6%	23,4%
France	64,3%	63,9%	9,8%	9,7%
Italy	37,6%	39,9%	22,4%	21,8%
Spain	42,6%	47,1%	30,4%	28,3%

Fuente: Bancos centrales y Tesoros Nacionales

Source: Central Banks, National Treasuries and BBVA Research

Chart 11
Net medium- and long-term bond issuance (EUR bn)

	2016
Germany	-2,5
France	79,0
Italy	40,0
Spain	45,0
Rest eurozone	32,9

Source: Bloomberg, National Treasuries and BBVA Research

b) Exchange-rate impact

The performance of the euro has been determined by two factors: i) less aggressive ECB action than the market was discounting; ii) a narrower spread between yields on US and German short-term tenors (as a result of a downward adjustment in market expectations regarding the Fed), and iii) lower demand for euros as a safe-haven asset. As a result of the above, the euro has had difficulty breaking through the 1.0814 level, even though the ECB has already indicated that it might take additional measures at its March meeting.

Are the ECB's measures working?

The most recent data indicate that the recovery could have gained some traction during 4Q15 and, in spite of suffering from the sharp increase in uncertainty at the beginning of the year, the growth will continue to be fairly resilient, supported by domestic factors and also giving slightly more optimistic signals for exports.

This heightened uncertainty was reflected in a fall in the January PMIs after an improvement in the fourth quarter, but they remain at high levels (similar to those in 1H15, when GDP growth reached 0.5% QoQ on average). These levels are consistent with a relatively robust expansion of activity, above all in the services sector – benefiting from the good momentum in demand – and to a slightly lesser extent in the industrial sector, although the fears of plunging export orders from the Eurozone appear to have dissipated somewhat. The resilience of confidence, or at least the absence of a sharp deterioration, is crucial if the recovery is not to suffer and continue gaining ground in the coming quarters thanks to the positive effects of some tailwinds, such as the fall in the price of oil and the further relaxation of both monetary and fiscal policy, which should offset the negative effects of the heightened uncertainty and the deceleration in global demand.

Nevertheless, the actual activity data to November do not reflect the relative optimism of the confidence surveys and continue to be rather disappointing. On the one hand, industrial production advanced in the last quarter of 2015 (based on November data) at a stable but feeble pace (0.2% QoQ), while retail sales pointed to a certain moderation in private consumption. The slightly more positive news was the improvement in exports to November. This, together with the reduced momentum in imports, should be reflected in net

exports not draining growth in the Eurozone as a whole (after making a negative contribution of 0.3pp to GDP growth in 3Q15).

Furthermore, export orders increased again at the beginning of the year and slightly eased fears of plummeting exports. In any case, the high levels of confidence, both in the services sector and of consumers, indicate domestic demand will continue to be the main engine of growth in the coming quarters. With all this information, our MICA-BBVA model estimates growth of around 0.4% QoQ in 4Q15, which could accelerate again slightly at the beginning of this year.

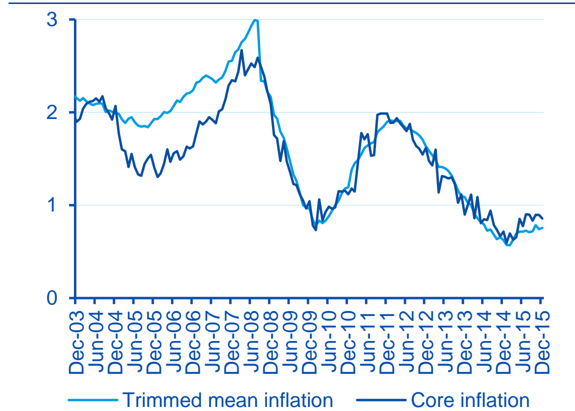
Regarding prices, inflation surprised to the downside in December for the second consecutive month, in spite of increasing by 0.1pp to 0.2% YoY (vs. 0.5% YoY expected), fundamentally due to the fact that the fall in oil prices limited the expected base effect on inflation of the energy component, while core inflation remained stable at 0.9% YoY. The evolution of oil prices will continue to be the principal determinant in the coming months[4], such that we are now expecting a further uptick in headline inflation in January to 0.4% YoY, although it will start to moderate in February and start to register slightly negative rates from March (around -0.2%), which could extend through the second quarter (which is when we are forecasting that oil prices will reach their lows) and only recover somewhat during the second half of the year.

Looking a little beyond the uncertainty regarding the evolution of oil prices, we think it is more interesting to evaluate how these might affect the ECB's review of its forecasts in March, which it will use to reassess its monetary policy measures. Taking into account that at present, oil futures (USD30.7/bbl in March, USD35.7/bbl in December, USD40.1/bbl at end-2017 and USD45.5/bbl at end-2018) which are the variable included in the assumptions used to update the scenario, normally the figures for the last week in February, we can see that these are around 35% and 30% lower in 2016 and 2017 (respectively) than those used in the ECB's December 2015 forecasts. Thus we think that at the next round in March, the inflation forecast could be downwards by around 1pp for 2016 and by around 0.3% for 2017, or to around 0% on average this year and slightly above 1% next year.

