Global Financial Trends

THE €1.5 TRILLION QUESTION (IN CHARTS)

Shweta Singh / Davide Oneglia

- We expect the ECB will announce a new stimulus package in September
- It may include a rate cut, a multi-tiered deposit rate and the restart of QE
- We expect QE-II to include public sector bonds, non-bank private debt and supranational bonds
- The size of eligible assets range from EUR1-1.5 trillion, depending on whether the ECB eases its QE curbs
- But , the fresh stimulus is unlikely to boost the EA's relative competitiveness
- The ECB is pushing on a piece of string and it is aware of it

key points

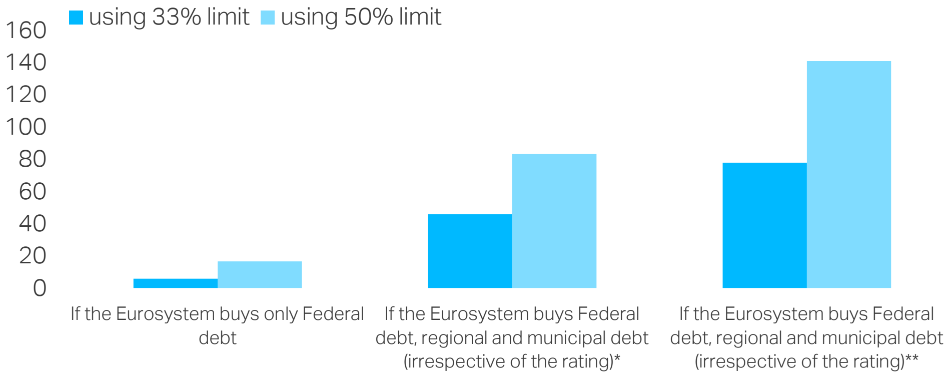
Summary

Growth slower for longer	• EA growth outlook has deteriorated rapidly • Trade-related uncertainty has dampened global demand, hurting EA exports, manufacturing and capex • Manufacturing weakness spreading to services; employers revising their hiring and investment plans lower
Inflation expectations plunge	• Inflation expectations – based on market pricing and survey-based measures – plunge • Producers delaying the pass-through of cost pressures to consumers • The disinflationary trend may be global, but the drop in EA inflation risk premium is significant • Markets seem to be questioning the ECB's ammunition and/or commitment to fight low inflation
The ECB toolkit	• The ECB has signalled more stimulus to combat the surging headwinds to growth and inflation expectations • We expect an easing package to be announced in September • It may include enhanced forward guidance, a rate cut, a multi-tiered deposit rate and the restart of QE • We expect QE-II to include public sector bonds, non-bank private debt and supranational bonds • The size of eligible assets range from EUR1-1.5 trn, depending on whether the ECB eases QE restrictions
Pushing on a piece of string	• The fresh ECB stimulus is unlikely to boost the EA's competitiveness as it did during 2014-16 o The starting point for EUR/USD is much lower than it was for QE-I o Most central banks, including the Fed, are also in easing mode o There are lingering concerns that trade wars may morph into a global FX war o External assets are less attractive for EA residents, especially on a hedged basis • QE-II will have a milder impact than QE-I o The size of QE-II will likely be smaller than QE-I o The boost to competitiveness will likely be more modest (see above) o Borrowing costs across the EA are generally lower and lending spreads tighter than at the start of QE-I o Fragmentation risks are muted while they were severe just before the ECB signalled QE-I • With its deposit rates already at a negative 40bps, its balance sheet surging to 41% of GDP and huge constraints on the bond-buying scheme, the ECB is pushing on a piece of string

Summary

How many govies can the ECB buy?

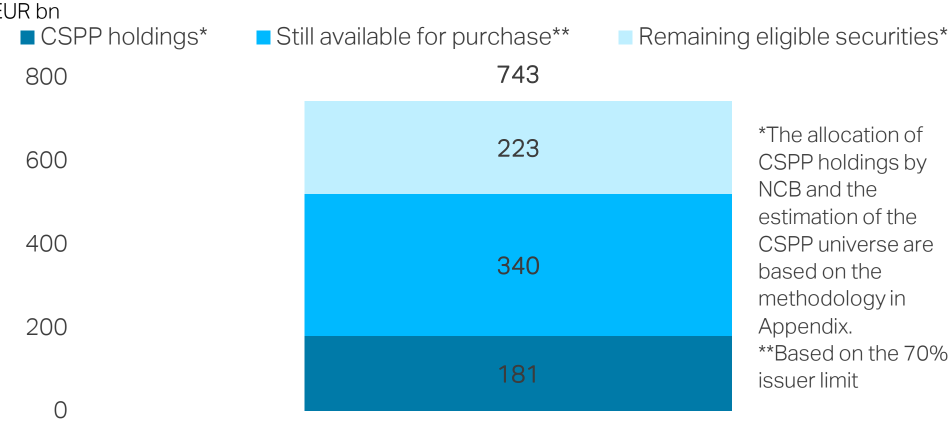
Size of ECB QE per month for 12 months, EUR bn



*assuming 50% of regional and municipal debt are financed using debt issues
**assuming all regional and municipal debt are financed using debt issues

How many non-bank corporate bonds can the ECB buy?

EUR bn



*The allocation of CSPP holdings by NCB and the estimation of the CSPP universe are based on the methodology in Appendix.
**Based on the 70% issuer limit

Global growth has slowed rapidly as trade-related uncertainty and a strong dollar take a toll on exports and financing conditions. These will continue to weigh on the euro area expansion, which we expect to remain lacklustre (just above 1% annually for 2019-20) and below its potential growth rate. Meanwhile, inflation expectations – based on both surveys and market pricing – have dropped sharply, raising worries about a potential de-anchoring of expectations.

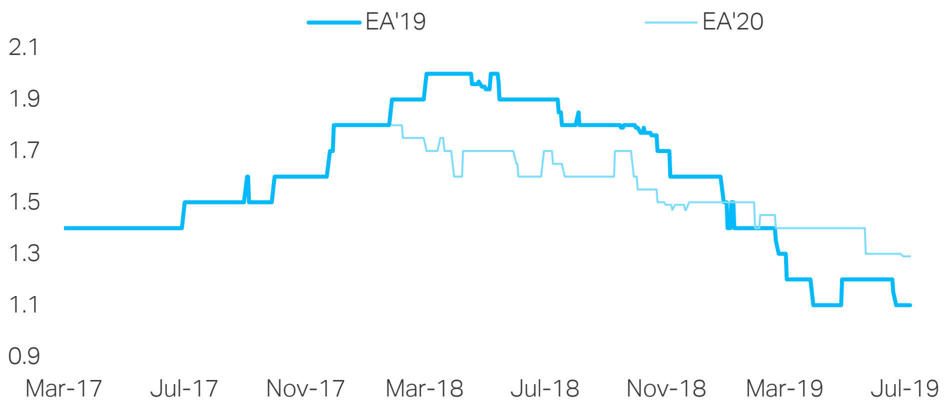
With not much support from fiscal policy, the European Central Bank has signalled a fresh stimulus package, which it could announce in September. We expect the ECB to enhance its forward guidance, cut interest rates, adopt a tiered deposit rate and restart QE. If the central bank were to adhere to the self-imposed constraints on its asset buying programme, the scope of QE-II would be quite limited: we estimate it could be just over a third of QE-I which was EUR2.6trn. But if the central bank were to loosen some of the restrictions, for instance by raising the issuer limit from 33% to 50%, it could buy up to EUR1.5trn of assets, including government, supranational and non-bank private sector debt. While not our base case, the ECB could always relax its politically sensitive eligibility criteria such as the capital key constraint and expand the type of assets it can buy such to include equities and bank bonds.

The key question is about the effectiveness of a fresh round of stimulus. The marginal benefits of cutting rates deeper into negative territory are limited at best, even if such a move is accompanied by a new round of cheaper long-term refinancing operations (TLTROs) and a tiering of deposit rates. On the other hand, QE-II could give a more meaningful boost to monetary and financing conditions. Even so, a second round of asset purchases would have a milder impact than QE-I, when borrowing costs were higher, fragmentation across the EA was severe and domestic risks were far greater. Crucially, the bar for the euro to edge lower and boost inflation expectations may be much higher this time, while the pool of eligible assets that the ECB can buy has shrunk since QE-I was launched.

EA growth slows sharply

Downward revisions to EA growth forecasts

Real GDP growth forecasts, %y/y, Bloomberg survey



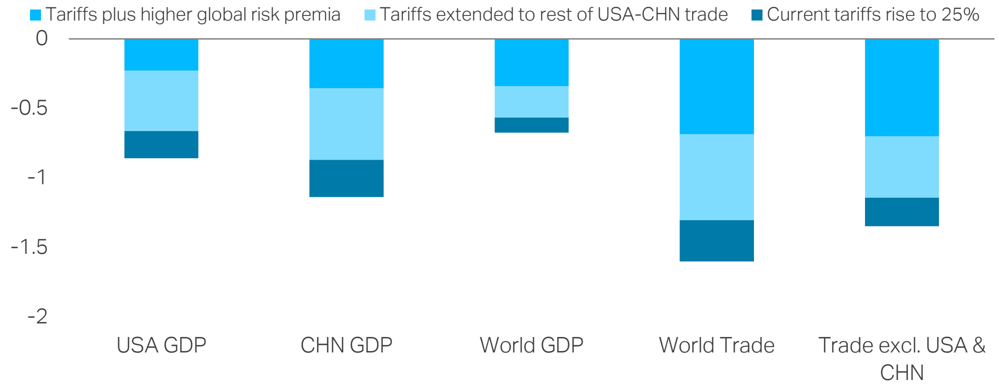
The euro area is reeling under the impact from a slowing global economy, which has damaged exports and dented factory output. Data has consistently surprised on the downside, even as forecasts have been revised lower. It has become increasingly evident that idiosyncratic factors have not been the main drag on growth. The deceleration has been led by persistent uncertainty about an escalation in trade tensions, a rise in tariffs and a strong dollar. These headwinds are unlikely to stop blowing in the near-term.

Consequently, analysts have revised down their EA growth forecasts sharply over the last 12 months. Projections for this year have halved and those for the next year have been scaled back significantly. The downgrades are most pronounced in the more externally focused economies of Germany and Italy.

Source: Bloomberg, Datastream, TS Lombard

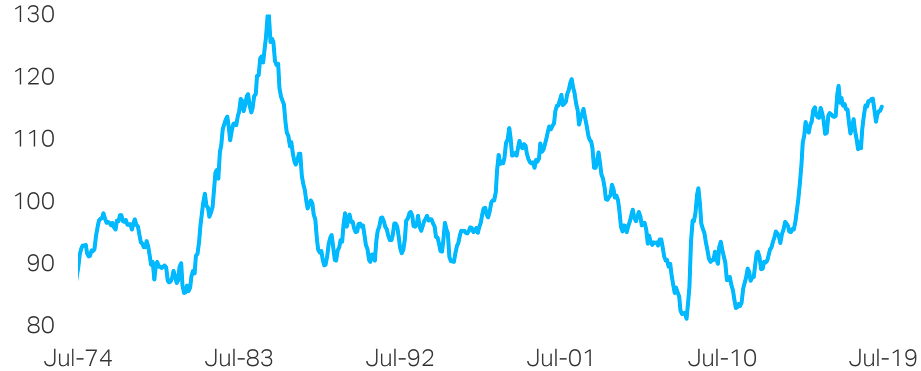
Impact of US-China tariffs

Impact on the level of GDP and trade by 2021-22, per cent difference from baseline



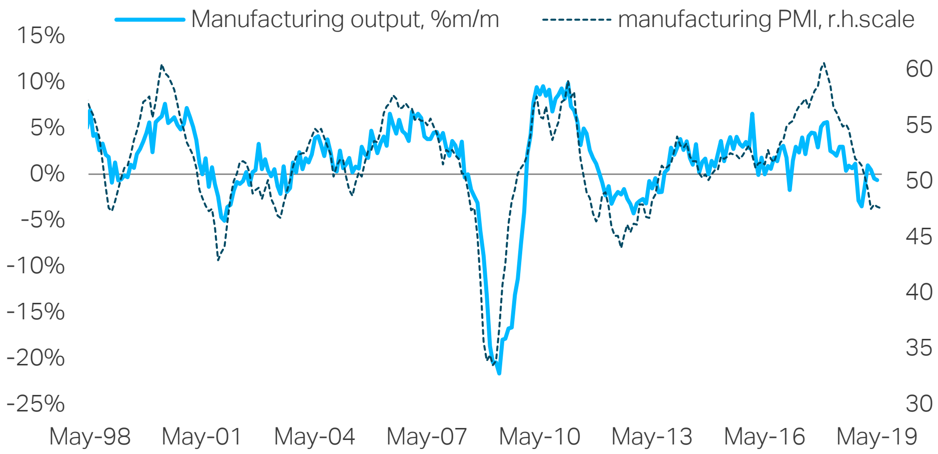
A strong dollar is punitive for global demand

