CENTRAL BANKS

Monitoring the expansion of the ECB balance sheet (March 2016)

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Balance sheet expansion

- In the 13 months that the asset purchase programmes (APP) have been in force, the ECB has bought €648 billion worth of bonds under the public sector purchase programme (PSPP), €115.8[1] billion under the covered bond purchase programme (CBPP3) and €15.5[2] billion under the asset-backed securities purchase programme (ABSPP).
- In March, the asset purchase programme (APP), which includes public and private assets, exceeded the monthly objective of €60 billion, with €61.3 billion being acquired. The ECB bought €53.1 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]. The average maturity of the purchases was eight years, similar to previous months and less than the average of the eligible euro-zone bonds under QE (9.1 years).
- Under the private sector asset purchasing programme, the ECB has acquired €8.2 billion, slightly less than the average purchases since the start of both programmes (ABSPP and CBPP3), which is €10.7 billion, concentrated in covered bonds (€7.8 billion).
- At its meeting on monetary policy on 10 March, the ECB cut rates and announced new unconventional measures to counter the heightened risks affecting the objective of price stability. In particular, it announced an increase of €20 billion in monthly purchases under the APP, to €80 billion, starting from 1 April. (see) (see).

Sovereign debt: banking exposure and sovereign issues

- Financial institutions in the euro-zone increased their sovereign bond holdings by €13 billion in February, following the previous month's trend, albeit to a lesser extent. Specifically, Italian banks increased their public debt exposure (by €9.6 billion), while Spanish and Portuguese banks increased theirs by €4 billion and €7 billion respectively.
- Bond issues are following a pattern similar to that recorded in 2015, with the rest of the euro-zone having financed over 20% of its gross emission requirements in 2016 (€858 billion), biased toward the 7-10 year term which is accumulating the highest percentage of this year's issues. The pace of financing in peripheral countries is somewhat lower than last year. Spain issued more than 32% (compared to 35% in January 2015) of the annual medium- and long-term debt issue objective (€125 billion) while Italy issued 25% (33% in January 2015) of the estimated objective for 2016 (€224 billion). The average life of emissions has recovered, thanks to syndicated programmes. International investors are becoming increasingly attracted to Spanish long-term debt, as has been seen in recent syndicated bond issues in Spain (and Italy), in which foreign investors' participation continued to increase. Furthermore, Spanish Treasury statistics point to the country's credit institutions having further reduced their holdings of

1: €165.6 billion since the start of the programme in October 2014.
2: €18.9 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.

Spanish bonds in January, whereas non-residents continued to increase their presence in Spanish sovereign bonds.

Market environment

- March saw a continuation of the falling trend in risk aversion which had started in February. Equities, commodities and emerging market assets generally posted better relative performances than defensive assets (bonds). However this trend seems to be curving downwards in the first weeks of April. This halt in the improving trend may have been caused by uncertainty about some of the factors that had underpinned the recent rally. In the first place, difficulties in reaching an agreement on freezing oil production. Secondly, US economic data have still not improved sufficiently to dispel the doubts about growth, while data from China and Europe show continued weakness. Lastly, recent remarks by Federal Reserve members reveal the lack of consensus. We should highlight the fact that in the case of European assets the improving trend came to a halt in mid-March, no doubt partly due to the euro's appreciation against the dollar (from $1.08 to nearly $1.14 by month-end) following the more dovish tone of the FOMC meeting and the remarks of Federal Reserve chair Janet Yellen. Additionally, European stock markets continue to be hampered by an environment of weak growth and by the banking sector. Nonetheless, banking risks moderated once central banks put a stop to talk of interest rates going deeper into negative territory. In other news, the shift in European debt markets away from core country bonds and into those of peripheral countries, which set the tone during much of March, seems to be running out of steam. This increased risk follows the recent trend of aversion, persistent political uncertainty in certain peripheral European countries and the continuing downward trend in inflationary expectations, particularly for the longer term. In this respect, the increase in the ECB's monthly purchases of sovereign bonds does not appear to be helping to contain peripheral countries' risk premiums. In Spain, the ten-year interest rate differential with Germany once again widened towards 139 bps after having narrowed to 120 bps. In the case of Italy the spread widened from 107 bps to 117 bps.

