

The ECB's monetary policy response to COVID-19

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Introduction

In early 2020, the world was turned upside down by a new viral infection named COVID-19, the spread of which the World Health Organization (WHO) declared as a pandemic on 11 March. The virus combines (at least) three shocks: health, financial and economic, causing one of the deepest crises ever seen in peacetime. Governments around the world quickly took unprecedented measures to fight the pandemic, with the top priority being the containment of the virus, closely followed by limitation of the financial panic and economic fallout, in which they were aided by central banks and supervisors.

This article focuses on the initial actions taken by the European Central Bank (ECB)¹ to mitigate the impact of the pandemic. The first section outlines the context: the global spread of the virus sent financial markets into turmoil, while the lockdown measures implemented by countries to mitigate the spread of the virus resulted in large short-term economic losses. Looking ahead, the macroeconomic outlook is extremely uncertain. The second section highlights the complementarity of the measures taken by fiscal, monetary and supervisory authorities around the world, which helped to curb the financial panic and cushion the economic fallout caused by COVID-19. Sections three and four focus on the ECB's monetary policy decisions taken during the first half of 2020. In order to achieve its primary objective – maintaining price stability – the ECB pursued three main goals: ensuring an overall sufficiently accommodative stance, supporting market stabilisation to safeguard the transmission mechanism and providing ample central bank liquidity, especially to maintain credit provision (Lane, 2020). Asset purchases were stepped up, both under the existing Asset Purchase Programme and by launching a new, temporary Pandemic Emergency Purchase Programme. The ECB also gave banks more scope for borrowing liquidity under its longer-term refinancing operations, while simultaneously easing its collateral requirements. Finally, enhanced US dollar and euro swap and repo lines mitigated pressures in global funding markets. The focus is on the motivation, purpose and impact of these measures rather than on their technical details. The final section concludes, and discusses the challenges posed for monetary policy by a low-economic growth and high-debt environment. While policymakers have steered the economy relatively well through the depth of the crisis, their task is far from over and may well become even more complex.

¹ For simplicity, this article uses the terms ECB and Eurosystem interchangeably, while noting that the Eurosystem comprises the ECB and the national central banks of the nineteen euro area countries. Monetary policy decisions are taken by the ECB's Governing Council (consisting of the six members of the ECB's Executive Board and the governors of the euro area's national central banks) and implemented at the level of the Eurosystem.

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1. An abrupt macroeconomic shock which triggered a financial panic and an economic crisis

COVID-19 will engrave 2020 in collective memory as the year of an exceptional health shock that caused untimely human death, had a dramatic impact on daily life, and disrupted financial markets and economic activity.

1.1 The health crisis quickly turned into an economic crisis

The COVID-19 outbreak quickly spread across the world causing a major global health crisis. The number of confirmed cases grew from 10 000 in China by late January 2020 to over 10 million cases worldwide by late June (of which 11 % were reported in the euro area).¹ Countries' first priority in battling the virus soon became "flattening the curve": slowing the spread of the virus in order to avoid overburdening the healthcare system, and limiting the tragic loss of lives. In order to do so, many countries imposed containment measures drastically restricting economic activity and limiting social interaction and mobility. China introduced these measures in late January, while Italy (being heavily impacted by the health crisis) was the first euro area country to follow suit, going into lockdown in early March. By the end of March, all euro area countries had implemented containment measures, but their strictness varied significantly.

The interventions proved successful in slowing the spread of COVID-19, but they also led to a sharp decline in economic activity in the euro area and elsewhere. This resulted in an unprecedented global economic crisis.

Financial and economic data took a deep dive in February and March, but stabilised somewhat during April and/or May

Financial markets were the first to undergo large corrections, with the turmoil being comparable to that of the 2008 financial crisis. Sentiment deteriorated abruptly by the end of February as the global spread² of the COVID-19 outbreak and its economic and financial cost became clearer.

In the euro area, financial conditions deteriorated suddenly, significantly and across all asset classes from the end of February (see chart 1). The equity market crashed, losing almost 40 % of its value on account of the bleaker economic outlook. In addition, spreads on corporate bonds widened, and the increase was especially dramatic for lower grade bonds (reflecting expectations of corporate defaults). The sovereign bond market also showed signs of fragmentation, with Belgian and French sovereign spreads against the German Bund remaining relatively contained, but Italian (and to a lesser extent Spanish) spreads rising noticeably (owing to concerns about the sustainability of public debt in the wake of the pandemic).

