CENTRAL BANKS

Monitoring of the expansion of the ECB's balance sheet (January 2016)

Agustín García / María Martínez / Cristina Varela

Balance sheet expansion

- In the first eleven months of the public sector purchase programme (PSPP), the ECB bought €544.2 billion of bonds, €100.3[1] billion through the third covered bond purchase programme (CBPP3) and €14.2[2] billion through the asset-backed securities purchase programme (ABSPP)
- In January, the asset purchase programme (APP), which includes public and private assets, exceeded the monthly objective of €60 billion, with €62.4 billion being acquired, following a significant reduction in December. The ECB bought €52.9 billion worth of bonds, with a country distribution practically in line with the ECB's capital key, taking into account a small adjustment for the non-purchase of Greek bonds[3] (no Cypriot bonds were purchased in January either). The maturity of the debt acquired in January was similar to that of previous months. The average maturity of the purchases was eight years, less than the 9.1-year average of the eligible euro-zone bonds under QE.
- Under the private sector asset purchasing programme, the ECB has acquired €9.5 billion, slightly less than the average purchases since the start of both programmes (ABSPP and CBPP3), which is €11 billion, concentrated in covered bonds (€7.2 billion).

Sovereign debt: banking exposure and sovereign issues

- In December, euro-zone financial institutions reduced their holdings of sovereign bonds by €71 billion, one of the biggest reductions seen. Specifically, French banks cut back sharply (by €23.8 billion) on their exposure to public debt, while Italian and Spanish banks reduced theirs by €15.7 and €12.3 billion respectively.
- In January, bond issues in the peripheral euro-zone countries continued 2015’s trend. Spain issued 14.9% (14% in January 2015) of the annual medium- and long-term debt issue objective (€125 billion) and Italy issued 9% (11% in January 2015) of the estimated objective for 2016 (€224 billion). The average life of the January issues is less than that seen in the same month of last year, although the syndicated long-term bond issues scheduled for February may correct this effect.

1: €150.5 billion since the start of the programme in October 2014.
2: €17.2 billion since the programme started in November 2014.
3: For the time being, as Draghi explained in the July monetary policy meeting, Greece does not meet the criteria for the ECB to start buying its bonds.

Market environment

- In January, the financial markets were dominated by an environment of risk aversion encouraged by uncertainty about the economic slowdown in China, the second-round effects deriving from low crude oil prices on inflation and on companies producing commodities and, more recently, by the weak data on activity in the United States. Against this background, we are seeing continuing correction on world stock markets, with refuge increasingly being sought in sovereign bonds, mainly those of the highest credit quality, which is driving yields down. Since the beginning of the year ten-year interest rates have fallen by 32 bps in Germany and 40 bps in the United States. In the peripheral euro-zone countries, the risk premium has increased slightly - political uncertainty and growing perception of banking risk following the resolution of Novo Banco in Portugal and the strategy for cleaning up Italian banks' balance sheets. In this context, the volume of bonds with negative yields continues to increase, especially in the 4-5 year tenors, affecting not only top credit quality bonds but also the next layer (AA+ to A+) this time. The European interest rate curve is showing negative rates for terms up to nine months, while twelve-month EURIBOR futures are also showing negative rates below those reached at the beginning of December 2015, which presages new actions on the part of the ECB.
- Apart from this, despite the ECB's dovish tone, the euro has not fallen below US$1.08 other than episodically, but its trading range has narrowed to between US$1.10 and US$1.08. Over the past few weeks carry trade flows seem once again to be marginally benefiting the euro.