US real effective FX rate, PPI-based, post-1973 average = 100



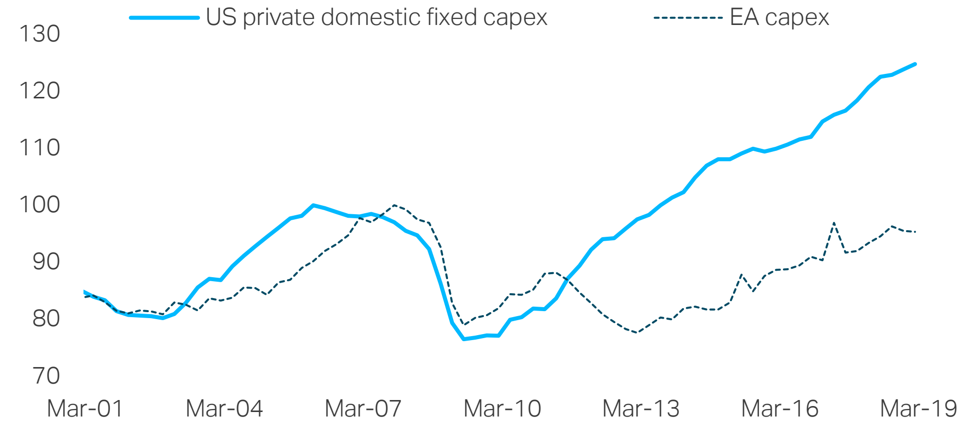
Manufacturing is the main drag

EA manufacturing the worst hit



EA capex struggling at already modest levels

Indexed to the peak prior to the GFC

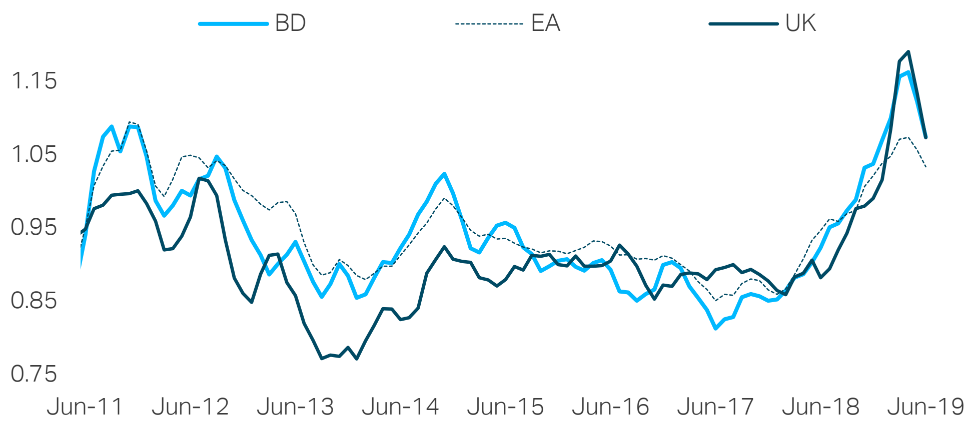


The manufacturing sector has been the main source of weakness for the euro area. The manufacturing PMI has stayed below 50 for most of the year: a reading below 50 is consistent with a sequential month-on-month drop in output (chart above). New orders – exports and domestic – have fallen more sharply, signalling that the sector is likely to remain under pressure (chart above). The decline in German manufacturing has been particularly severe – factory output has declined sequentially in five out of six quarters since last year.

The dismal manufacturing outlook is beginning to weigh on capex and job growth. This is occurring even as EA capex has been weaker than in most developed economies (chart in the top-right corner) and has plenty of room to expand. Businesses still have relatively sound balance sheets and borrowing costs are cheap. Yet firms are hesitant to increase investment, largely because of continued uncertainty regarding policy and its impact on global demand.

The inventory overhang

Manufacturing PMI: Stock of existing purchases to new orders

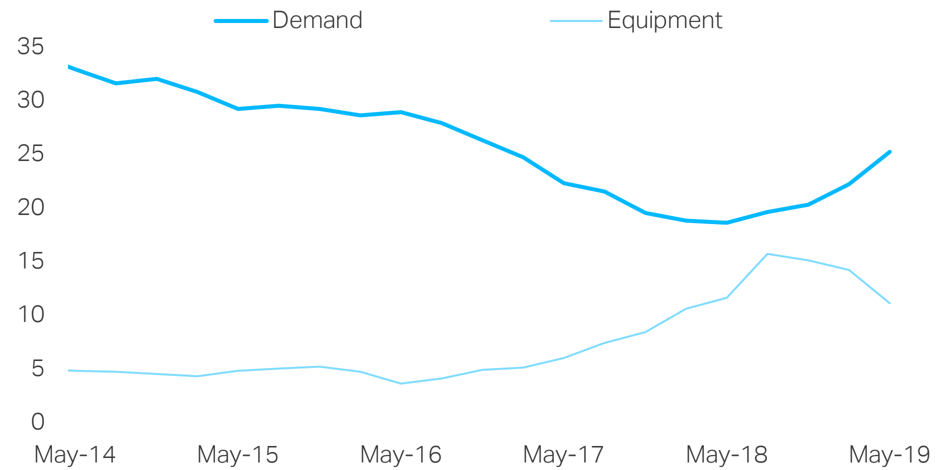


Source: Bloomberg, Datastream, Markit, TS Lombard

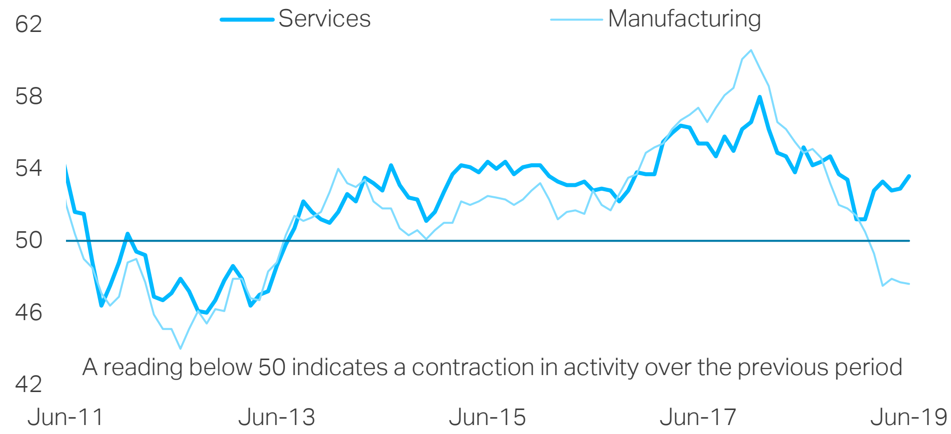
Weakness spreading to services

Weak demand a growing concern

Factors limiting production, % of surveyed firms

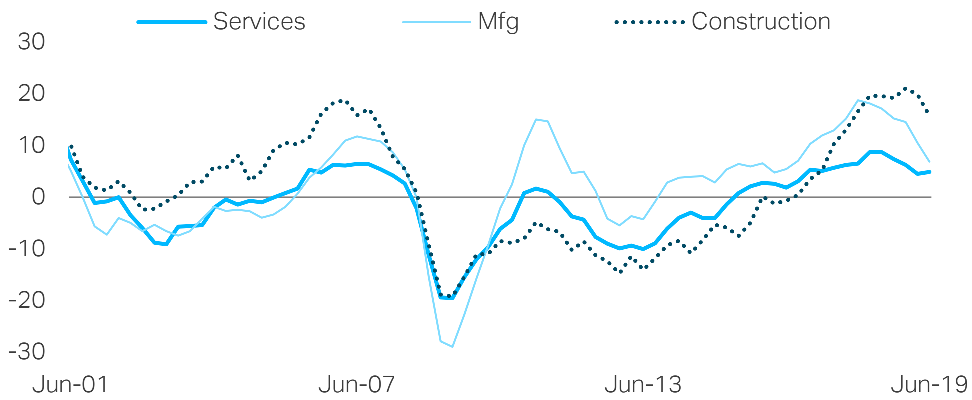


Services PMI has stabilised recently at a modest level



Firms less optimistic about hiring in general

Firms' employment expectations over the next three months, net balance



Prolonged uncertainty has caused weakness in manufacturing to spread to the erstwhile resilient services sector. Consumers have been the main engine of the EA economy as brisk growth in wages and jobs and muted inflationary pressures have boosted real incomes.

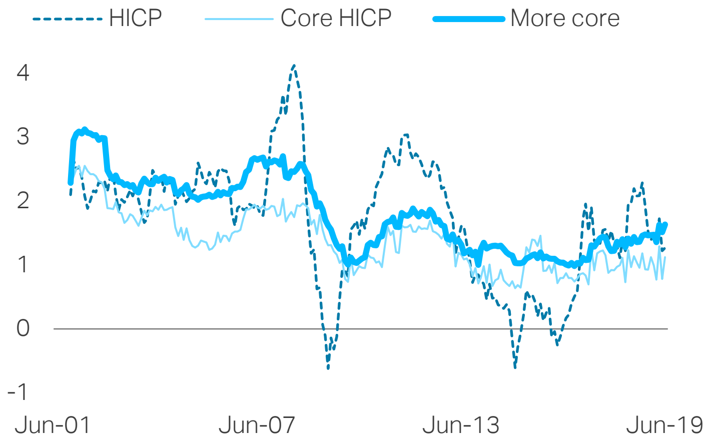
But services are beginning to show signs of fatigue (chart in the top-right corner). A larger share of surveyed firms are citing weak demand as the factor holding back production plans (chart above). This is in sharp contrast to the trend observed since mid-2013. Businesses in services and construction are also revising lower their hiring intentions chart in the bottom-right corner), which is set to dampen consumer spending further.

Source: Bloomberg, Datastream, EC, TS Lombard

Disinflationary risks

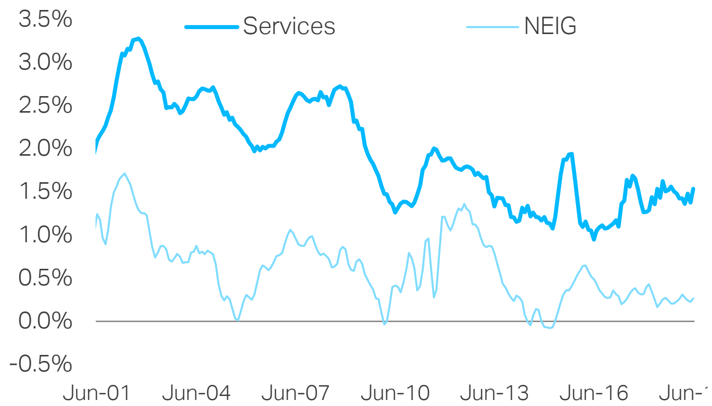
EA inflation - headline, core and 'more' core

% annual change



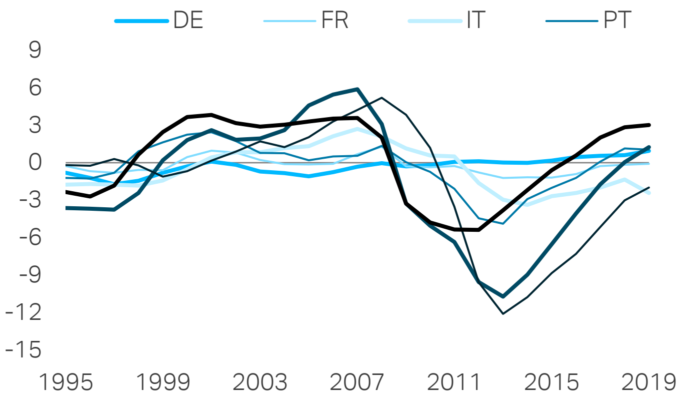
EA inflation - NEIG and services

EA HICP, % annual



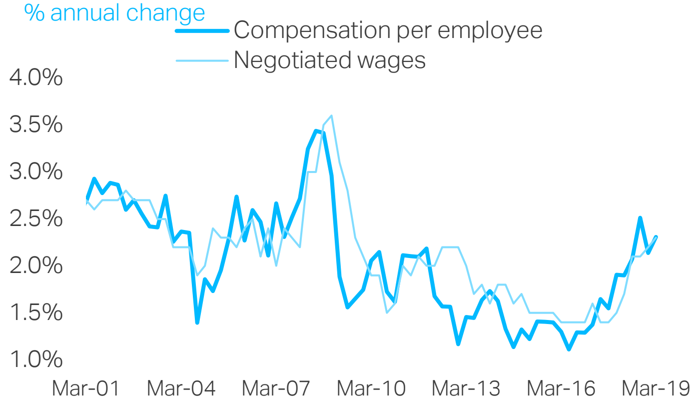
EA unemployment

NAIRU less unemployment rate, %



Wage growth picks up

% annual change



Source: Bloomberg, Datastream, EC, ECB, TS Lombard

With growth slowing sharply, disinflationary concerns have taken centre stage. The latest ECB monetary policy statement noted that inflation rates, both realised and projected, have been persistently below the ECB's target (headline CPI inflation close to but below 2%).

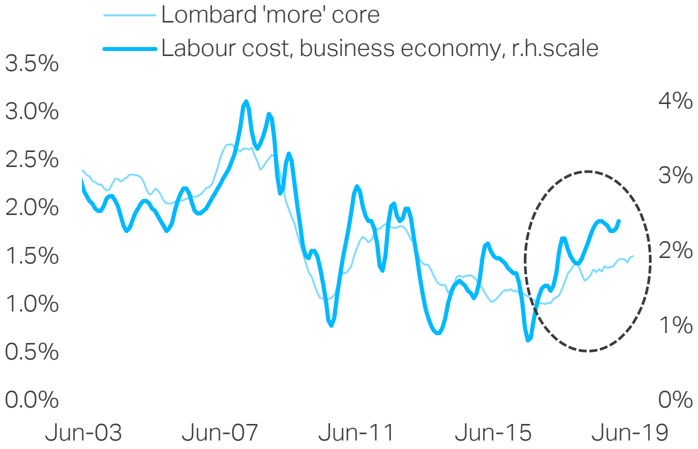
Our measure of 'more' core inflation – which includes items in the CPI basket that have a significant relationship with the output gap – has been inching higher, albeit very gradually. It rose to 1.6% from 1.3% a year ago (chart in top-left corner). However, core inflation has been stuck at 1% rate since 2016.

The pace of increase in the prices of non-energy industrial goods has remained sluggish as the lagged impact of past EUR appreciation on a trade-weighted basis feeds through the economy. Services inflation has held up relatively better, although it has also been sticky – hovering around 1.5% since 2017. Wages are growing at a brisk rate, but the pass-through to the real economy has been weak – perhaps because there is still slack in the economy.

