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ECB Preview: Setting the ground for the next QE extension

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With the euro area inflation still weak and the full shock of the UK's Brexit referendum outcome yet to come, the ECB is widely expected to announce an extension of its APP program at the 8 September meeting. While key policy rates and the size of the monthly purchases are expected to be kept unchanged, a 6 to 9 month extension of asset purchases to September 2017 seems to be on the cards, possibly accompanied by some modifications in QE technical modalities in order to tackle the bond scarcity problem. Meanwhile, the ECB will present its updated quarterly macro forecasts amid a modest continuing economic recovery. We do not expect any significant changes to the ECB's June inflation projections of 0.2% for 2016, 1.3% for 2017 and 1.6% for 2018. Nevertheless, GDP growth projections could be revised downwards from the respective 1.7% June estimate for 2017 and 2018 on the back of a possible slowdown in countries with strong trade linkages with the UK.

Below we present some of the possible key ECB options in order for the QE to be effectively adjusted. Moreover, we analyze the potential market impact of each option.

(i) Increase of the 33% issue/issuer share limit

The issue share limit per ISIN (International Securities Identification Numbering) is the maximum share of any single public-sector security that a central bank in the euro area can hold and is actually set to prevent the ECB from gathering a blocking minority to any future possible debt restructuring plans due to the presence of collective action clauses (CACs). The 33% threshold applies as well to the exposure to any specific bond issuer. The ECB has already increased the issue/issuer share limit twice in the past, i.e. from 25% to 33% for assets without CACs in September 2015, and from 33% to 50% for EU supranational institutions in June 2016. The ECB could raise the issue limit on non-CAC bonds from 33% to 40-50% in order to increase the available pool of eligible assets without triggering political concerns, while an increase in the issue limit for CAC bonds is less likely given the uncertainty such a move would cause on the effectiveness of the CAC mechanism in case of a potential debt restructuring proposal. Given that the total market value of the 2-31y European Government Bonds (EGBs) is currently at ca EUR 6.0trn and about 61% of them do not have CACs[1], an increase in the issue share limit on these non-CAC bonds from 33% to 50% would add roughly an additional EUR 620bn to the pool of PSPP-eligible bonds for purchase (assuming unchanged bond yields). In Germany, an issue share limit increase from 33% to 50% would add an additional EUR 100bn to the eligible pool (61% of ~EUR 600bn 2-31y bonds do not have CACs).

[1] All Euro area government securities issued since 1/1/2013 have Collective Action Clauses (CACs)

Nevertheless, 45% of the EUR 100bn eligible German government bonds are trading below the ECB deposit facility rate of -0.40%, so roughly EUR 55bn would be added to the pool of eligible bonds, which is equivalent to about 4-6 more months of purchases under the existing monthly pace of EUR 80bn. However, it should be noted that the total amount of eligible bonds largely depends on the level of yields as well, as a rise in the German yields would lead to an increase in the total amount of bonds for purchase given that more non-CAC bonds would start trading above the ECB deposit rate.

Potential market impact: Raising the issue share limit from 33% to 50% for the non CAC bonds (bonds without collective action clauses) would allow the QE program to be extended further without hitting the issue issuer limit. This option should lead to a lengthening of the average maturity purchased, as under the current shape of the yield curve, for example in Germany, the weighted average maturity of non CAC bonds that are trading above the ECB deposit rate is 17.5y versus 12.5y for bonds with EU model CACs. The curve would probably flatten in this case, with long term rates falling further. However, the future availability of purchasable bonds will still depend on the deposit rate limit. There is unlikely to be a clear bias for peripheral or semi core spreads. Impact should be limited with spreads moving slightly wider on repricing of total ECB purchases on those markets.

(ii) Removal of the Deposit-Rate Floor for QE purchases

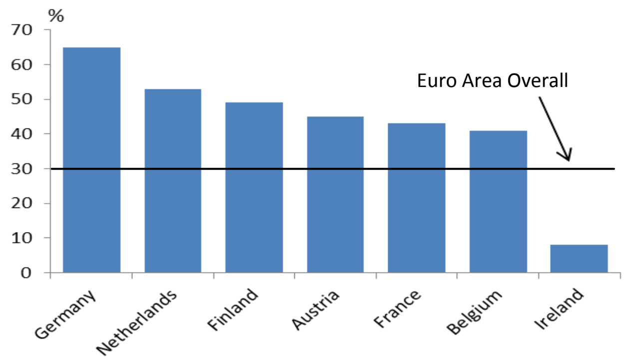
The ECB currently buys bonds yielding above the -0.40% deposit facility rate. Should it remove the deposit rate floor, it would actually de-link PSPP eligibility from yield levels so that a large amount of short end bonds trading at present below the ECB deposit rate will be included again in the PSPP. More specifically, this option would help tackle the bond scarcity problem in Germany, as German government bonds up to 8 years yield below the deposit rate and amount to roughly EUR 470bn (more than 60% of the German curve, see Figure 1). Hence, such a move would make about EUR 155bn bonds eligible for the purchase program. Nevertheless, this removal could result in losses for the Eurosystem, as buying a bond that yields less than the deposit facility rate, with which excess liquidity in the Eurosystem is paid, induces a negative cash flow on ECB purchases.

Market impact: Removing the Depo floor will de link PSPP eligibility from yield levels. All short end bonds currently trading below the ECB deposit rate (-0.40%) will be eligible again. This should push yields in the short end of core lower and trigger substantial curve steepening, as purchases in longer maturities would decrease. The 2-7y area is expected to outperform across the curve. The 10y Bund yield currently trading at (-0.05%) is expected to correct into positive territory.