Macroeconomic environment

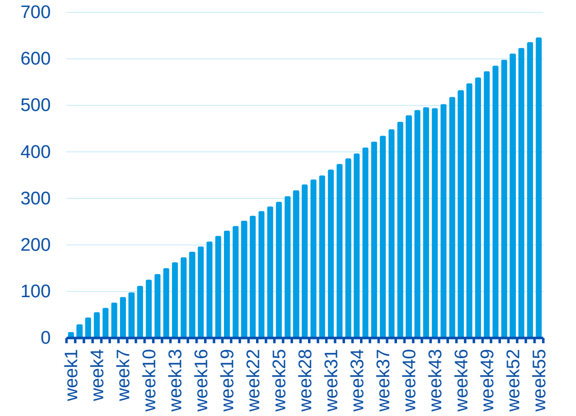
- With the real data for activity up to the end of February, which evolved better than expected, it seems likely that growth in the euro zone as a whole will have picked up some momentum in the first quarter of the year, following the negative impact of certain temporary factors that depressed activity in the latter part of 2015. Nevertheless, faltering confidence over the first quarter as a whole and slackening global demand continue to fuel misgivings about the sustainability of the recovery. On the one hand, increased retail sales in February for the fourth consecutive month signal robust growth in the quarter to date (0.8% QoQ relative to the average for Q4 2015), which suggests that the moderation in household consumption in Q4 2015 may have been temporary.
- However, it remains to be seen whether the consolidation of growth in domestic demand is sufficient to offset the lower export sales momentum, following the moderation in global growth and the gradual dissipation of the effect of the euro's depreciation over the course of 2015. With exports virtually stagnant during the second half of 2015, the further deterioration in export orders, together with the dynamism of imports, suggest that net exports will continue to weigh on the economy in the first quarter. On the other hand, the worst news is the generalised decline in economic agents' confidence, which could end up depressing growth. This correction in confidence follows the sharp upturn seen at the end of 2015 (EC sentiment: -2 pp to 104 in Q1 2016, composite PMI: -1 pp to 53.2), so in fact agents' sentiment continues at high levels, similar to those seen at the beginning of 2015. All in all, with this information, our MICA-BBVA model estimates growth of around 0.4% QoQ in Q1 2016.

- As for prices, inflation rose by 0.1 pp in March, to -0.1% YoY, one tenth of a percentage point above expectations, due to increased prices of food and services, which more than offset the further fall in energy prices and led to an increase of 0.1 pp in core inflation, to 0.9% YoY. Beyond the price volatility of services in the past two months – one-off measures in February and a certain holiday effect in March, we continue to see core inflation staying weak yet stable (at just under 1%) throughout the year, while oil prices will keep headline inflation negative until summer, after which it will pick up slowly to reach somewhat positive rates at year-end (just over 0.5% YoY).

What we expect from the ECB

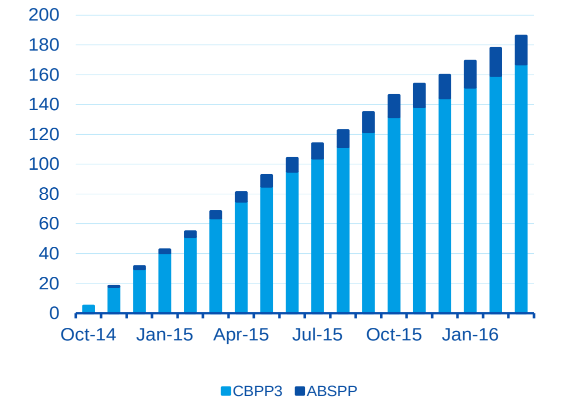
- At the monetary policy meeting held on March 10, in addition to the new package of measures, the ECB stressed that there was room to adopt more, dismissing the view that everything possible had already been done in terms of QE policy and emphasising that, if necessary, it would prefer to apply unconventional measures rather than further rate cuts. This change of strategy is welcome in view of the possible negative consequences of persisting with negative rates. The latest statements by ECB members continue to support this view that it is prepared to take more measures if necessary and that it might even cut rates further. All the same, the ECB has less and less room for manoeuvre, and at the same time, as Draghi pointed out, the effectiveness of additional monetary measures diminishes if they are not accompanied by coordinated fiscal stimulus measures.