Plunging inflation expectations a key worry

Producers delay cost pass-through

% annual change, 3MMA

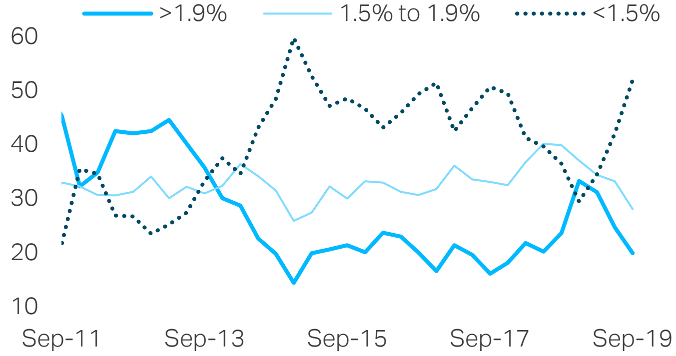


Inflation expectations plunge

EUR 5y5y

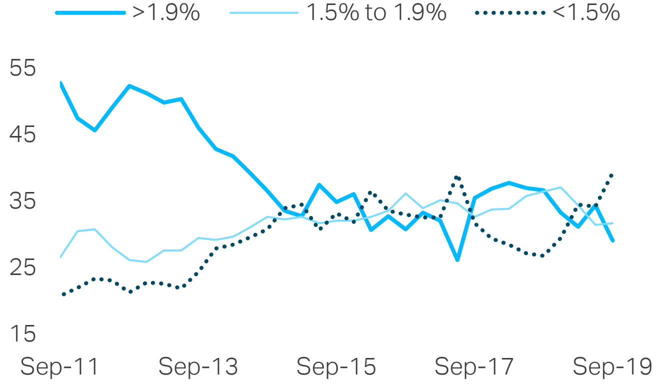
Survey-based inflation expectations (1Y) plummet

Inflation forecasts, 1-year forward



Survey-based inflation expectations (5Y) fall

Inflation forecasts, 5-years forward



Source: Bloomberg, Datastream, SPF, TS Lombard

Unemployment in the EA has dropped to the lowest level since the global financial crisis. But when adjusted for NAIRU – estimates of which have been consistently revised lower – the decline in labour market slack looks less impressive (chart in the bottom-left corner on the previous page).

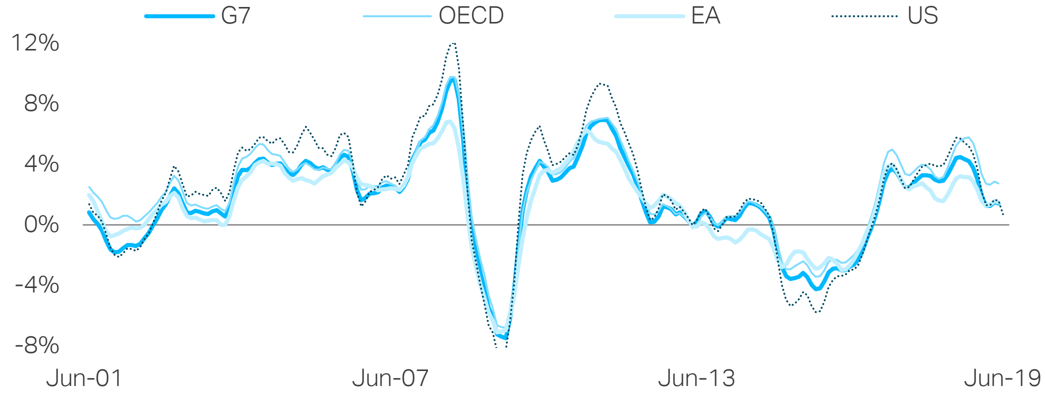
There is also a structural element at play: EA businesses generally have less pricing power due to regulations fostering greater competition. Even so, **the divergence between core inflation and labour costs in the EA is at its widest since data became available** (chart in the top-left corner). Firms are increasingly hesitant to pass on rising costs to consumers as they anticipate weak demand.

Crucially, **disinflationary risks have risen markedly as inflation expectations have slumped.** Market–based inflation expectations in particular have been in a freefall and continue to flirt with all-time lows (chart in the top-right corner). Survey-based measures of inflation expectations, which had been stable until recently, have also deteriorated rapidly over the last two quarters (charts at the bottom).

A global disinflationary trend, but inflation risk premium falls more sharply in EA

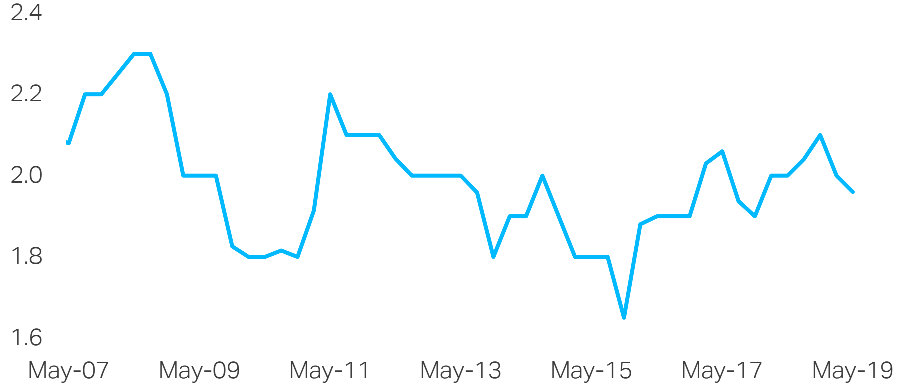
A global disinflationary trend

Manufacturing PPI, % annual change, 3MMA



US inflation expectations fall

US professional forecaster survey, five-year forward PCE inflation, median expectations

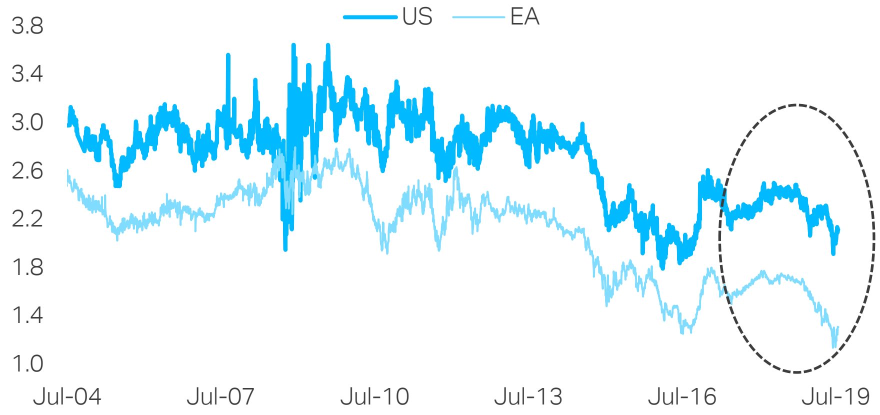


The recent increase in disinflationary pressure is not confined to the euro area. Factory output prices have fallen sharply globally (chart above) since last year. The yuan weakened as the US-China trade war escalated. RMB depreciation dampened emerging markets' relative competitiveness, pushing EM exchange rates lower. Producers also cut their export prices to retain market share.

Inflation expectations have also fallen globally. In the US, for instance, there has been a decline in both survey-based and market-based measures. While the trend is similar to that in the EA, there are some key differences. As, ECB Executive Board Member Benoît Cœuré highlighted in a March speech, the gap between market-based inflation expectations in the US and the EA is the widest since data became available in 2004, suggesting that idiosyncratic factors are at work too. While Cœuré also said the divergence was unlikely to be related to concerns about the ECB's credibility, more data have become available since his speech that suggest **the market is challenging the ECB's commitment and its ability to meet its inflation target.**

US and EA inflation expectations plunge

EUR and US 5y5y

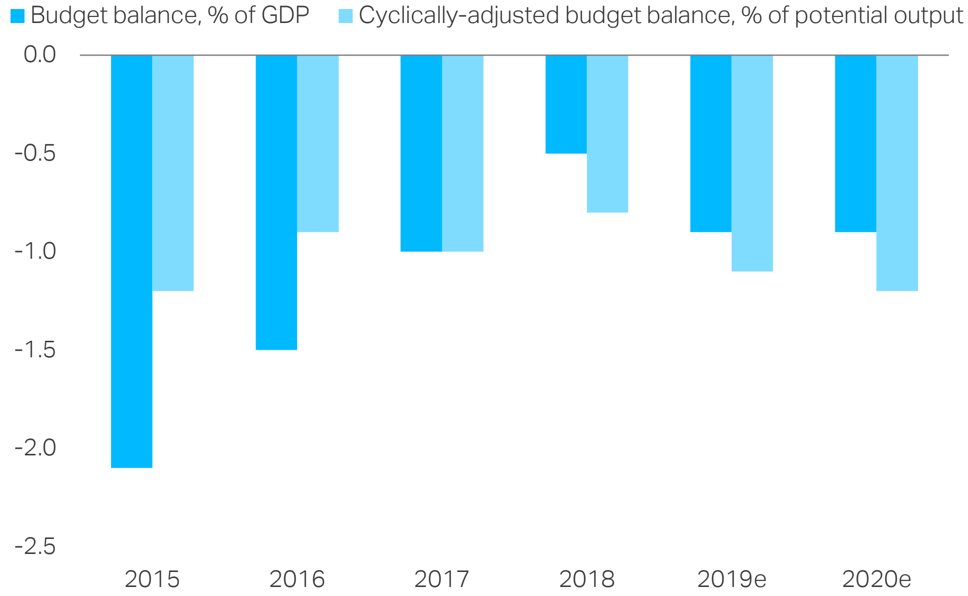


Source: Bloomberg, Datastream, IMF, TS Lombard

Only a modest fiscal stimulus to kick in

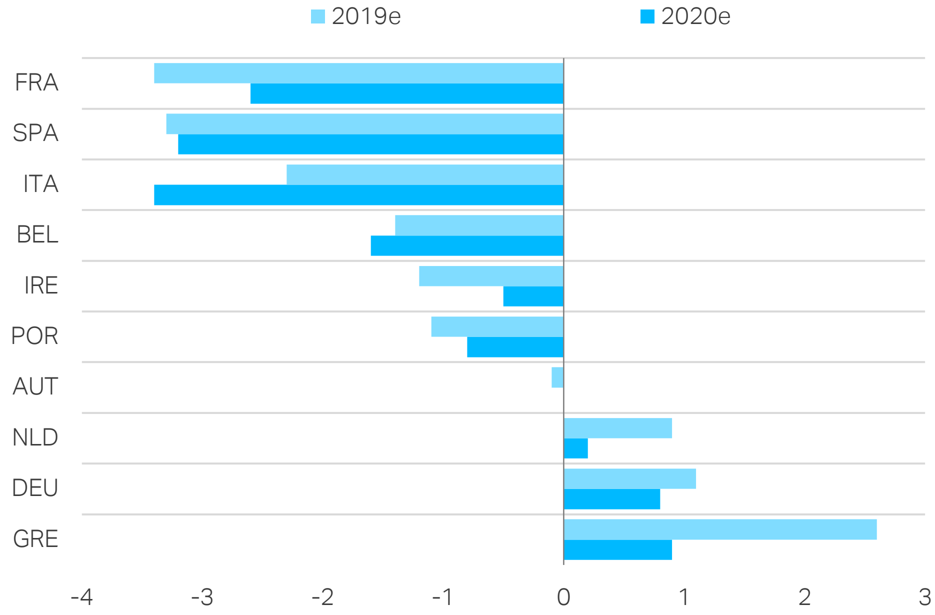
Modest fiscal stimulus to kick in

EC Spring 2019 forecasts for 2019-20



Fiscal balances by country

Cyclically-adjusted budget balance, % of GDP, EC 2019 Spring Report forecasts

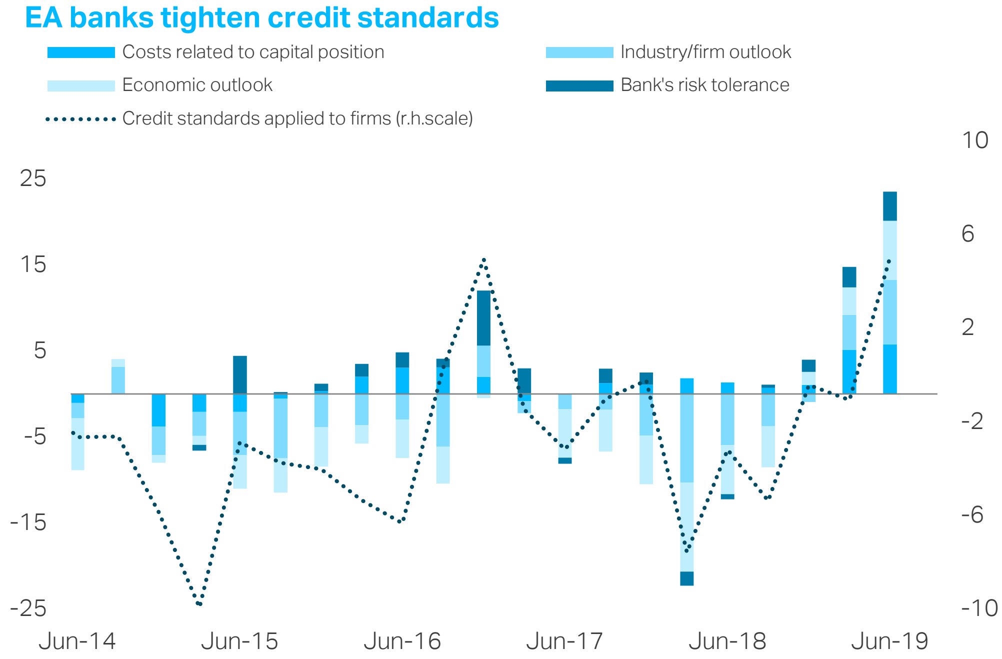


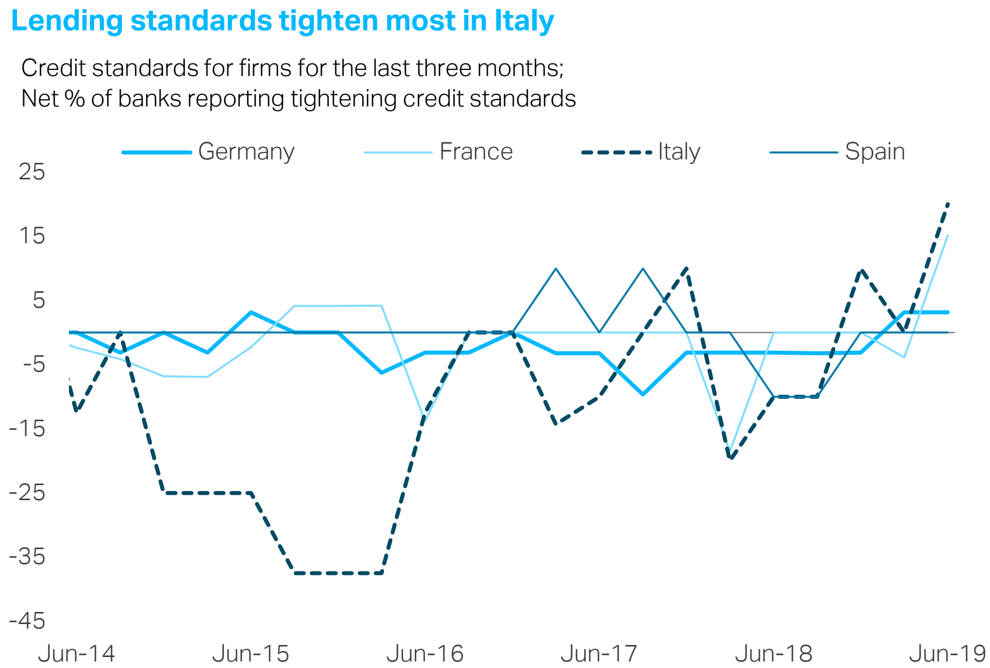
Meanwhile, **the fiscal policy response by EA governments to weakening growth leaves a lot to be desired.** According to the latest European Commission forecasts, the cyclically adjusted budget deficit for the EA is expected to increase marginally from 0.8% in 2018 to 1.1% this year and 1.2% in 2020. Germany will continue to run one of the largest budget surpluses globally over the next couple of years in spite of the sharp deterioration in its economic outlook. By contrast, fiscal stimulus for France and Spain is set to be more substantial.