Following prompt and decisive monetary and fiscal policy measures (see the following sections), financial conditions in the euro area stabilised from the end of March, with the stock market rebounding and bond spreads narrowing again. It therefore appears that an amplification of the virus shock through the financial system has been avoided.

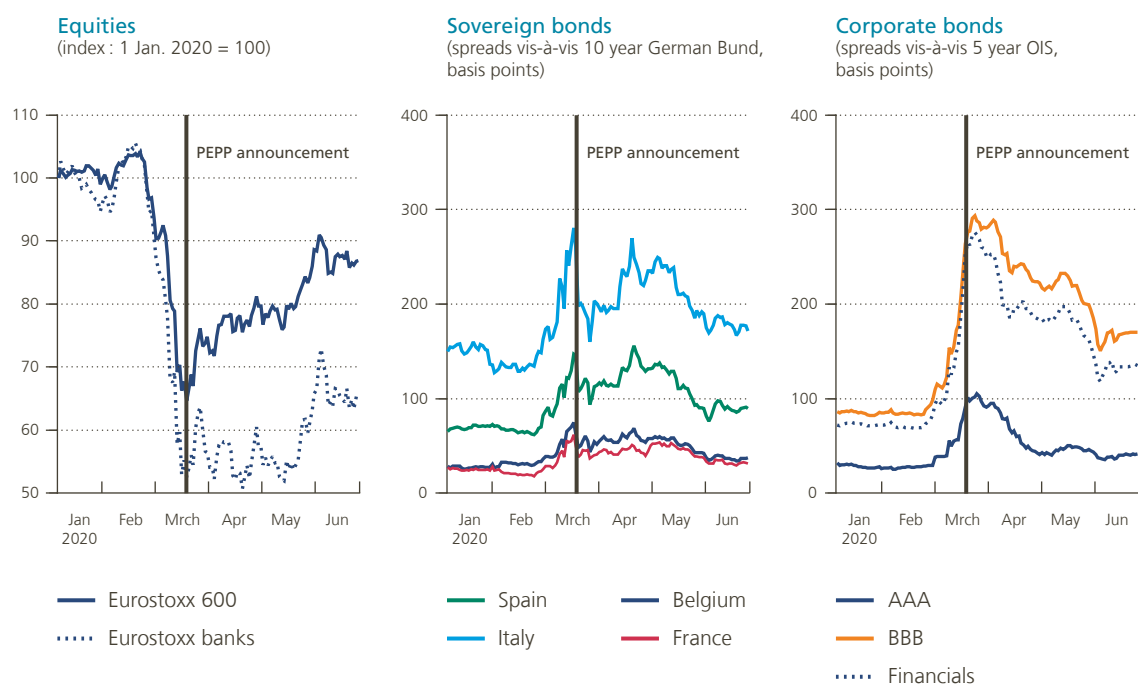
Nevertheless, economic data for the euro area also deteriorated sharply. Timely survey indicators on confidence and economic activity fell sharply in March and plunged to all-time lows in April, highlighting the unprecedented economic fallout of the pandemic and the related containment measures. With euro area countries gradually lifting restrictions during May, survey indicators have edged up slightly, but they still point to a strong contraction in GDP in the second quarter. More specifically, following a record 3.6 % quarter-on-quarter contraction in the first quarter of 2020, euro area economic activity is expected to fall even more sharply in the next quarter. Further ahead, the economic recovery path remains highly uncertain.

¹ COVID-19 statistics are from the John Hopkins University.

² In Italy, for instance, confirmed cases started rising quickly in the last week of February.

Chart 1

Euro area financial markets reacted abruptly to COVID-19



Source: Refinitiv.