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



Sources: ECB and BBVA Research

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



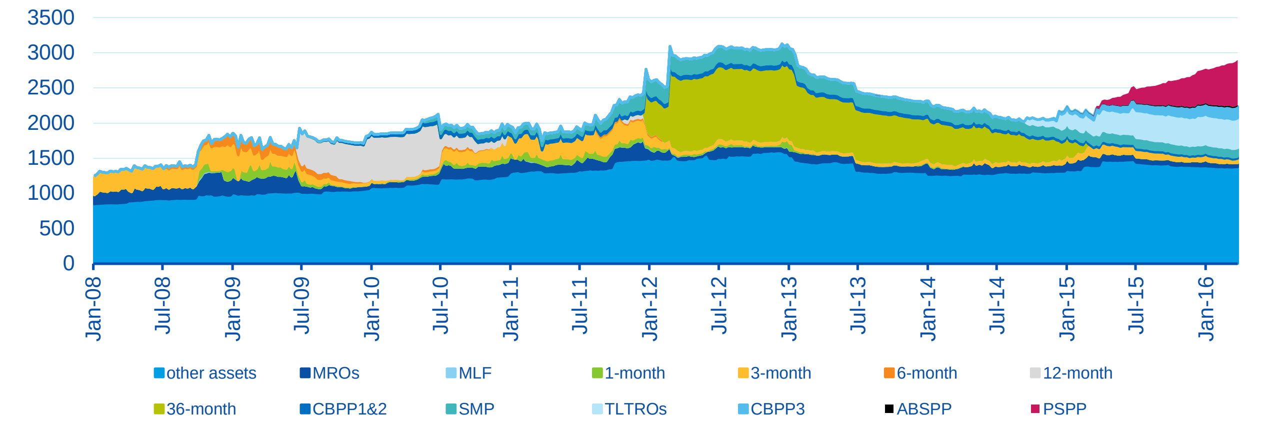
Sources: ECB and BBVA Research

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	Feb-16	Mar-16
TLTRO	82,6			130,0			97,8			73,8			15,5			18,3			7,3
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	7,8	7,8
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	2,3	0,9	0,4
PSPP							47,4	47,7	51,6	51,4	51,4	42,8	51,0	52,2	55,1	44,3	52,9	53,4	53,1

Sources: ECB and BBVA Research

Graph 3
ECB balance sheet (€ billions)

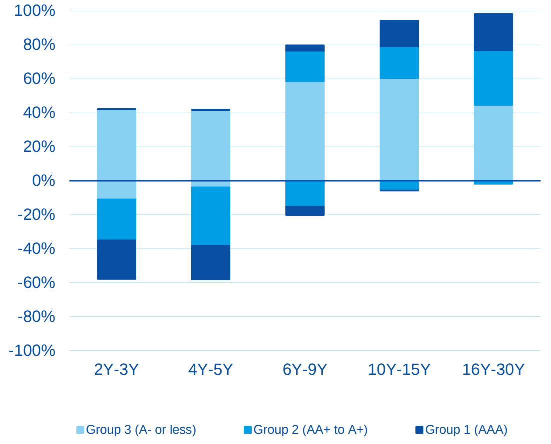


Sources: ECB, Bloomberg and BBVA Research

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

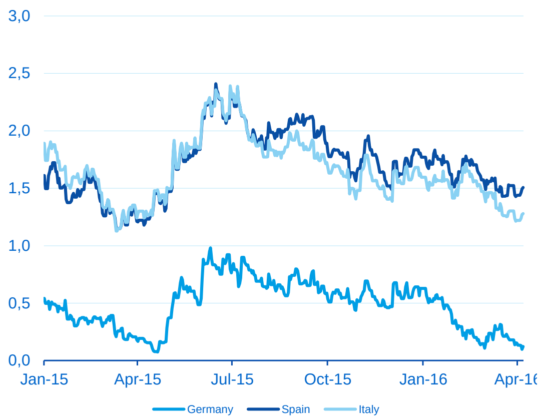
*Eligible under the PSPP
Sources: Bloomberg and BBVA Research