The confrontation between Italian policymakers keen to deliver on their populist promises and the European Commission will escalate as the deadline for the approval of next year's budget draws near. The tussle between Rome and Brussels in the past has caused spreads to widen, the cost of funding for banks to rise and credit to contract. This has exacerbated the pain for an Italian economy mired in protracted stagnation.

Source: EC, TS Lombard

Banks tighten credit standards





The deteriorating economic outlook is weighing on EA lenders, especially Italian banks. According to the latest ECB Bank Lending Survey, banks tightened standards for both business loans - for the first time since 2016 - and consumer credit. This marks the end of the net easing period that began in 2014.

Banks reported that they dialled back their tolerance of risk because of a deterioration in the general economic climate and the situation of specific firms. Banks' cost of funds and balance sheet constraints, driven by costs related to their capital position, were other factor behind the tightening of credit standards.

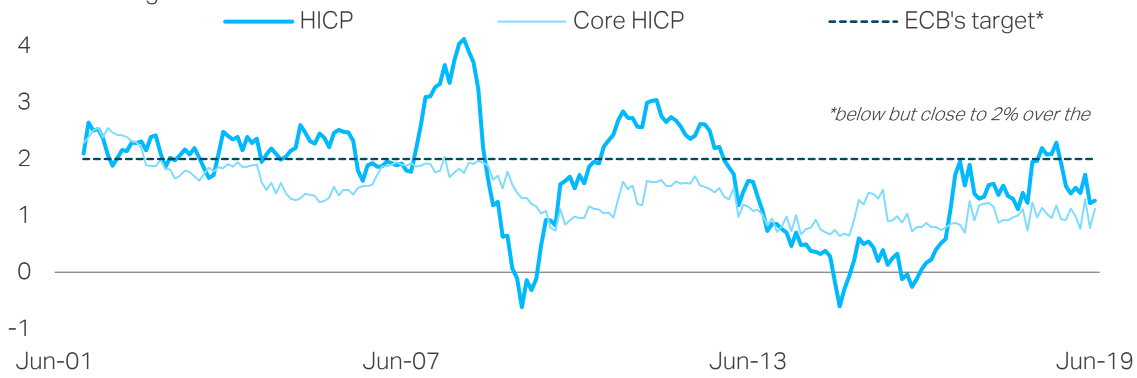
To counter the darkening economic outlook, and especially the fall in inflation expectations and the rise in risk premia, the ECB has signalled that more monetary stimulus is forthcoming. A package of measures could be announced in September. We now turn to the potential size of the package and its likely impact.

Source: ECB BLS, TS Lombard

Tool 1: A symmetric inflation target

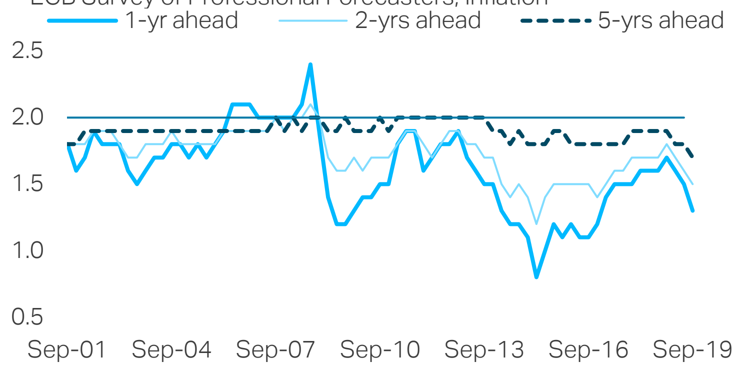
EA inflation

% annual change



Survey-based inflation expectations fall

ECB Survey of Professional Forecasters, Inflation

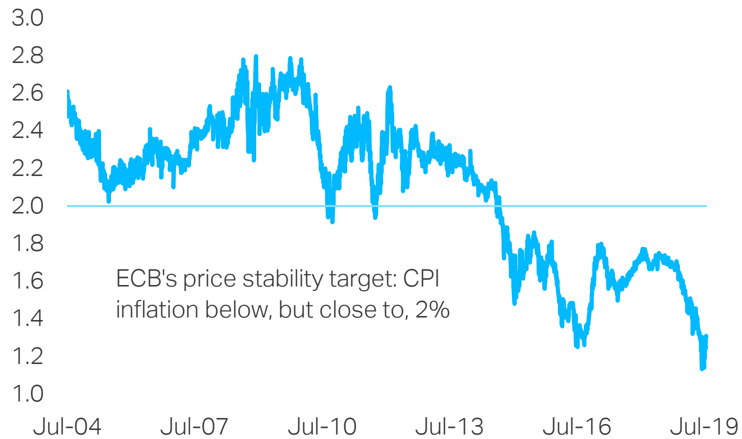


One of the ideas being floated is to make the ECB's inflation target (below but close to 2% in the medium term) symmetric. The latest monetary policy statement explicitly noted that if the medium-term inflation outlook continues to fall short of the ECB's aim, the Governing Council is determined to act, in line with its commitment to symmetry in targeting inflation. In his press conference following the meeting, Draghi highlighted that symmetry basically means that there is no 2% cap and that inflation can deviate on both sides of the target; the GC would act with the same determination whether inflation was above or below target. There was also a discussion in the GC about potentially changing the current inflation target.

A symmetric target may signal a stronger commitment from the ECB to achieve its aim, but we don't think modifying/moving the goalpost would be a game-changer. Headline inflation has consistently undershot the ECB's target since 2013. Underlying inflation has been weaker still. Survey-based inflation expectations (one and two years ahead) have rarely met the ECB's target since the GFC. It is difficult to see how making the inflation target symmetric will resolve this deficiency unless the central bank succeeds in convincing markets that it has tools to stimulate domestic demand, overall growth and inflation expectations. But, as we argued earlier, markets are not persuaded: the fall in the market-based measure of inflation expectations is largely due to growing concerns regarding the ECB's ability to meet its current target. **The market is not questioning the target itself.**

Market-based inflation expectations plunge

EUR 5y5y

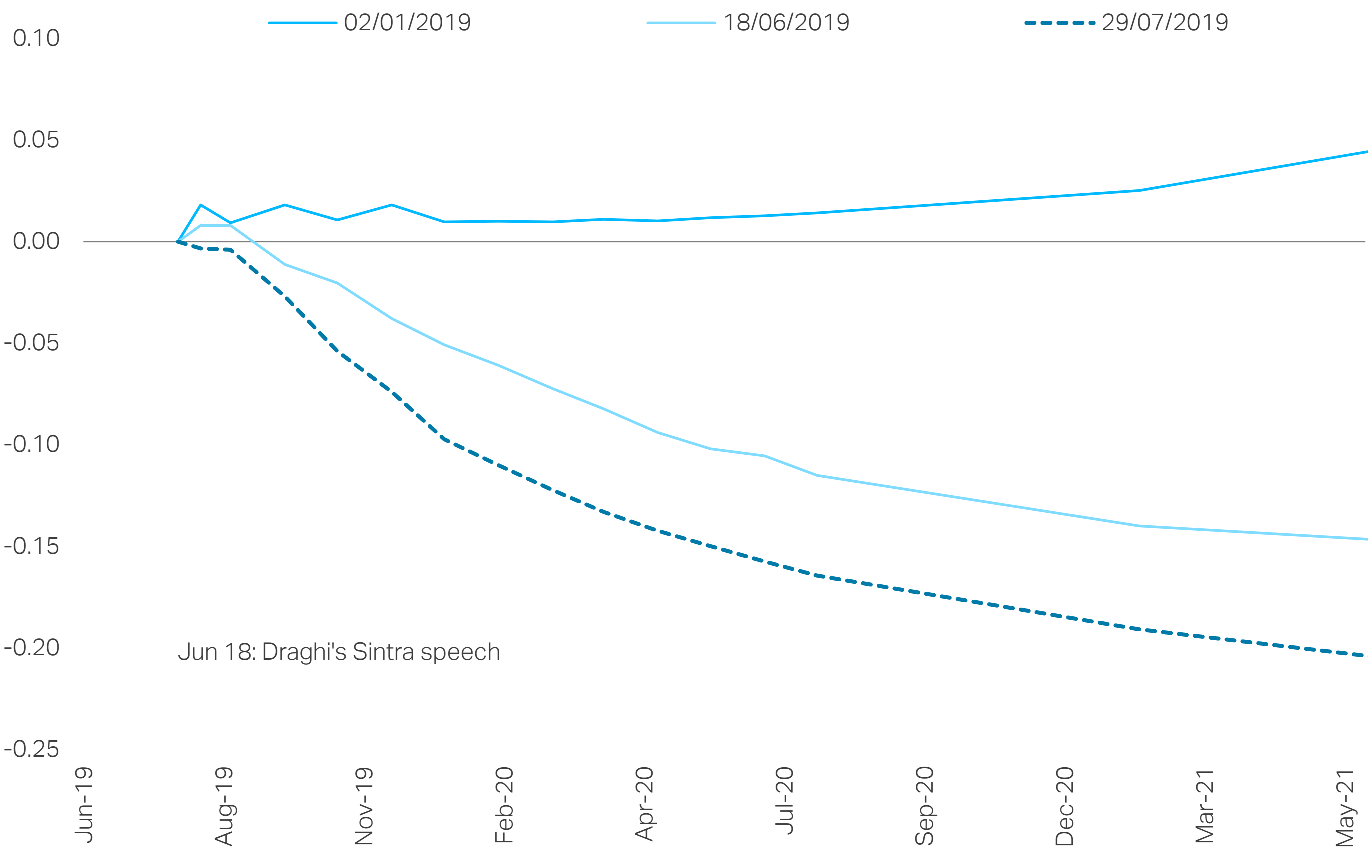


Source: Bloomberg, Datastream, ECB, SPF, TS Lombard

Tool 2: tweaking forward guidance

EONIA curve

Percentage point change from the current deposit rate



Source: Bloomberg, TS Lombard

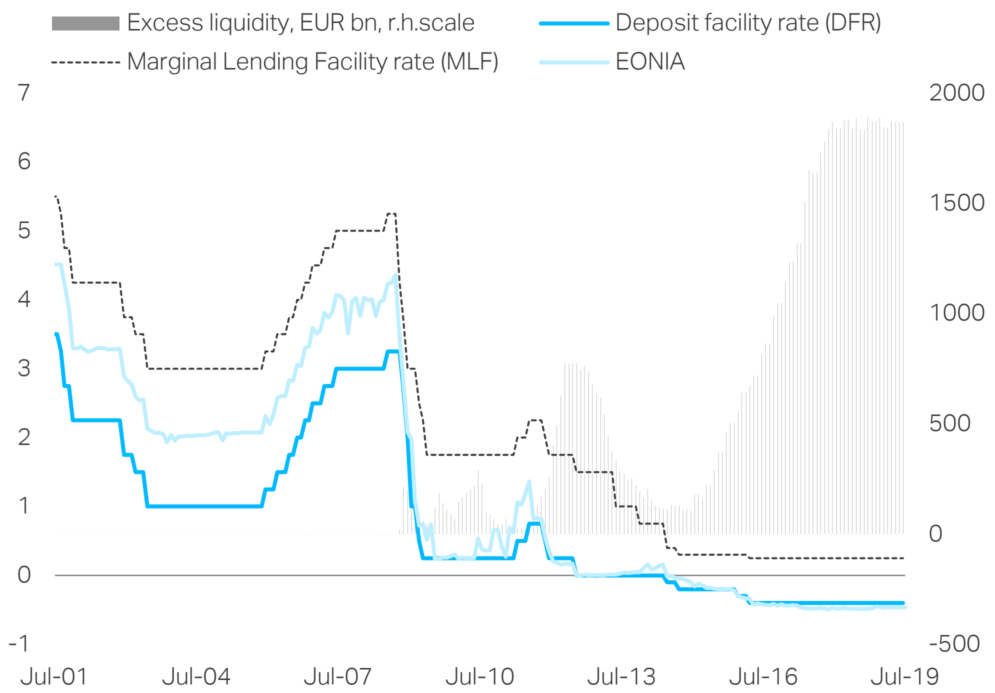
In last week's monetary policy decision, the central bank introduced 'lower' in its interest rate forward guidance, paving the way for interest rate cuts. Specifically, 'the GC expects the key ECB interest rates to remain at their present or lower levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to our aim over the medium term'.