1.2 Looking ahead: macroeconomic projections are subject to great uncertainty

Given the many uncertainties in the current situation, macroeconomic forecasting has recently become extremely complex. These uncertainties relate first and foremost to the pandemic itself, including the possibility of a second wave of infections in the euro area and the development of a vaccine. In addition, there is also uncertainty about how economic agents will respond to the pandemic, including future actions by governments (such as renewed restrictions), shifts in spending patterns and behavioural change (such as people avoiding public transport). Moreover, with the euro area being a relatively open economy, the pattern of external demand – which is equally dependent upon how the pandemic plays out – adds an extra layer of uncertainty. To take this extraordinary uncertainty into account, Eurosystem staff have opted to work out three macroeconomic scenarios for the euro area which differ in the assumptions about how the pandemic develops¹.

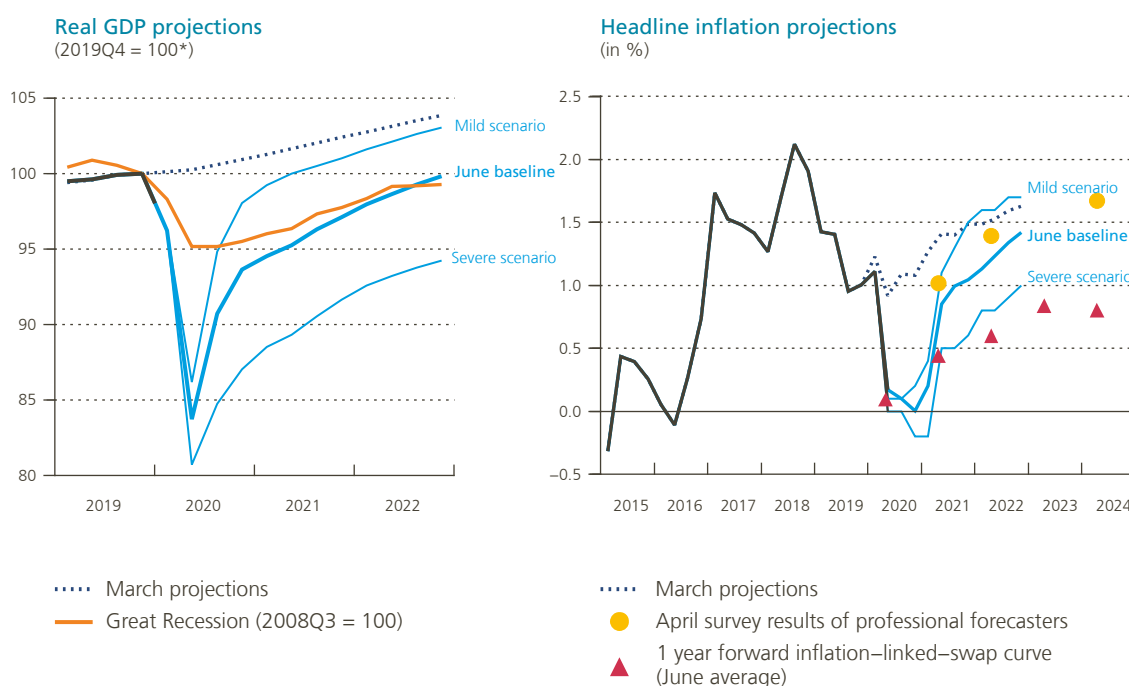
A deep recession followed by a very slow recovery of economic activity

The baseline projection scenario assumes only partial success in containing the virus: new waves of infections over the coming quarters require persistent containment measures (weakening supply and demand) until a medical solution becomes available (which is assumed to happen by mid-2021). While high uncertainty and deteriorating labour market conditions are expected to induce further cuts in private spending, public sector stimulus should help cushion the impact of the crisis. Under these assumptions, real GDP growth in the euro area is projected to follow a V-shaped pattern: growth falls by 8.7% in 2020 and rebounds by 5.2% in 2021 and by 3.3% in 2022. However, in terms of levels, economic activity remains depressed: at the end of the projection

¹ For more information about the projections for the euro area and Belgium, see ECB (2020) and NBB (2020), respectively.

Chart 2

June Eurosystem staff projections foresee a deep recession and a slow path to recovery that is subject to high uncertainty



Sources: ECB, Refinitiv.

* Unless mentioned otherwise.