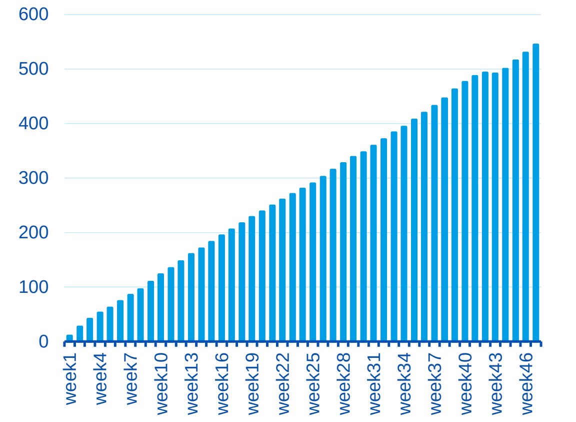
Macroeconomic environment

- The latest data point to recovery in the euro-zone possibly having gained some traction during the last quarter of 2015, despite suffering from the sharp increase in uncertainty. Growth continues to be supported by domestic factors, and also with somewhat more optimistic signs for exports. Our MICA-BBVA model estimates growth of around 0.4% QoQ in Q415, which could accelerate again somewhat in the early part of this year. Nonetheless, inflation was surprisingly low in December for the second month in a row (0.2% YoY as against the expected 0.5%), due basically to the fall in oil prices limiting the expected base effect on inflation of the energy component, while core inflation held steady at 0.9% YoY. In this context, movement in oil prices will continue to be the main determining factor in the coming months. Inflation could moderate in February and show slightly negative rated from March, which could extend into the second quarter. For 2016 as a whole, we expect headline inflation to be around 0.2%, with core inflation of 1%. As regards this scenario, in view of the high degree of uncertainty about commodity prices, we continue to see downside risks for this year, but we also see upside risks in 2017 due to a foreseeable recovery in oil prices or stronger domestic demand.
- Other inflation indicators, such as 5Y5Y forward inflation expectations and our composite indicators, which cover inflation measurements from current data to expectations ten years into the future, deteriorated significantly in January, mainly in the medium- and long-term component, in line with commodity prices which continued to plummet.

What we expect from the ECB

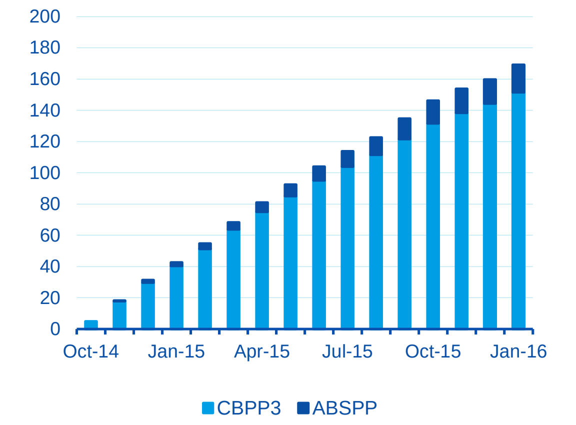
- In the monetary policy meeting held on 21 January, the ECB opened the door to further measures in March in response to the context of greater global uncertainty and growing downside risks. We expect a cut in the deposit rate of 10 basis points, as well as changes in the APP. Although the cyclical situation and the fragility of the recovery justify continuing with a highly accommodative monetary policy, the fact is that the ECB has less and less margin for maneuver and effective action.

Graph 1
PSPP: weekly purchases of bonds, cumulative since 9 March 2015, (€ billions)



Source: ECB and BBVA Research

Graph 2
CBPP3 and ABSPP
Cumulative weekly purchases (€ billions)



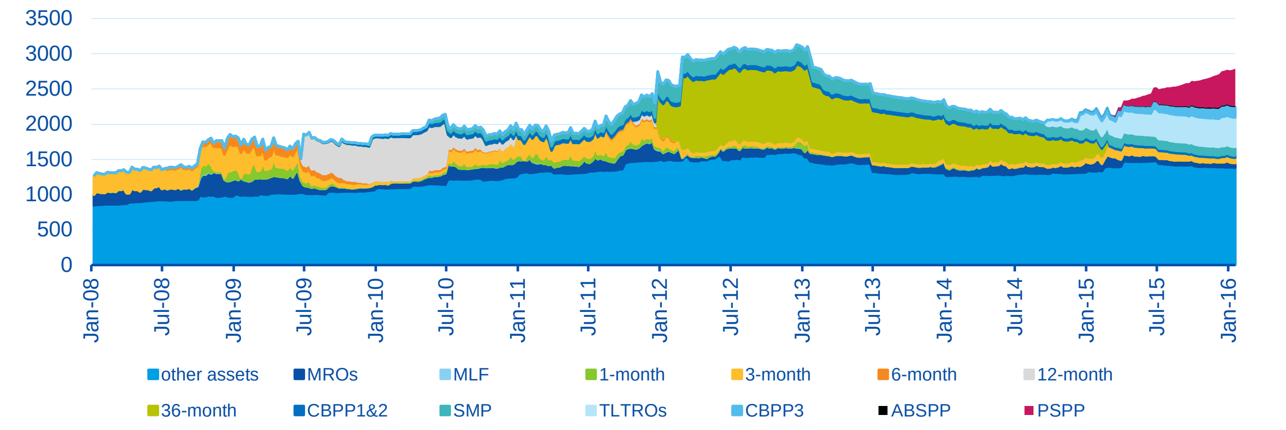
Source: ECB and BBVA Research

Table 1
Monetary expansion measures (€ billions)