Note that the forward guidance has date-based and state-contingent elements. The latter remains a powerful stabiliser, as is evident in the 'very substantial' shift in the entire interest rate swap curve since the beginning of the year. The calendar-based component has been progressively pushed back such that it is aligned with market expectations. As a result, its signalling value has been diminishing.

Markets are unlikely to get excited with the continuing dovish shift in the ECB's forward guidance as they already pricing in 20 bps of rate by the end of next year.

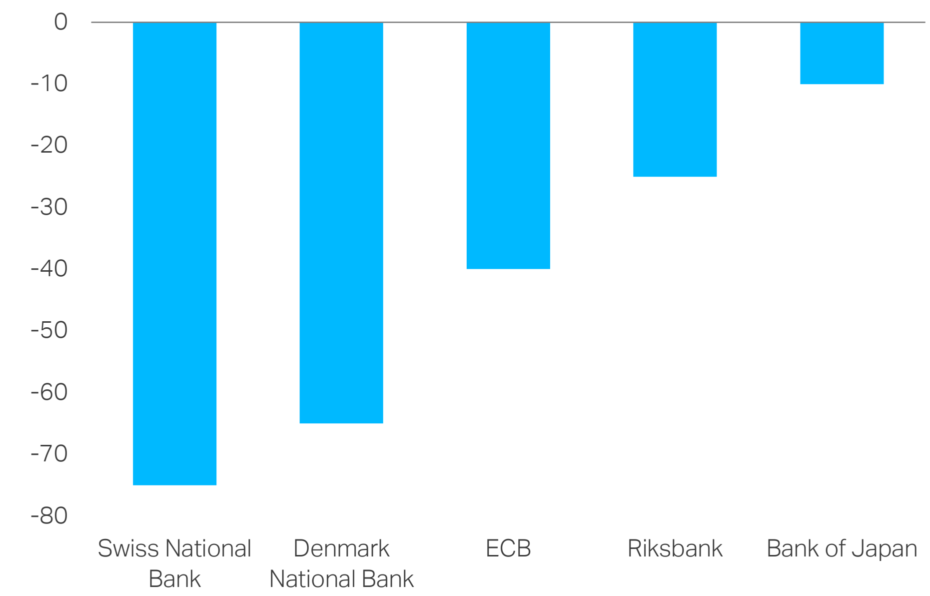
Tool 3: cutting rates

ECB policy rates and excess liquidity



Negative interest rates gobally

Central bank deposit rates, bps



The ECB has clearly signalled that its next move will be to cut interest rates. But how much lower can rates go? More importantly, how effective will (even) lower rates be in stimulating credit growth and boosting economic activity and inflation expectations?

Excess liquidity in the euro area has surged since 2014, exacerbating the squeeze on EA lenders. With the interest rate on excess reserves parked at the ECB's deposit facility (the deposit facility rate, DFR) already at a negative 40 bps – one of the lowest in the world– **any benefit from pushing rates even lower would be marginal at best.**

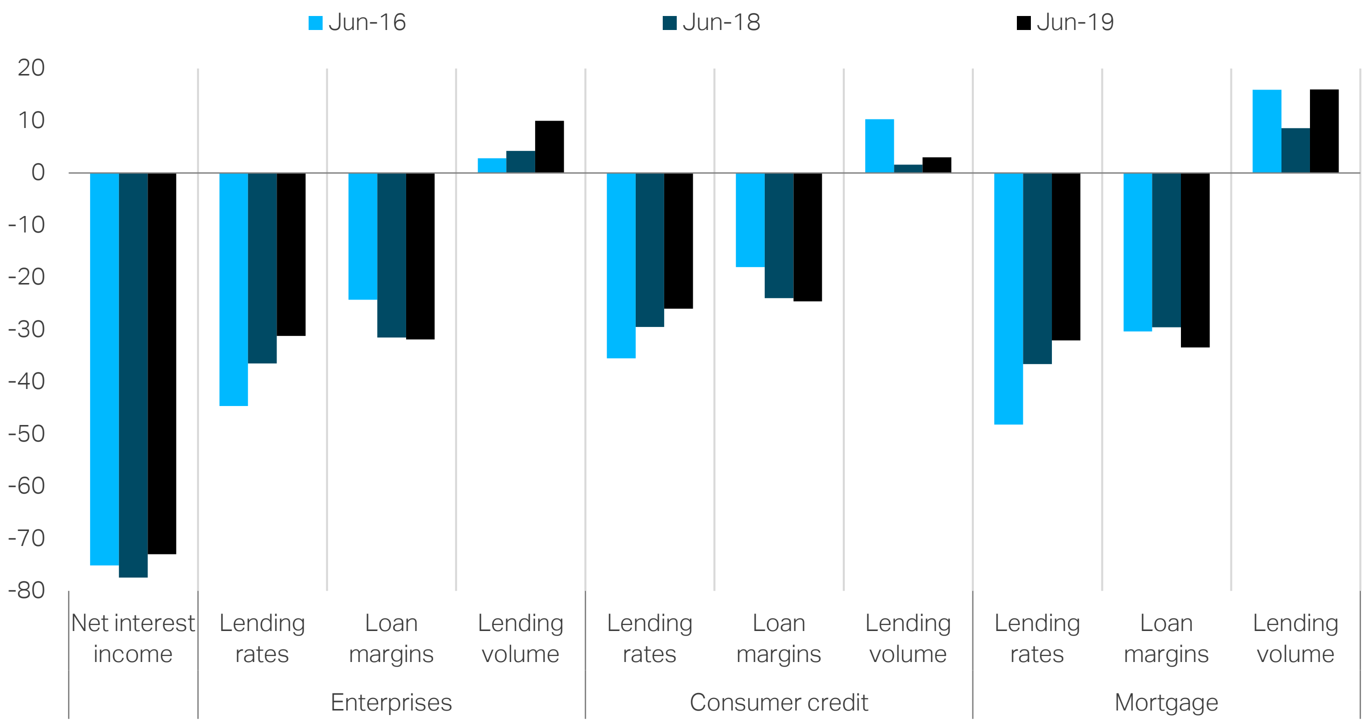
Source: ECB, Datastream, TS Lombard

Impact of negative rates

Negative interest rate and the impact on bank lending and profitability

Impact of the negative Deposit Facility Rate on banks' net interest income and bank lending

Difference between the sum of the % for "increased considerably" and "increased somewhat" and the sum of the % for "decreased somewhat"creased considerably"



Source: ECB BLS, Datastream, TS Lombard

The ECB's Bank Lending Surveys provide some insight into the impact of negative interest rates on banks' lending and profitability.

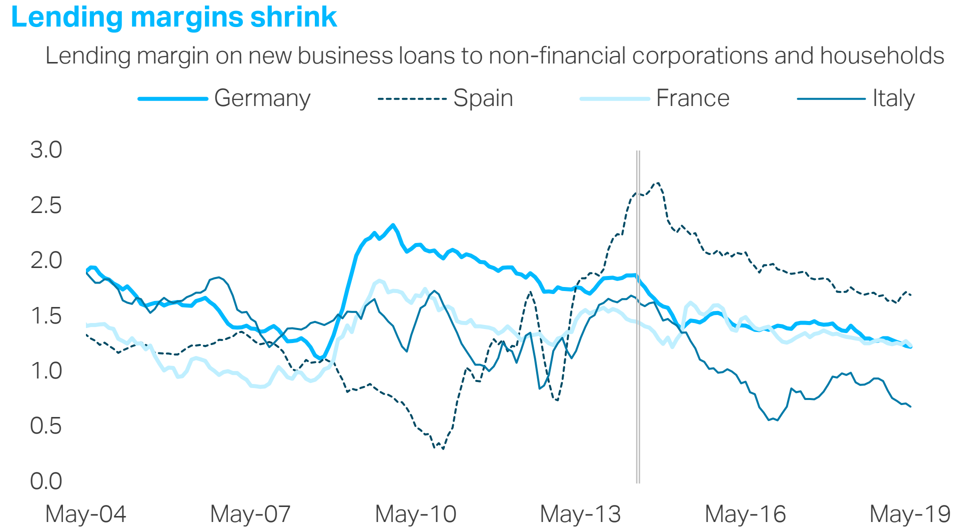
A modest share of surveyed banks reported a decline in the lending rates for business loans, consumer credit and mortgages as a result of the ECB's negative rates. A much smaller share of lenders said that the sub-zero DFR increased lending volumes for all types of credit.

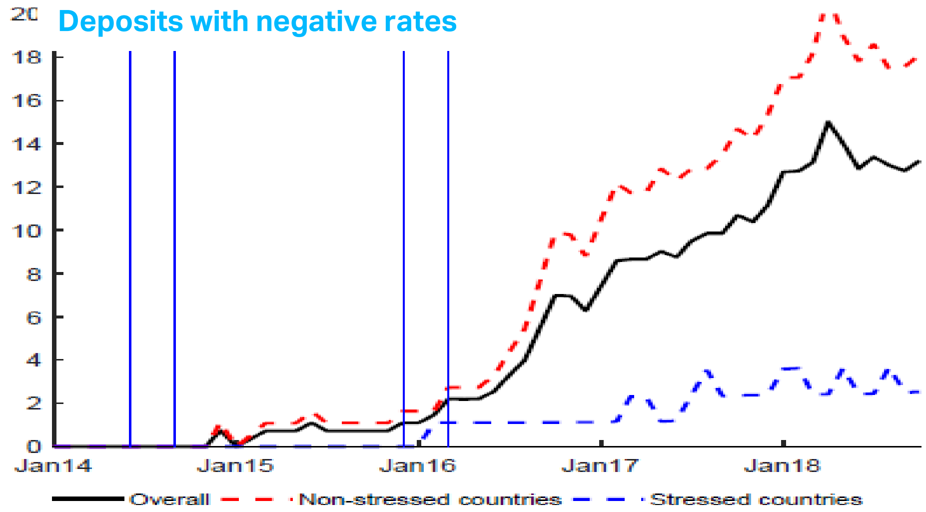
But negative rates have also crimped loan margins across the board. A significantly large net percentage of banks continued to report that a **negative DFR had led to a deterioration in their net interest income** over the last six months. They expect no change in this trend over the coming six months.

Crucially, **the gains from negative rates have been diminishing rapidly:** a progressively smaller share of banks report a fall in their lending rates. The net proportion of lenders reporting an increase in loan volumes has also fallen for all types of credit since 2017.

Meanwhile, **the drag from the sub-zero DFR is increasing:** for instance, a growing proportion of lenders report a decline in their loan margins as a result of negative rates.

Weak banks suffer more





A recent study by the ECB concludes that policy rates have not reached the zero lower bound. It shows that banks with relatively sound balance sheets can pass negative rates on to their corporate depositors without experiencing a decline in funding. They argue that these policy effects become stronger as policy rates move deeper into negative territory. Banks offering negative rates provide more credit than other banks, suggesting that the transmission mechanism of monetary policy is not hampered. The central bank's negative interest rate policy has provided further stimulus to the economy through firms' asset rebalancing: firms with high current assets linked to banks offering negative rates appear to increase their investment in tangible and intangible assets and to decrease their cash holdings to avoid the costs associated with negative rates.

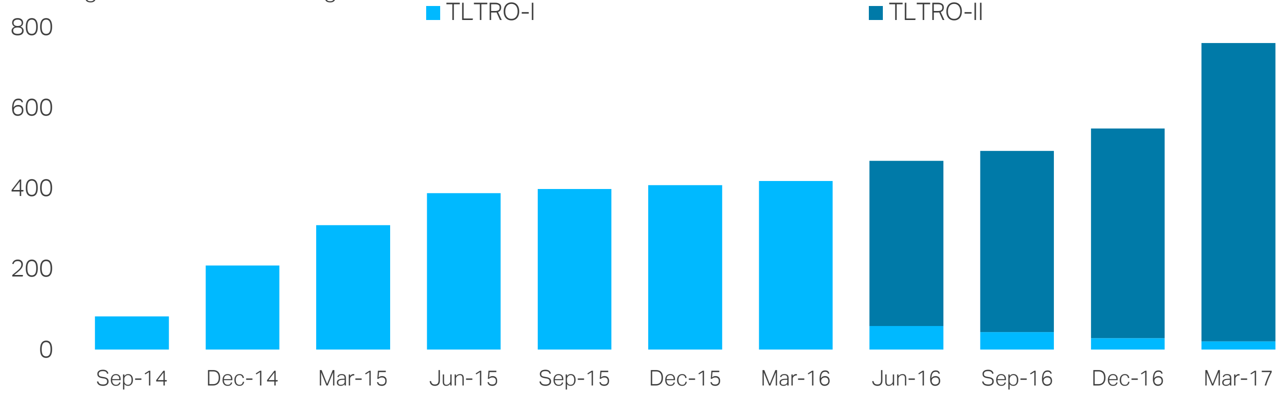
However, these conclusions could be misleading. Net interest margins have declined across the euro area since 2014, notably in Italy (chart on the left). On previous occasions, we have shown that NIRP disproportionately hurts banks and countries with relatively weak balance sheets. The ECB study confirms that the pass-through from negative interest rates is concentrated in banks that have healthy balance sheets. For instance, the chart above shows that the percentage of lenders that offer negative interest rates is much higher in non-stressed countries. Banks that have a weak starting point and/or those in countries with relatively fragile balance sheets face higher market-funding costs. As a result, they rely more on wholesale funds, which limits their ability to pass on rising costs. Additionally, depositors' flight-to-safety instinct might further discourage the pass-through further in the weaker banks.