In addition, for the first time the ECB will publish its inflation forecast for 2018, which will be key to determining whether the inflation objective will be achieved, as will be the bank's assessment of the possible second-round effects after a prolonged period of very low inflation. Regarding the former, our forecasts point to the achievement of the objective being delayed again, until 2018, while we estimate second-round effects of around 0.3pp, leaving core inflation at around 1% in 2016. The data so far indicate limited second-round effects beyond the stabilisation of core inflation vs. the forecasts of a slight increase, and wage containment in a context of high unemployment rates. Nevertheless, the PMIs for January suggest that companies could be passing through to consumers the falls in commodity prices Eurozone-wide, but with differences by country. In France, this behaviour seems clearer, although already partly expected due to the need to stimulate demand, while in Germany the companies are not passing through the benefits and could be taking advantage to improve their margins. This comes hand in hand with the high degree of uncertainty regarding commodity prices, which means that we continue to see downside risks this year (if there continues to be no floor to oil prices), but also upside risks in 2017 thanks to a possible recovery in oil prices or stronger domestic demand, which should benefit from the smaller increase in prices.

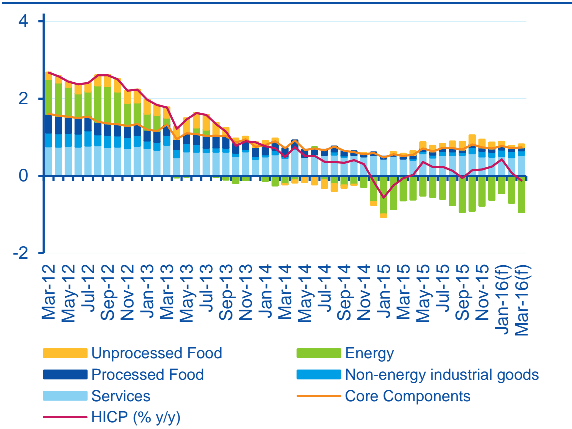
4 See Oil Price Outlook (January 2016).

Chart 12
EMU: inflation (% YoY)



Source: Bloomberg and BBVA Research

Chart 13
EMU: inflation (% YoY) and component contributions (pp)

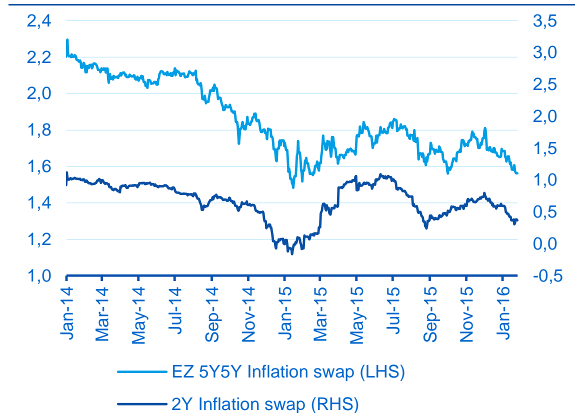


Source: Bloomberg and BBVA Research

According to our composite indicators for monitoring inflation (which take into account inflation measures from the present date to expectations at 10 years), in December the convergence towards the mean continued. However, this convergence is reversing in January in line with the correction in commodity prices (which are in even steeper decline).

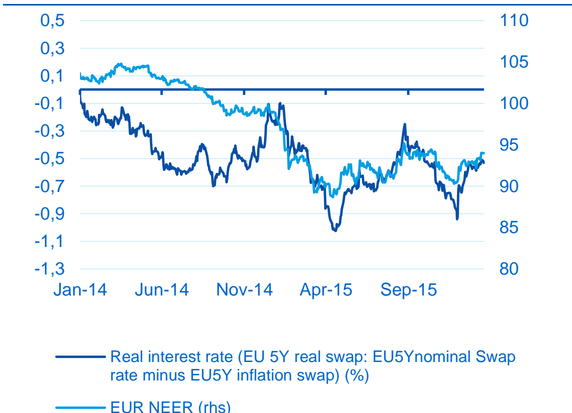
On the other hand, financial conditions tightened in December via higher real interest rates and the appreciation of the euro. In addition, so far in January, the trend has continued.

Chart 14
Eurozone: implicit inflation expectations in the markets (%)



Source: Bloomberg and BBVA Research

Chart 15
Tensioning of financial conditions



Source: Bloomberg and BBVA Research

Chart 16
Composite indicators to monitor inflation*
Standard deviations from the mean

*These indicators are built using analysis of principal components. To combine these diverse variables in each sub-index, we calculate a Z-score for each one, and then the first principal component of these Z-scores. The variables included in the short term are: headline and core inflation and the GDP deflator. In the medium term: the ECB's inflation forecasts 2 years ahead, the 2Y inflation swap and inflation in two years' time published by the *Survey of Professional Forecasters*. In the long term: the 5Y inflation swap, long-term inflation published by the *Survey of Professional Forecasters* and the 5Y inflation swap in five years' time. We will be publishing an Economic Watch explaining these indicators on the BBVA Research web page. Source: Bloomberg and BBVA Research

Conclusion: the balance of the ECB's sovereign bond purchases in the last month remains positive. In December, the central bank did not meet its purchasing target of EUR60.0bn, just as it did not in August. In spite of this decline in purchases, the bank met the monthly average (since the programme began in March 2015) target of EUR60bn, as the ECB has exceeded its target in several of the 10 months of the programme.

Given the new episode of volatility in the financial markets, the sharp fall in commodity prices and the uncertainty regarding EM growth, the ECB opens the door to new measures. On this occasion, we estimate that the impact on inflation of a scenario of lower oil prices for longer and the environment of increased global uncertainty justify the ECB's recent communiqué. The ECB will probably announce a further recalibration of the purchase programme, as well as an additional cut in the depo rate, but its room for manoeuvre is increasingly limited and any additional measures could be progressively less efficacious.

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