Note that the March projections are made by ECB staff, while the June projections are the result of joint work between national central bank staff and ECB staff.

horizon (i.e. the fourth quarter of 2022) real GDP would still be slightly below its pre-crisis level and around 4 % below the level expected in the March projections (see chart 2).

The baseline scenario is complemented by a mild scenario (which assumes successful containment of the virus) and a severe scenario (which assumes a strong resurgence of infections implying stricter containment measures that significantly depress economic activity). These alternative scenarios provide a range of possible recovery paths around the baseline projection. Note that all scenarios imply a severe decline in output in the initial phase of the crisis, dwarfing the decline caused by the Great Recession (see orange line in chart 2). A faster recovery could limit the medium-term output loss to comparable levels, however.

The pandemic appears disinflationary in the short-term, but its longer-term impact on inflation remains uncertain

Following the outbreak of COVID-19, HICP inflation in the euro area initially fell, dropping from 1.2 % in February 2020 to 0.1 % in May. This mainly reflected the collapse in oil prices which was in turn partly driven by lower oil demand owing to the pandemic. Longer-term inflation expectations derived from financial markets also plunged during March, reaching new historic lows in the euro area, mainly because markets were pricing in rising uncertainty and the size of the economic fallout.

As the pandemic and related containment measures disrupt both the demand- and supply-side of the economy, the future path of inflation will depend upon which forces prevail. In the coming months, inflation

Chart 3

Inflationary and disinflationary forces related to the pandemic: a non-exhaustive overview

		SHORT TERM	LONGER TERM (i.e. post lockdown)
SUPPLY – DRIVEN	Upward price pressures	<ul style="list-style-type: none"> Lengthening of supplier delivery times 	<ul style="list-style-type: none"> Firms face extra costs related to safety and health measures (e.g. hand sanitizers, plexiglass, more space between seats in restaurants, ...) Liquidity-constrained firms increase their selling prices Widespread corporate bankruptcies (limiting supply and increasing industry concentration) could lead surviving firms to increase their prices Wage increases demanded by “frontline” workers Self-sufficiency / deglobalising supply chains Lower investment lowers potential output, narrowing the output gap (i.e. reducing slack in the economy)
	Downward price pressures	<ul style="list-style-type: none"> Firms give price discounts to reduce their stocks 	<ul style="list-style-type: none"> Firms give price discounts to attract new and existing clients Fast rebound in productive capacity
DEMAND – DRIVEN	Upward price pressures		<ul style="list-style-type: none"> Large-scale fiscal and monetary stimulus may create upward price pressures (but possibility of Ricardian equivalence) Pent-up demand (i.e. spending forced savings as nominal income has been sustained e.g. via fiscal transfers)
	Downward price pressures	<ul style="list-style-type: none"> Oil price decline (less oil demand due to pandemic) Containment measures restrict consumer demand 	<ul style="list-style-type: none"> Higher unemployment depresses demand Austerity / public and private debt deleveraging Soft post-lockdown demand (e.g. for travel, leisure) Increased precautionary/emergency savings by firms and households

Source: NBB.

is expected to remain depressed, as downward price pressures stemming from weak demand should offset upside price pressures related to supply-side disruptions and shortages. Further ahead, the outlook for inflation is clouded in considerably more uncertainty. At the time of writing, the consensus among markets and economic forecasters seems to be that negative demand shocks will continue to predominate over negative supply shocks, thus keeping a lid on inflation. This is also evident in the Eurosystem staff macroeconomic projections: the June baseline inflation path lies consistently below the March projections. At the end of 2022, inflation would have only risen to 1.4%, far below the ECB’s objective of below, but close to 2%. Depending upon the strength of the economic recovery, inflation might turn out to be a bit higher (cfr. the mild scenario) or a bit lower (cfr. the severe scenario), but it is not projected to accelerate drastically. Likewise, recent longer-term survey-based inflation expectations (see yellow dots in chart 2) remained at historic low levels and longer-term market-based inflation expectations (see red triangles in chart 2) are even more subdued.¹ That said, chart 3 indicates that there are plausible factors that might push up post-pandemic inflation. Hence, it is prudent to keep an open mind with respect to the importance of upside versus downside risks to inflation in the longer run.

¹ The gap between the two can largely be explained by the sizeable negative risk premia contained in the latter.