Source: ECB, Datastream, TS Lombard

Tool 4: mitigating measures – more generous TLTROs

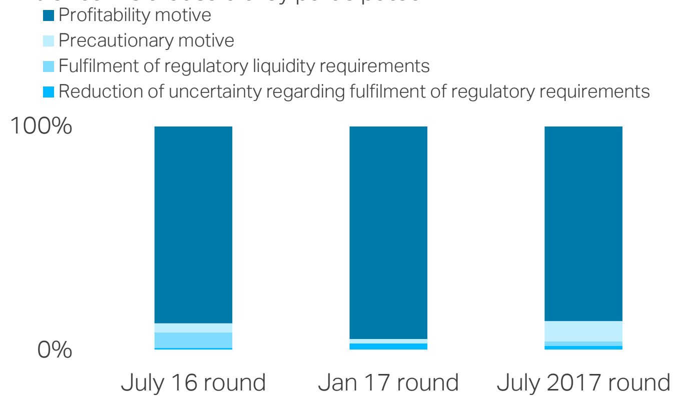
TLTRO borrowings

Banks' gross TLTRO borrowings, EUR bn



Reasons for participation in TLTRO

% of banks that said they participated



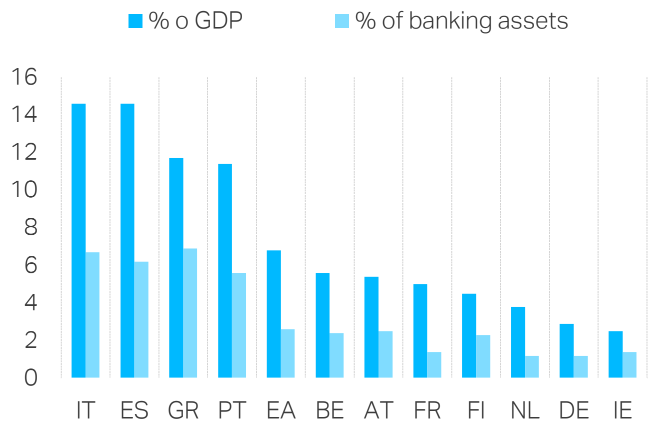
Negative interest rates are like a tax on banks. The ECB launched a series of progressively more generous targeted longer-term refinancing operations (TLTROs) from 2014 to mitigate the impact of negative interest rates on lenders and help the transmission of low rates to the real economy. Specifically, the ECB offers cheap funding to lenders, with the price of this funding linked to banks' loan books: the more they lend, the cheaper the funds. **TLTROs thus act as a subsidy for banks.**

The third round of TLTROs, TLTRO-III, was announced in March 2019 and the first series of auctions will be conducted in September. Banks will be entitled to borrow from the ECB for two years a sum equivalent to 30% of their stock of eligible loans as at 28 February 2019. The interest rate on the loans will be set 10 bps above the main refinancing operations (MRO), currently at 0%. If the size of the loans meets a certain benchmark, rates can go as low as 10 bps above the deposit rate, currently at a negative 40bps. In other words, the ECB will pay banks up to 30bps to take out two-year loans.

Banks on the EA periphery benefited more from earlier TLTROs than those in the core, in part because they face relatively higher market-funding costs. Banks used TLTROs to pad their profits (chart in the top-right corner). Crucially, TLTROs did not really succeed in boosting the bank transmission channel. For instance, credit to households and non-financial corporations in Italy and Spain – which account for 56% of total TLTRO loans – continued to contract. For more details, see here.

TLTRO borrowings

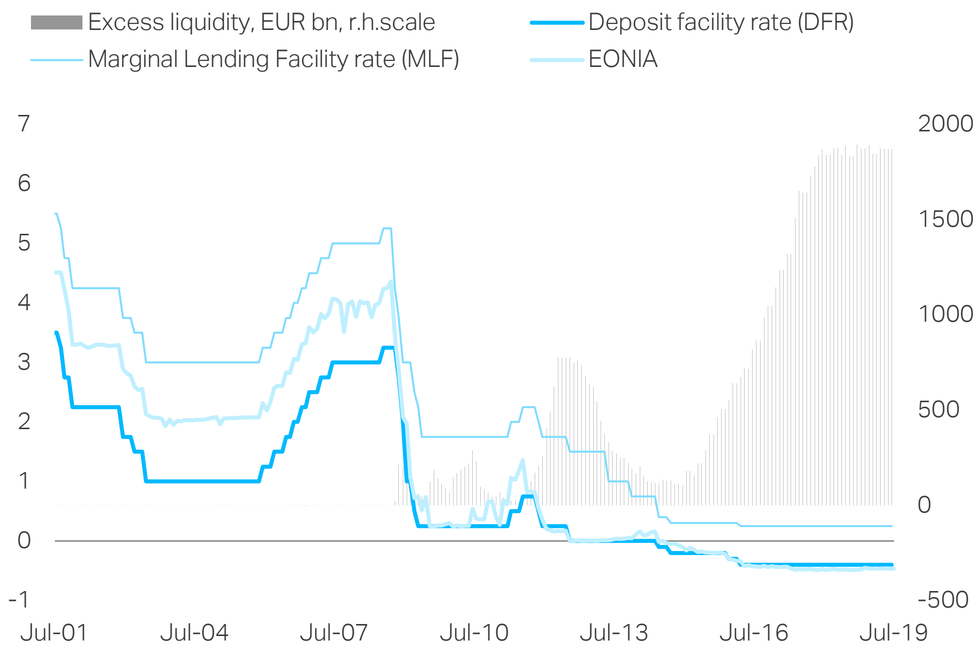
Long-term refinancing operations, EUR bn



Source: ECB, BLS, Datastream, TS Lombard

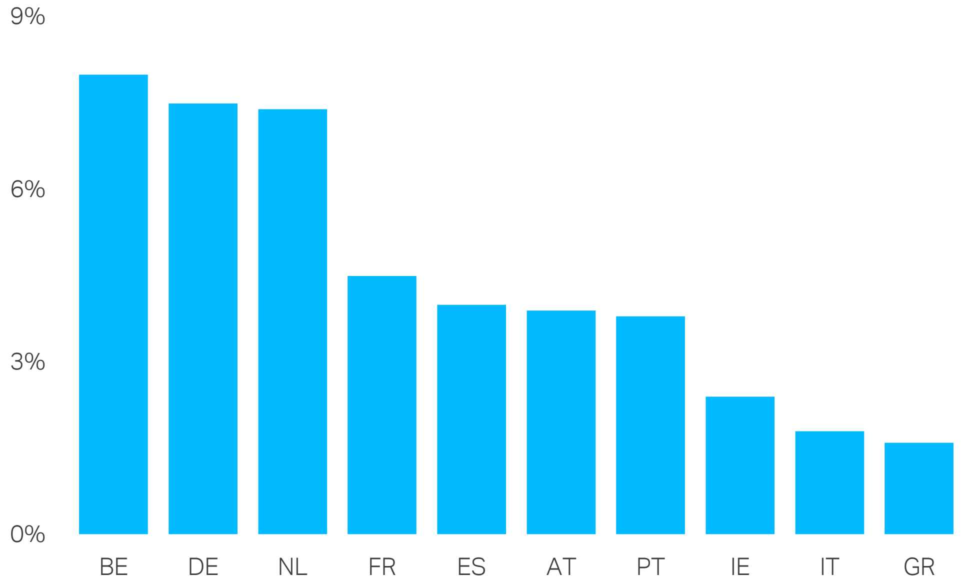
Tool 5: mitigating measures - tiering

ECB policy rates and excess liquidity



Disparate distribution of excess liquidity

Holdings of excess liquidity by country, ratio to banking system assets, 2018



Policymakers have recently floated the possibility of a multi-tiered deposit rate to ease the impact from negative interest rates. As we noted earlier, excess liquidity in the EA has surged since 2014. But it is concentrated at lenders in core countries, especially in Germany, the Netherlands and France. But TLTROs are designed in such a way that periphery countries stand to benefit more.

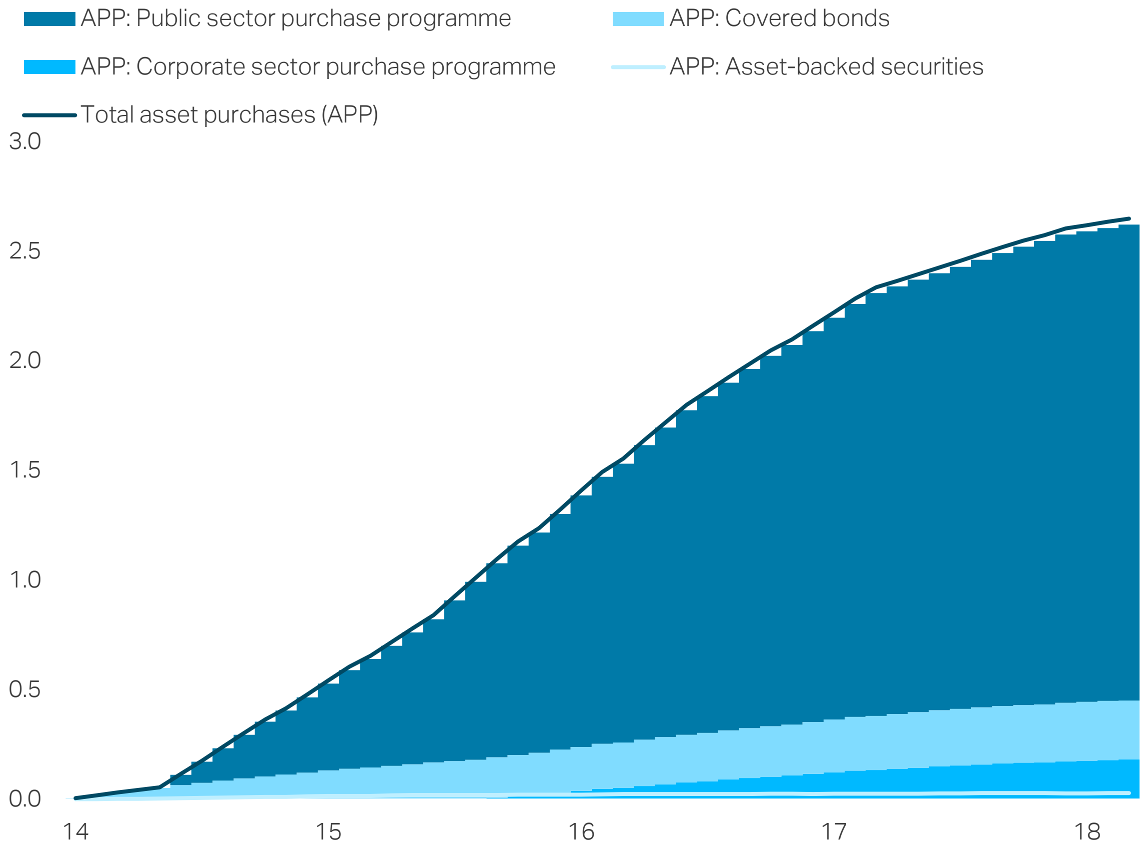
Thus a tiered deposit system may ease some of the pain that banks in the core countries in particular are enduring for the privilege of parking cash with the ECB. The central bank has not hinted at how the tiering might work. We will explore in upcoming pieces some of the tiering mechanisms that other central banks have adopted to help assess the ECB's options.

Source: ECB, Bank of Spain, Datastream, TS Lombard

Tool 5: re-start QE

ECB QE by type of assets

ECB's asset purchases, cumulative, EUR trillion



Source: ECB, Datastream, TS Lombard

We think the ECB will also resume QE in addition to changes to its forward guidance, interest rate cuts and a potential tiering of deposit rates.

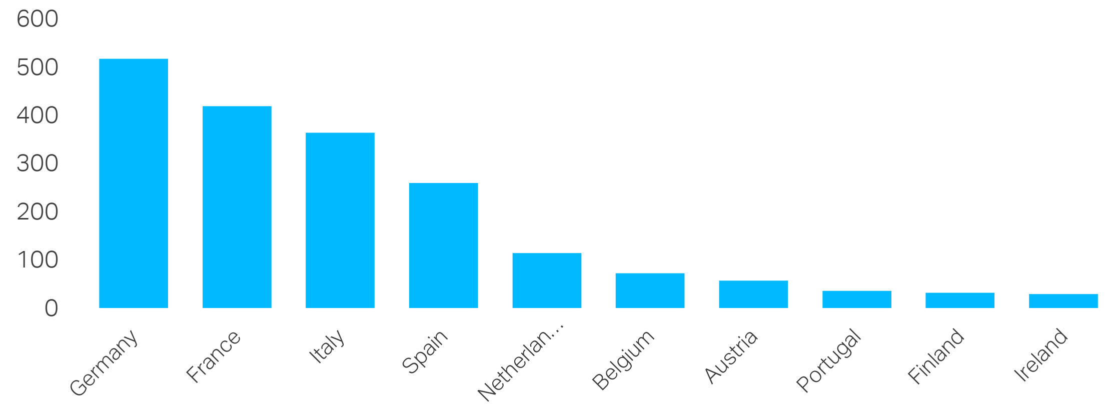
We are sceptical of the impact from cutting rates deeper into negative territory. The marginal benefits are limited at best, even if lower rates are accompanied by cheaper TLTROs and tiered deposit rates.

But we are slightly more constructive about a fresh round of net asset purchases. QE-II could encourage portfolio rebalancing and improve monetary and financing conditions. Businesses and consumers might also increase their spending as they feel their net wealth rising. QE-II could also help mitigate the impact of deeper negative interest rates, for instance by generating capital gains on assets that banks hold in their investment portfolios.

Under QE-I, the ECB bought covered bonds, asset-backed securities, non-bank private debt (CSPP) and public and supranational bonds (PSPP). Government bonds were by far the biggest share – just under 75% – of QE-I. Public sector debt will continue to be the largest asset that the central bank buys when it restarts QE. Non-bank private debt and supranational bonds could be next. Theoretically, the ECB could also buy bank bonds and equities, but we think it would face significant legal and political hurdles.