	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	Jan-16
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	7,2
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	2,3
PSPP							47,4	47,7	51,6	51,4	51,4	42,8	51,0	52,2	55,1	44,3	52,9

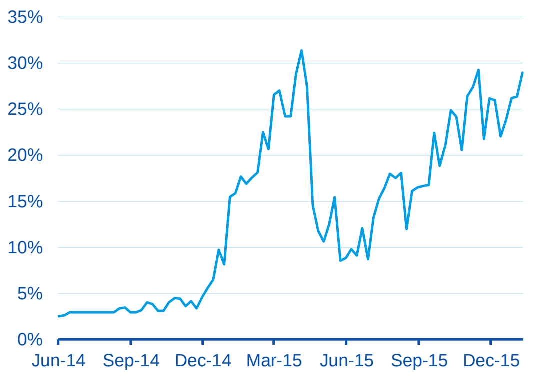
Source: ECB and BBVA Research

Graph 3
ECB balance sheet (€ billions)



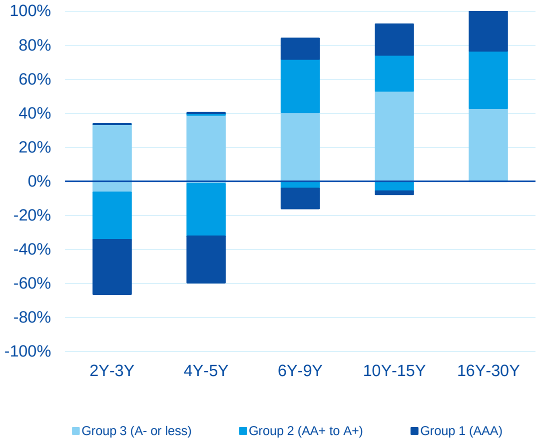
Source: ECB, Bloomberg and BBVA Research

Graph 4
sovereign debt* (euro-zone) with negative rates as % of total debt



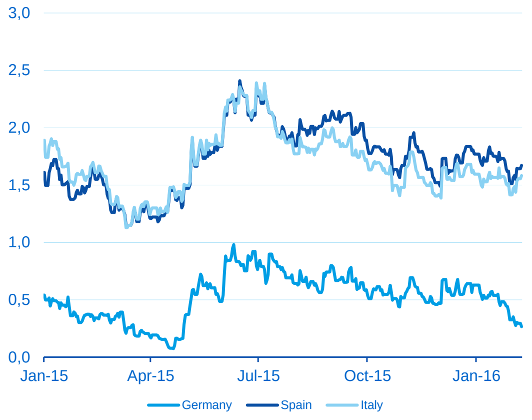
*Eligible under the PSPP
Source: Bloomberg and BBVA Research

Graph 5
% of sovereign debt* (euro-zone) with positive/negative rates, by country rating.



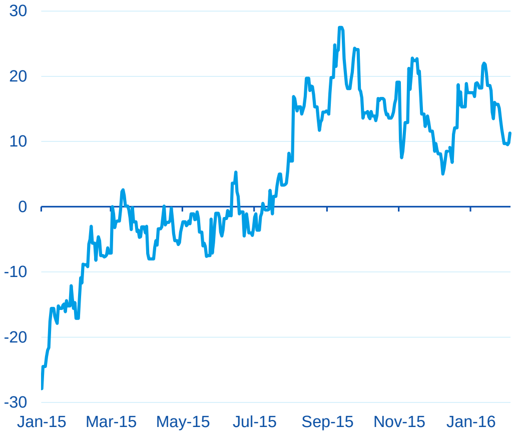
*Eligible under the PSPP
Source: Bloomberg and BBVA Research