2. Governments, central banks and supervisors reacted fast

All over the world, governments, central banks and prudential authorities deployed measures which were unprecedented in both size and speed, to help curb the financial panic and cushion the economic impact caused by COVID-19.

In view of the targeted nature of the policy response, governments have been, and still are, at the forefront of the fight against COVID-19 and its economic fallout. Thanks to a combination of automatic stabilisers and discretionary measures, the drop in households' disposable income was limited compared to the decline in economic activity, and firms' weakening solvency was shored up. On top of such measures that support private sector solvency, governments also provided liquidity support in the form of tax deferrals and various credit guarantee schemes (sometimes accompanied by private and/or public moratoria on outstanding loans) that helped firms and households to preserve access to bank credit. In contrast to net transfers, guarantees do not directly weigh on public finances but create contingent liabilities for governments that only later might turn into actual expenses. In Europe, it is not only national governments that have reacted fast and decisively: at the EU level, too, important initiatives were taken to deal with liquidity problems and support the recovery. Most notably, the European Commission proposed to issue € 750 billion of debt on financial markets. Combined with a revised long-term EU budget of € 1,100 billion for 2021-2027, this forms its Recovery Plan for Europe. That plan comes in addition to the three safety nets of € 540 billion already put in place by the EU to support workers, businesses and countries¹.

Using the terminology of J. Powell, chairman of the US Federal Reserve, central banks have complemented governments' spending powers with their powers to lend (Powell, 2020). They brought down interest rates through policy rate cuts and asset purchases. They also paid particular attention to ensuring that the monetary stimulus reached households and firms by setting up dedicated and targeted lending programmes (Cavallino and De Fiore, 2020). Governments' credit guarantees leveraging the impact of such measures and central bank bond purchases keeping interest rates in check when debt issuance spikes are just two examples of the complementarities between fiscal and monetary policy at the current juncture.

As the financial sector is key in channeling funds from savers to borrowers, the responses of prudential authorities have also been instrumental in supporting financial intermediation, and notably lending to the real economy. Supervisory authorities in the euro area allowed banks to use capital and liquidity buffers, granted them more flexibility on deadlines and procedures, and requested banks to refrain from paying dividends so as to preserve balance sheet capacity. This gives central banks' lending stimuli and governments' loan guarantee schemes even more traction.

The following sections explain in more detail the monetary policy reaction in the euro area.

3. The ECB's crisis response measures

On the eve of the crisis, the monetary policy stance in the euro area was already very accommodative. Since the end of 2011, the ECB had been continuously lowering its interest rates, with its main policy rate – the deposit facility rate (DFR) – standing at a record low of –0.5 % since September 2019. In addition, asset purchases under the ECB's Asset Purchase Programme (APP) had been resumed since November 2019, at a monthly pace of € 20 billion. Furthermore, the ECB's forward guidance ensures that a very easy policy stance will remain in place

¹ For more details, see <https://www.consilium.europa.eu/en/policies/coronavirus/covid-19-economy/>

until euro area inflation robustly converges towards its target of below, but close to, 2 % over the medium term. To support the bank-based transmission channel in a world of negative interest rates, the ECB had also launched a third series of targeted longer-term refinancing operations in September 2019 – the so-called TLTRO III – on more favourable conditions than initially planned. While the maturity of the operations had been lengthened by one year, borrowing rates had also been lowered, down to the deposit facility rate (DFR), or –0.5 %. Lastly, a two-tier system for reserve remuneration was introduced from the end of October 2019. The scheme exempts part of banks’ excess liquidity holdings with the Eurosystem from negative remuneration at the DFR – to be compensated at 0 % instead.