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



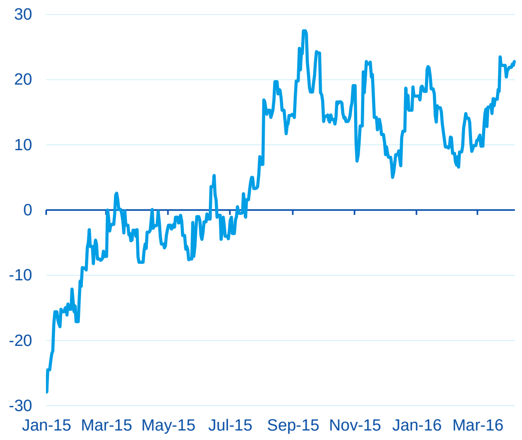
*Eligible under the PSPP
Sources: Bloomberg and BBVA Research

Graph 6
Ten-year interest rates (%)



Sources: Bloomberg and BBVA Research

Graph 7
Differential ten-year bond Spain-Italy (bps)

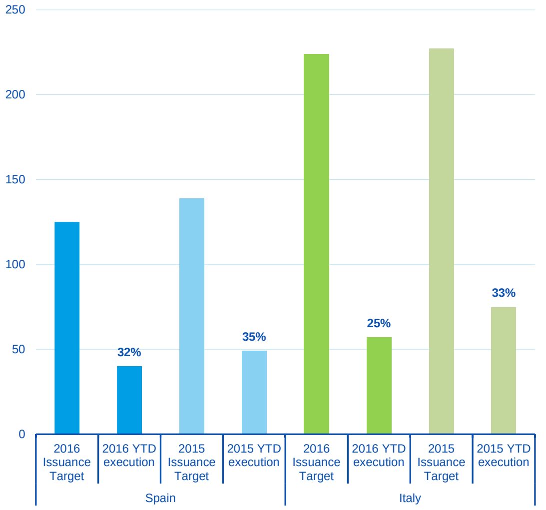


Source: Bloomberg and BBVA Research

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

Source: National Treasuries, Bloomberg and BBVA Research

Figure 9
Development of medium- and long-term bond issue programmes (March, € billions)



Source: National Treasuries, Bloomberg and BBVA Research

Table 2
Holders of debt (% of total debt)

Country	Non-resident		Domestic Banking sector	
	2014	2015	2014	2015
Germany*	61,8%	59,4%	23,6%	23,4%
France	64,3%	62,8%	9,4%	9,8%
Italy *	37,6%	38,9%	22,2%	21,6%
Spain	42,7%	47,0%	30,4%	25,1%

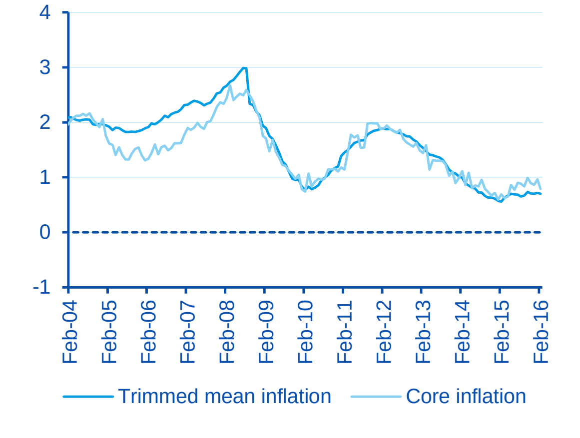
*Data to Q4 2015
**Data for Spain includes only Treasury debt
Source: Central banks, National Treasuries and BBVA Research

Table 3
Objectives for 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

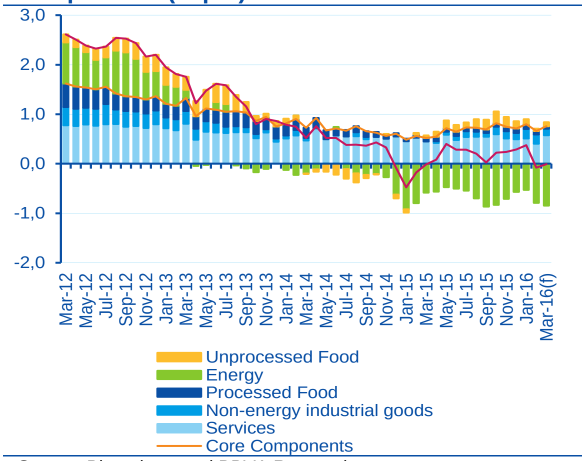
Source: Bloomberg, National Treasuries and BBVA Research