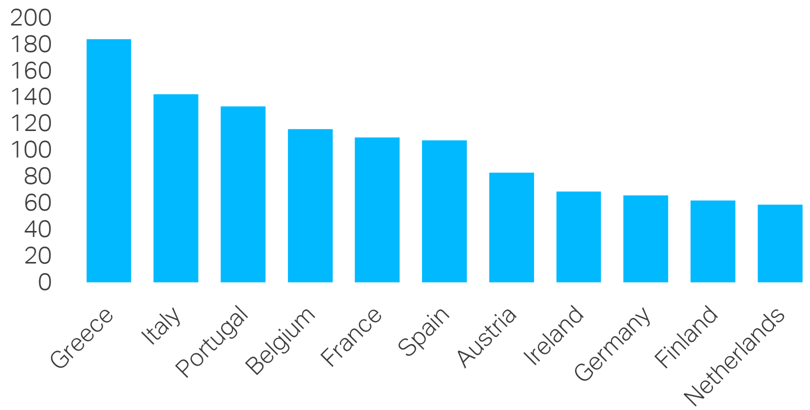
QE-II: PSPP – buy more public debt

Cumulative PSPP purchases by the Eurosystem, EUR bn



Euro area public debt by countries

General government debt, % of GDP, Q4 2018

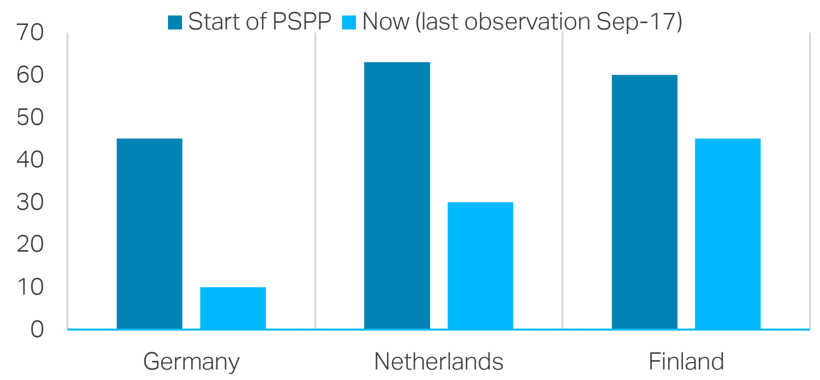


The ECB's PSPP programme has a few self-imposed restrictions. For instance, the central bank can buy assets only up to the 33% issue limit. The other constraint – which has led to a lopsided QE programme - is that the ECB purchases assets according to a country's share in the ECB's capital. (This capital key is determined by each country's population and nominal GDP.) As a result, the central bank buys a lot more German assets than, say, Italian govvies, even though Germany's public debt is much lower than Italy's and Germany runs a large budget surplus while Italy has a large deficit.

Thus, the ECB's asset purchase programme has led to a slump in the share of outstanding central government bonds held by the private sector, especially in Germany, the Netherlands and Finland. According to ECB estimates, only 10% of German bunds were in private hands as of September 2017 (right-hand chart). Our strategy team estimates that the share has fallen further since then to 5%. This would suggest major constraints on the size of the pool of eligible public sector assets that the ECB could buy under QE-II.

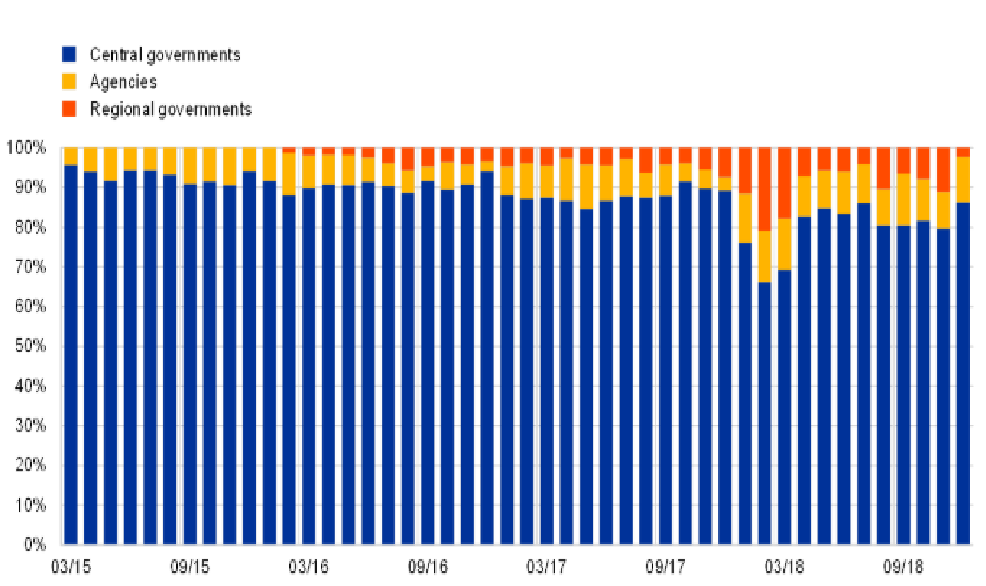
ECB crowding out national debt

Estimated % share of outstanding central government bonds held by private investors



Source: ECB, Bloomberg, Datastream, TS Lombard

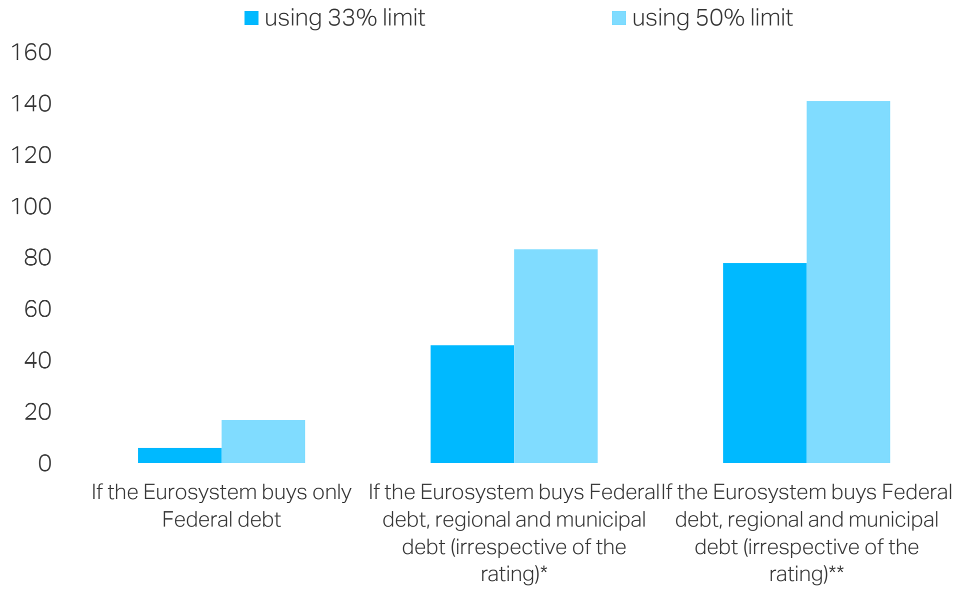
QE-II: PSPP – buy more state debt



Source: ECB.

How many govies can the ECB buy?

Size of ECB QE per month for 12 months, EUR bn



*assuming 50% of regional and municipal debt are financed using debt issues
**assuming all regional and municipal debt are financed using debt issues

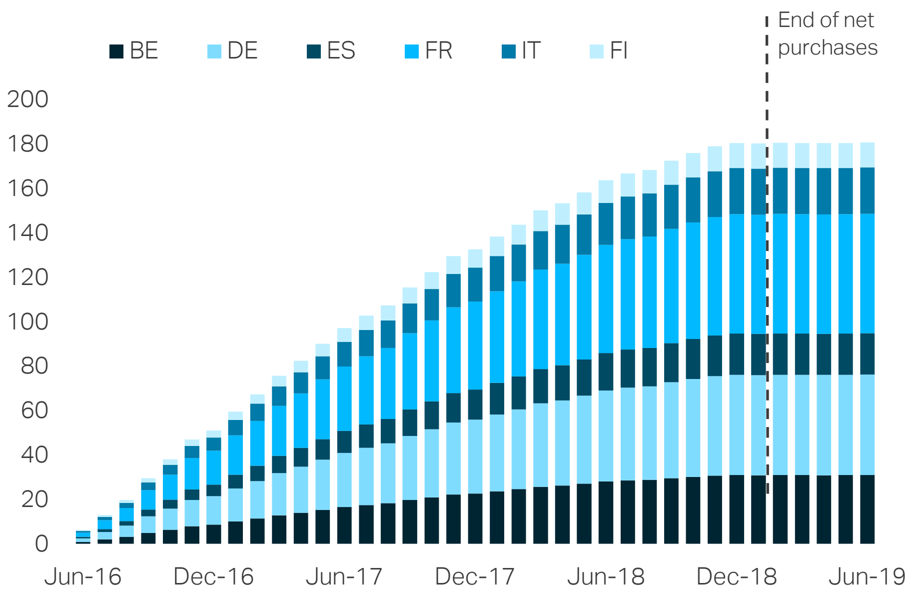
The good news is that while the ECB has rapidly drained the pool of eligible central government assets it can buy, **there is plenty of eligible state and local government debt.** If the central bank were to relax some of its purchase criteria, a large share of municipal debt would also become eligible for QE-II.

Our estimates suggest that if the ECB were to stick to its 33% issuer limit, it could buy up to EUR50bn of public assets a month for 12 months. If the limit were raised to 50%, the universe of eligible assets could expand to EUR90bn a month. Separately, we assume that the ECB will buy supranational bonds of around 10% of public sector bonds.

Source: Bloomberg, ECB, Datastream, TS Lombard

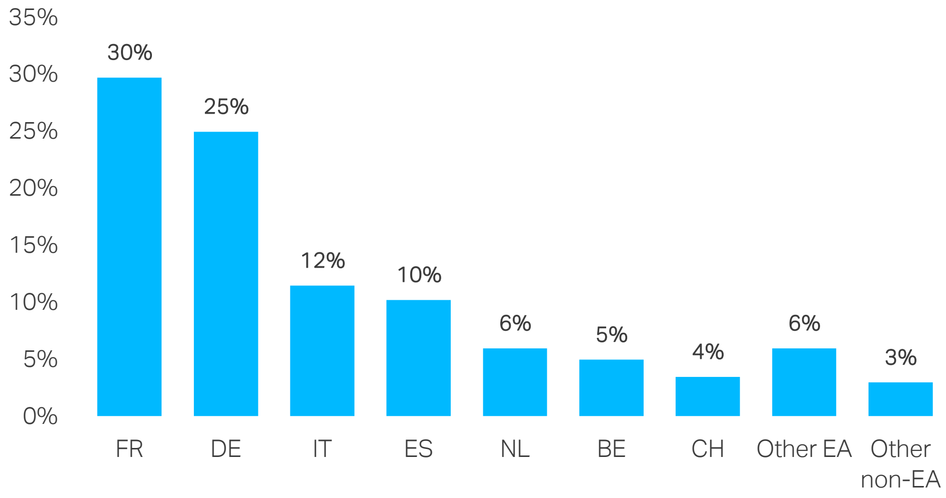
QE-II: CSPP – buy more corporate bonds

ECB's corporate sector bond purchases so far



Eurosystem's CSPP holdings by country of risk

2017Q3-2019Q1 average



The ECB could also restart the purchase of corporate sector bonds (CSPP). The CSPP makes up only 7% of total cumulative asset purchases (compared to 82% for the PSPP), but it has played a large part in invigorating the EA's capital markets. Generally, the Eurosystem buys investment-grade euro bonds issued by companies other than banks. It also buys notes from non-EA companies provided they are issued via a local entity. The ECB limits the purchases to no more than 70% per issuer.

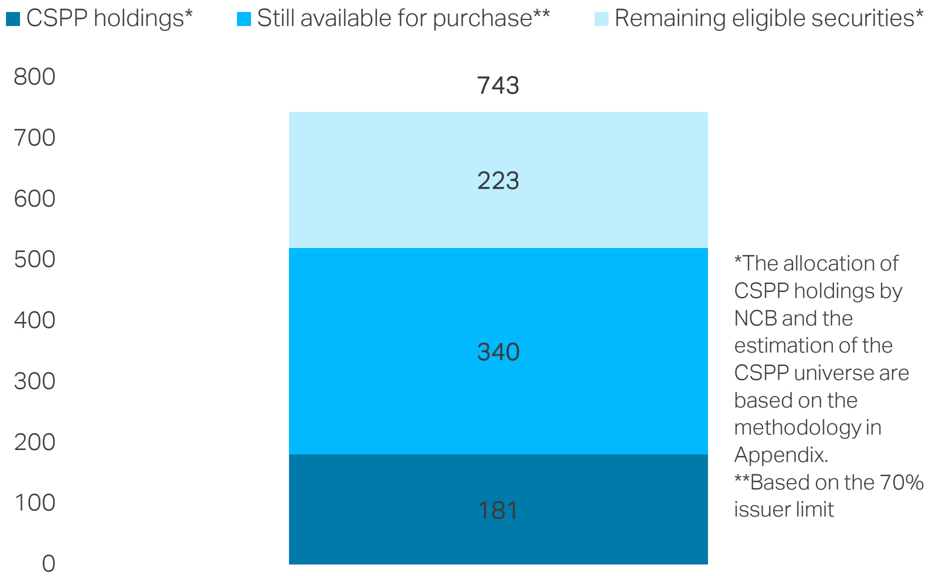
Unlike with the PSPP, the central bank does not provide data on the evolution of CSPP holdings for each National Central Bank (NCB) engaged in the implementation of the programme.

Our analysis (for details, see the appendix) shows France has the largest CSPP holdings as measured by the 'country of risk'. This is not surprising given the large size of the French private debt market. France is followed by Germany, and only at a distance by Italy and Spain. Italy's cumulative CSPP purchases amount to less than 40% of France's.