(iii) Shift from capital key towards debt key criteria

The PPSP purchases are currently allocated between the national central banks (NCBs) in accordance with their capital key weights. In more detail, the NCBs' shares in the ECB's capital are calculated using a key reflecting the respective country's share in the total population and GDP of the EU. These two determinants have equal weighting. The ECB adjusts the shares every five years and whenever a new country joins the EU. According to the ECB database, the capital of the ECB of all EU Member States amounts to €10,825,007,069, out of which €7,619,884,851 comes from euro area NCBs. Column 1 of Table 1 depicts the breakdown of the fully paid-up subscriptions of euro area NCBs, while Column 2 shows the equivalent ECB's capital key weights. However, this definition includes non Euro-area-countries as well, so the euro area member states ratios are adjusted accordingly in Column 3.

Figure 1: Sovereign Debt yielding below the deposit facility rate (as a % of total)



Source: Bloomberg, Eurobank Economic Research

Table 1: Euro area NCBs' contributions to the ECB's capital

National Central Bank	Paid-up capital (€)	ECB Capital key %	Adjusted Capital key after the removal of non-Euro countries
Nationale Bank van België/Banque Nationale de Belgique (Belgium)	268,222,025	2.48	3.52
Deutsche Bundesbank (Germany)	1,948,208,997	18.00	25.57
Eesti Pank (Estonia)	20,870,614	0.19	0.27
Central Bank of Ireland (Ireland)	125,645,857	1.16	1.65
Bank of Greece (Greece)	220,094,044	2.03	2.89
Banco de España (Spain)	957,028,050	8.84	12.56
Banque de France (France)	1,534,899,402	14.18	20.14
Banca d'Italia (Italy)	1,332,644,970	12.31	17.49
Central Bank of Cyprus (Cyprus)	16,378,236	0.15	0.21
Latvijas Banka (Latvia)	30,537,345	0.28	0.40
Lietuvos bankas (Lithuania)	44,728,929	0.41	0.59
Banque centrale du Luxembourg (Luxembourg)	21,974,764	0.20	0.29
Central Bank of Malta (Malta)	7,014,605	0.06	0.09
De Nederlandsche Bank (The Netherlands)	433,379,158	4.00	5.69
Oesterreichische Nationalbank (Austria)	212,505,714	1.96	2.79
Banco de Portugal (Portugal)	188,723,173	1.74	2.48
Banka Slovenije (Slovenia)	37,400,399	0.35	0.49
Národná banka Slovenska (Slovakia)	83,623,180	0.77	1.10
Suomen Pankki – Finlands Bank (Finland)	136,005,389	1.26	1.78
Total	**7,619,884,851**	**70.39**	**100.00**

Source: ECB, Eurobank Economic Research

It should be noted that, given that (i) 90% of the total PSPP purchases are allocated to government banks and recognized agencies and 10% are allocated to Supranationals (international organizations and multilateral development banks) and that (ii) Greek and Cypriot domestic securities are currently excluded from the PSPP purchases, the final country ratios may be subject to minor changes.

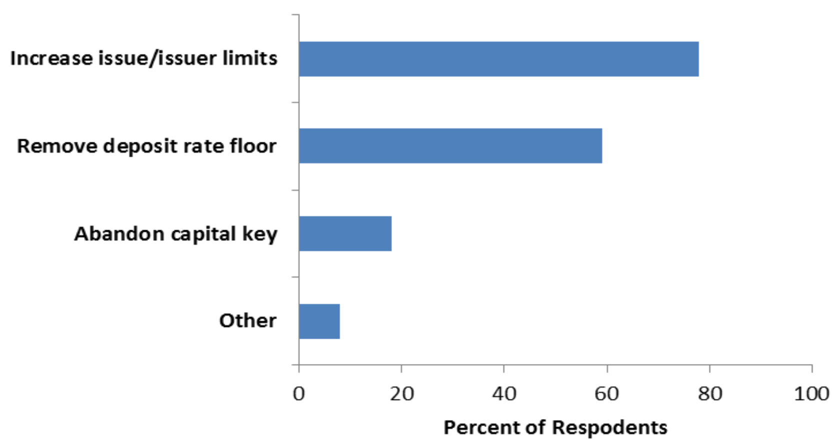
A deep-seated option for the ECB could be to change its allocation of asset purchases between euro area countries based on the ECB capital keys to an allocation based on the actual size of their outstanding debt. Nevertheless, this option could raise opposition by some Governing Council members, and particularly by those originating from Germany, as countries with higher debt levels such as Italy and France would be actually rewarded with higher purchases at the expense of Germany, Netherlands and Finland. ECB's Jens Weidmann has recently criticized this option, highlighting that increasing bond purchases from countries with high indebtedness or bad credit ratings would distance the ECB further from its core mandate.

Potential market impact: Shifting from capital key towards outstanding debt-weighed key would be the most drastic option for the ECB. It could result in a bear steepening of the German curve. Purchases of German paper could decline substantially compared to purchases of Italian paper, leading to a significant tightening between the two curves.

Conclusion

We have highlighted three main potential changes in the technical parameters of the program that could improve the implementation of the ECB's quantitative easing program on the sovereign bond space. As we approach Thursday's ECB meeting, market participants are divided in their views on whether ECB's President Mario Draghi will proceed to an immediate policy announcement or delay the move until October or December. In our view, at least a commitment from the ECB to extent QE beyond March 2017 would be needed so as not to disappoint the markets. While some suggestions of possible changes in QE technicalities could be revealed at tomorrow's press conference, we cannot rule out the possibility that such modifications are finally announced towards the end of the year.

Figure 2: Changing the Rules, Four in five economists predict the ECB will tweak the parameters to its QE program



Source: Bloomberg survey of 50 economists conducted Aug. 30- Sept. 1

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