Figure 10
EMU: inflation (% YoY)



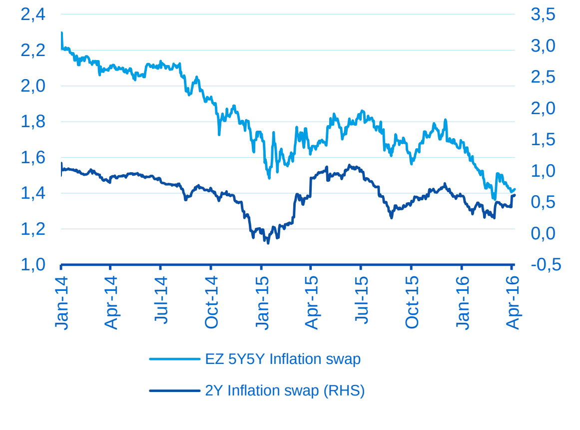
Source: Bloomberg and BBVA Research

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



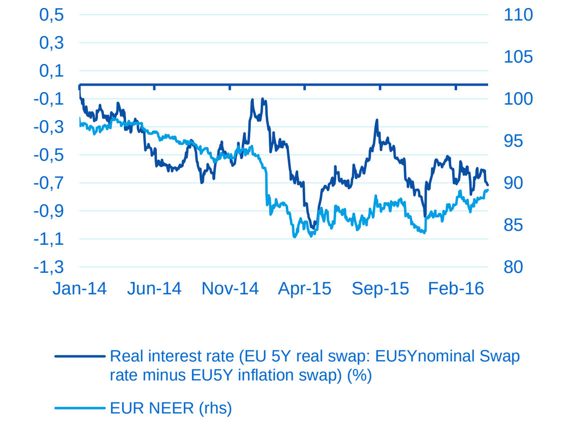
Source: Bloomberg and BBVA Research

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



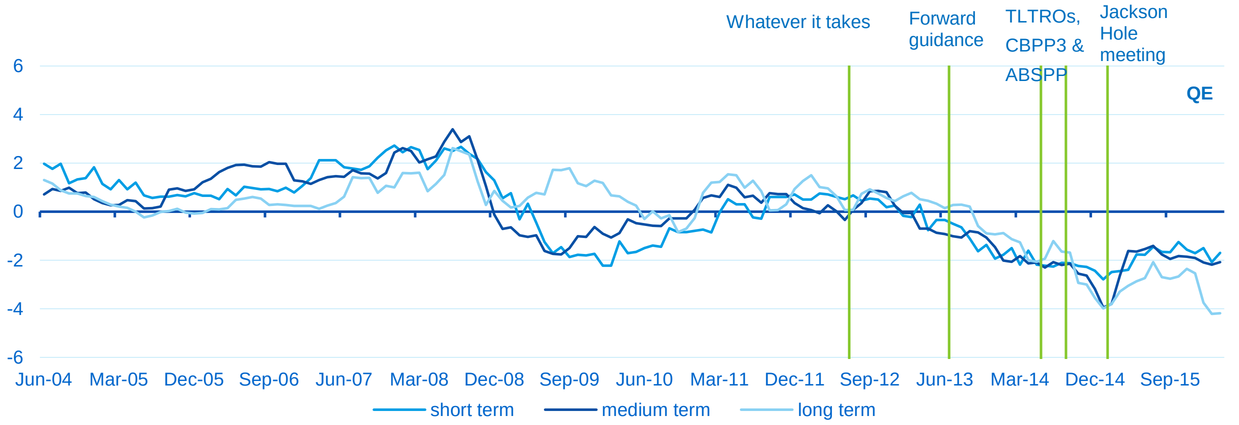
Source: Bloomberg and BBVA Research

Figure 13
Tightening financial conditions



Source: Bloomberg and BBVA Research

Figure 14
Compound indicators for monitoring 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, 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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