Graph 6
Ten-year interest rates (%)



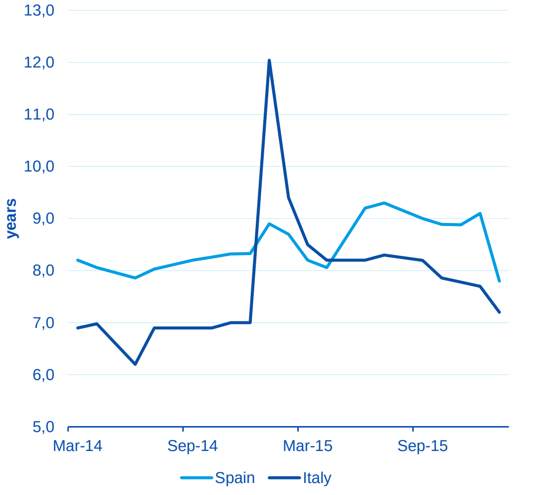
Source: Bloomberg and BBVA Research

Graph 7
Ten-year bond spread Spain-Italy (bps)



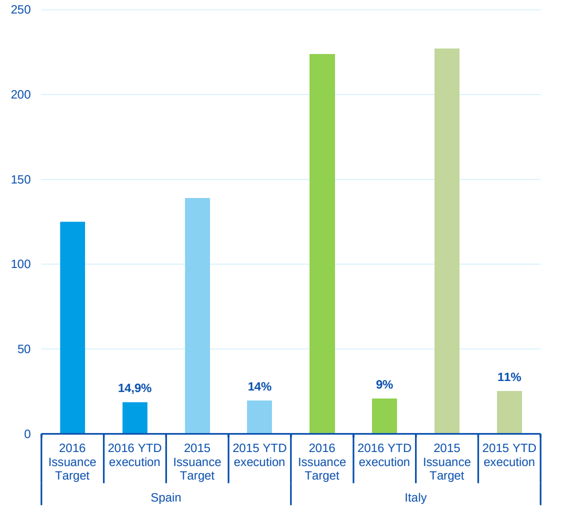
Source: Bloomberg and BBVA Research

Graph 8
Average life of new debt issues* at medium and long term



Source: National Treasuries, Bloomberg and BBVA Research

Graph 9
Development of medium- and long-term bond issue programmes (€ billions)



Source: National Treasuries, Bloomberg and BBVA Research

Table 2
Holders of debt (% 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%

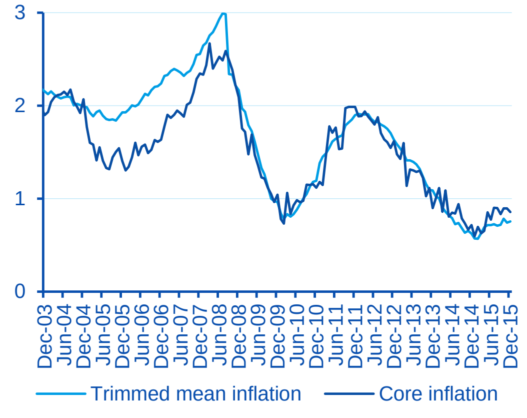
Source: Central banks, National Treasuries and BBVA Research

Table 3
Net issues of medium- and long-term bonds (€ billions)

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

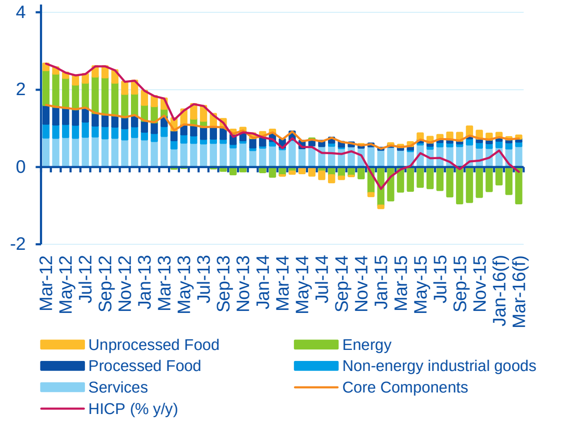
Source: Bloomberg, National Treasuries and BBVA Research

Graph 10
EMU: inflation (% YoY)