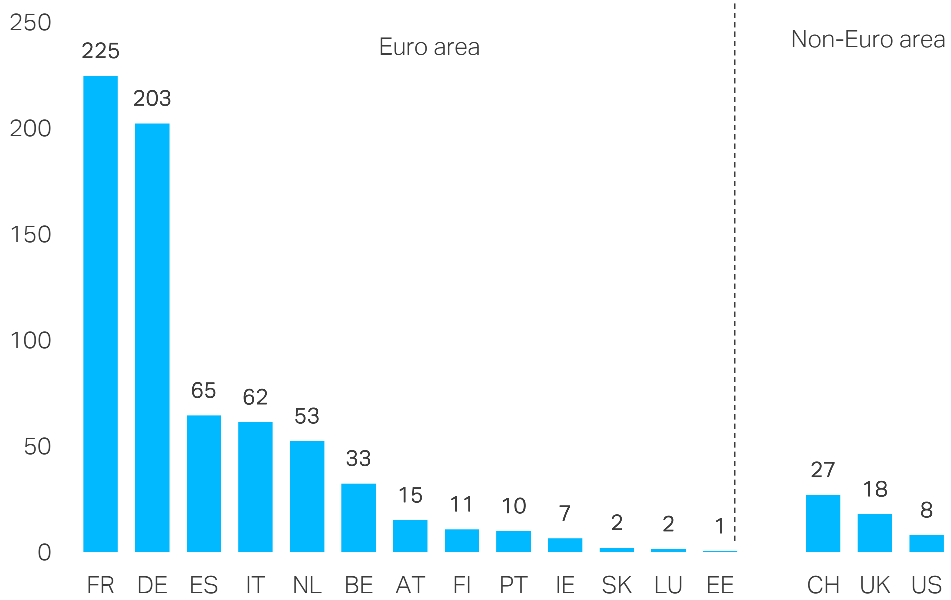
Source: Bloomberg, Datastream, ECB, TS Lombard

QE-II: CSPP – buy more corporate bonds

Breakdown of the estimated CSPP-eligible bond universe (EURbn)



Breakdown of the estimated CSPP-eligible bond universe by country of risk (EURbn)



If the ECB were to resume CSPP, how many assets could it buy? According to our estimates, the size of the ECB-eligible CSPP universe is EUR743bn. But under the 70% issuer limit, the pool shrinks to EUR 520bn. So far, the ECB has bought only EUR181bn under the CSPP, leaving EUR 340bn of bonds available for purchase if it were to stick with the 70% limit.

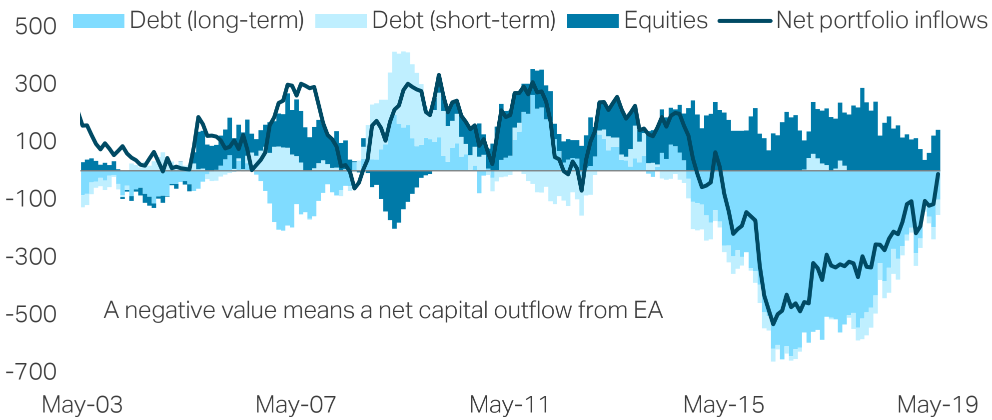
We also estimate the CSPP-eligible securities universe based on the country of risk. France continues to stand out as the key beneficiary from a potential CSPP-II, followed by Germany.

Source: Bloomberg, Datastream, ECB, TS Lombard

The FX effect

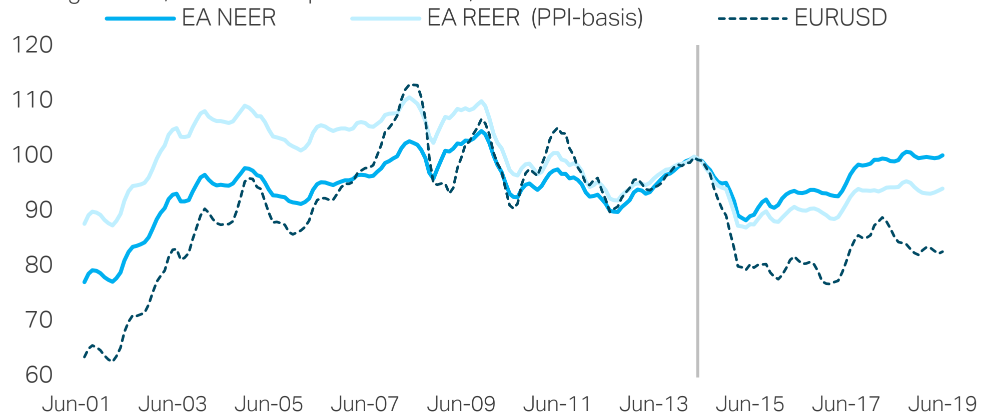
ECB QE led to a surge in portfolio outflows from the euro area

Net portfolio flows, 12-month sum, EUR Bn



The currency effect

Changes in FX, indexed to April 2014 = 100, 3MMA



One of the key channels through which ECB QE worked is a weaker currency. The bond-buying programme suppressed EA yield differentials, prompting an exodus of capital from the EA. Net portfolio debt outflows peaked at €660bn (12-mth sum) in mid-2016, a record since the launch of the euro in 1999, led by net selling of long-term paper (chart above).

The euro depreciated on a trade-weighted basis in nominal and real terms, boosting the EA's relative competitiveness. The fall was particularly sharp against the dollar, helped by the Fed's move towards normalising policy. But the euro started drifting higher in 2017, when the euro area was growing at a brisk rate and investors were beginning to anticipate an end to QE.

The EA has lost momentum rapidly since then, and yet the currency has been on an upward trend. The escalation in trade tensions between the US and China has led to a weaker yuan and a meaningful depreciation in emerging market currencies in general, especially against the dollar. As a result, the euro has appreciated on a trade-weighted basis even as it has fallen against the dollar.

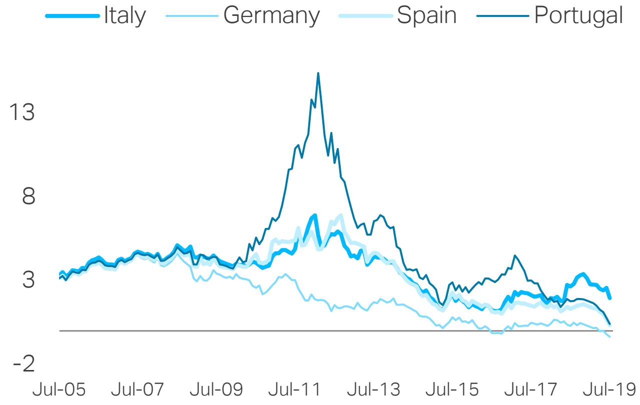
QE-II is unlikely to boost the EA's relative competitiveness this time around, unless global growth improves considerably. The starting point for EUR/USD is much lower than it was for QE-I. Most central banks, including the Fed, are also in easing mode. There are lingering concerns that trade wars may morph into a global FX war. External assets are less attractive for EA residents, especially on a hedged basis, than at the onset of QE-I. Besides, unless the ECB eases the self-imposed constraints on its bond-buying scheme, the universe of eligible assets that the central bank can buy is modest.

Source: Bloomberg, Datastream, ECB, TS Lombard

Impact of ECB easing – why it's limited this time

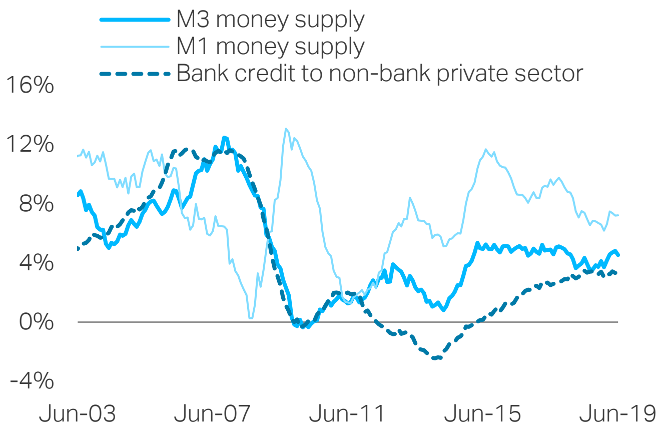
EA 10-year yields

10 year yield, per cent



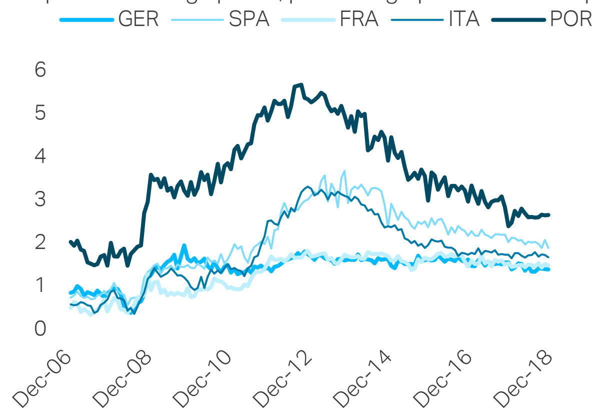
EA credit and money growth

% annual change



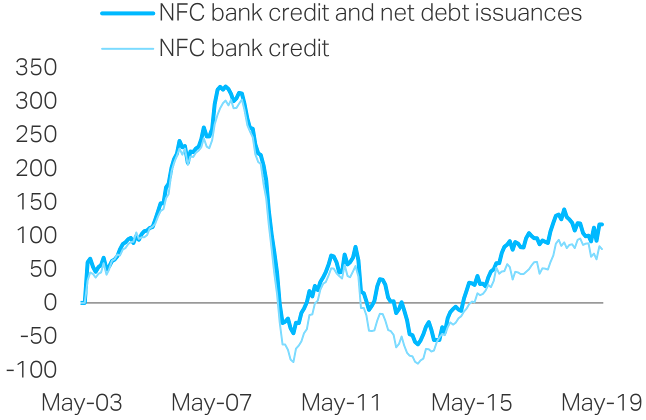
Lending spreads

Corporate lending spread, percentage points over swap



Lending to EA corporates

Credit to non-financial corporates (NFCs), 6-mth sum,



Thus, **one of the most powerful transmission channels for QE is likely to be much less potent this time around**. Other indicators also suggest that a second round of asset purchases could have a milder impact than QE-I.

For instance, 10-year bund yields continue to trade at all-time lows. Borrowing costs across the EA are generally much lower and lending spreads tighter than at the start of QE-I. Fragmentation risks are modest while they were severe just before the ECB signalled QE-I.

What the EA needs is a demand boost. With external demand set to remain sluggish, the ECB's deposit rate already at a negative 40bps, its balance sheet surging to 41% of GDP last year, and huge constraints on the bond-buying scheme, **the ECB is pushing on a piece of string.** This realisation is increasingly evident in the speeches by ECB policymakers, with references to **the need for fiscal policy to lay a greater role becoming more prominent.**

For instance, in the Q&A session following last week's monetary policy meeting, Draghi said that if there were to be a significant worsening in the EA, a significant fiscal policy response would soon become of the essence. He reiterated that a supportive fiscal stance would allow monetary policy to deliver better and more swiftly with fewer side effects. Is German Finance Minister Scholz taking note?

Source: Bloomberg, Datastream, ECB, TS Lombard

Appendix

Estimating the allocation of CSPP purchases by NCB

The ECB doesn't publish time-series data on CSPP holdings at National Central Bank (NCB) level, but only aggregate monthly net purchases by the Eurosystem. The implementation of the CSPP differs from that of the PSPP, as only six NCBs carry out corporate debt purchases (i.e. Bundesbank, Bank of France, Bank of Spain, Bank of Italy, Bank of Finland and Bank of Belgium). This technical reason can partly explain the lack of NCB-level time series for CSPP holding. CSPP purchases are allocated across the six "specialist" NCBs on the basis of the "country of risk" of the security's issuer. Each issuer is assigned a country of risk based on the location of management, country of primary listing, country of revenue and reporting currency. The country of risk can differ from the country of residence of the issuer. The Bank of Finland and the Bank of Belgium are the only two NCBs to purchase bonds of issuers from other countries of risk, both inside and outside the EA (see the table below). The ECB publishes some semi-annual statistics on the distribution of CSPP holdings by country of risk and by sector that go back to 2017Q3. To estimate the evolution of CSPP holdings by NCB we take the average shares of CSPP holdings by country of risk. Unfortunately, the ECB provides disaggregated data only for France, Germany, Italy, Spain, Netherlands, and Belgium, so to adjust the share of CSPP holding we assume that Finland and Belgium each buys 50% of the remaining bonds whose issuer's country of risk is not listed separately (namely "Other (euro area)", "Other (non-euro area)", and "Switzerland"). Finally, we just apply the adjusted shares to the time series of aggregate Eurosystem's CSPP holdings.

NCB	Allocation of CSPP purchases by country of risk	Adjusted share of CSPP holdings*
Bank of Belgium	BE, CY, GR, LU, MT, PT, NL, SI, SK	17%
Bundesbank	DE	25%
Bank of Spain	ES	10%
Bank of Finland	AT, EE, FI, IE, LT, LV	6%
Bank of France	FR	30%
Bank of Italy	IT	12%

Source: ECB, TS Lombard. *Based on 2017Q3-2019Q1 average shares*

Appendix

Estimating the universe of CSPP-eligible bonds

We collect a large dataset of security-level information about corporate sector bonds that meet CSPP eligibility criteria on residual maturity, sector of the issuer (i.e. non-bank), currency of denomination, minimum credit rating, and country of incorporation (Euro area). Alongside amount outstanding, for each security we also collect information about the country of risk of the issuer (field: CNTRY_OF_RISK). Using data published weekly by the ECB, Bloomberg maintains a variable (field: NCB_PURCHASE_PROG_ELIG_SECS_LEND) that returns "ECBCSPP" for each security purchased through CSPP and made available by the Eurosystem for securities lending. Securities purchased under CSPP have been available for securities lending since the inception of the programme. So, we exclude from calculations all securities for which the Bloomberg's indicator for APP eligibility takes values different from "ECBCSPP". Finally, to get to the universe of CSPP-eligible bonds we sum the amounts outstanding across all securities (€743bn). To break down the universe by the six "specialist" NCBs in charge of purchases, we cross-link the information in the table above with the data on each issuer's country of risk at security level and then sum the amount outstanding across.

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