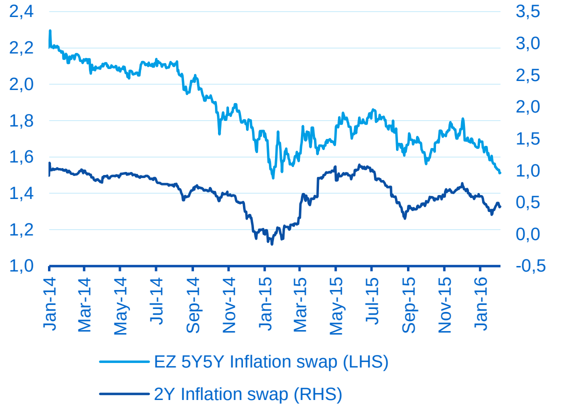
Source: Bloomberg and BBVA Research

Graph 11
EMU: Inflation (% YoY) and contribution of components (% pts)



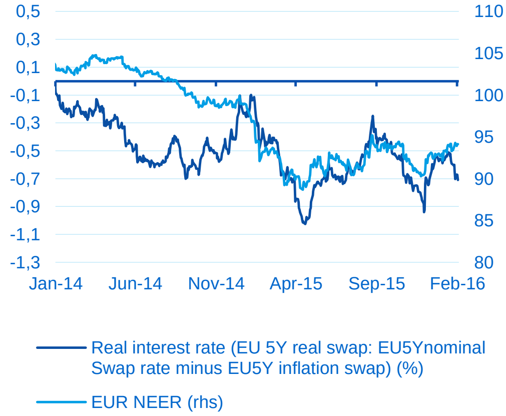
Source: Bloomberg and BBVA Research

Graph 12
Euro-zone: Inflationary expectations implicit in the markets



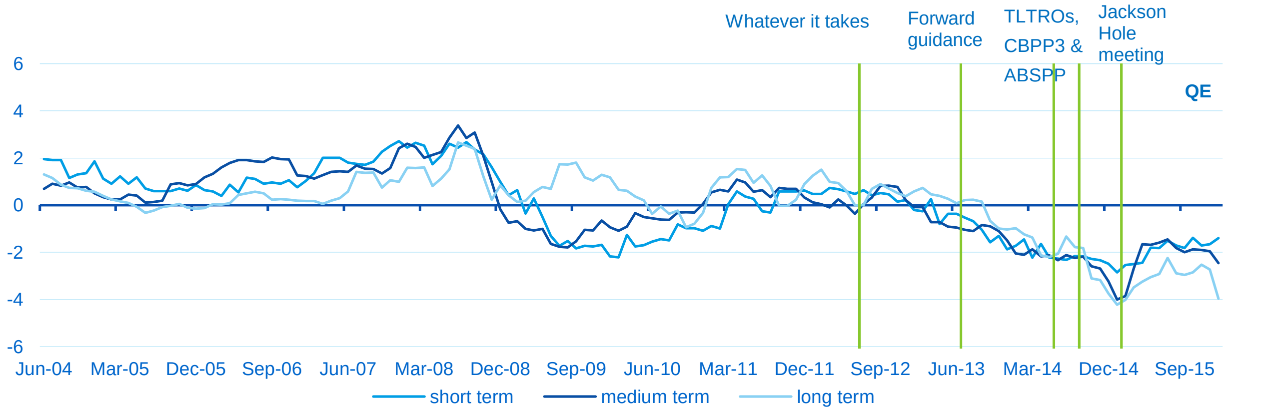
Source: Bloomberg and BBVA Research

Graph 13
Tightening financial conditions



Source: Bloomberg and BBVA Research

Graph 14
Composite indicators to monitor inflation*
Standard deviations from the mean



*These indicators are constructed using PCA (principal component analysis). To combine these different variables in each sub-index, a z-score is calculated 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 GDP deflator. In the medium term: ECB inflation forecasts at a two-year horizon, the 2 yr inflation swap and inflation at a two-year horizon published by the Survey of Professional Forecasters. In the long term: the 5 yr inflation swap, the long-term inflation published by the Survey of Professional Forecasters and the 5 yr/5 yr forward inflation swap. An economic observatory explaining the indicators will be published on the website.
Source: Bloomberg and BBVA Research

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