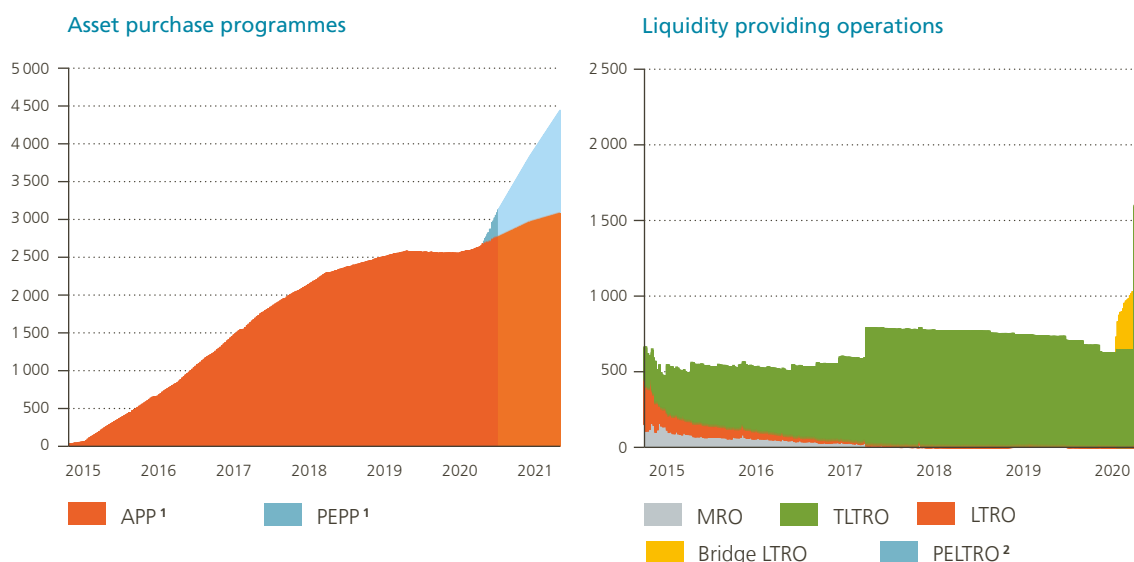
When designing the monetary policy response to COVID-19, the Governing Council of the ECB has three goals in mind, all critical in achieving the primary objective of maintaining price stability:

- Ensuring an overall sufficiently accommodative stance, despite the surge in public debt issuance that – all other things being equal – would push up bond yields with knock-on effects on other interest rates.
- Supporting market stabilisation to safeguard the transmission mechanism, including by avoiding fragmentation across euro area countries, which are not all hit equally hard by COVID-19 and not all had similar starting points when the crisis hit.
- Providing ample central bank liquidity, especially to keep access to bank credit intact for firms and households. This is very important in the euro area where bank loans account for a very large chunk of the private sector’s external financing.

Chart 4

The ECB expanded its balance sheet

(billion €)



Sources: ECB, own calculations.

1 Realised asset purchases until 30 June, 2020. The light areas show projected asset purchases for the period July 2020 – June 2021, based on an assumption that the remainder of the temporary € 120 billion APP and € 1,350 billion PEPP envelopes would be exhausted, as a result of constant daily purchases, by the end of 2020 and the end of June 2021 respectively, and monthly APP purchases of € 20 billion would be continued until at least end-June 2021.

2 The first two PELTRO operations, settled on 21 May and 24 June, for a total of € 16 billion, are included but, due to their limited amounts, not visible in the chart.

The ECB stepped up its asset purchases

On 12 March, in a first reaction to the crisis, the ECB stepped up its purchases under the APP, adding an envelope of € 120 billion to top up planned asset purchases until the end of 2020. By ensuring a substantial contribution from the private sector purchase programmes and extending the eligibility of assets to non-financial commercial paper, the ECB further supported favourable financing conditions for the private sector. As the virus rapidly spread and lockdown measures were being introduced across Europe, it quickly became clear that the crisis would cause more severe damage to the economy than previously anticipated. Against that background, on 18 March the ECB launched a new, temporary asset purchase programme, the so-called Pandemic Emergency Purchase Programme (PEPP), with an envelope of € 750 billion. At the beginning of June, this envelope was scaled up to € 1,350 billion in a context of downwardly revised projections for euro area activity and inflation. The horizon for purchases under the PEPP was also extended until at least the end of June 2021, from the end of 2020 initially planned. In addition, the ECB announced that the principal from maturing securities purchased under the PEPP would be reinvested until at least the end of 2022.

While the rules are broadly the same for the APP and PEPP, purchases under the latter can be conducted with a larger degree of flexibility, reflecting the importance for the ECB to act as needed in a context of extreme uncertainty about how the crisis will evolve and its impact on the economy and financial conditions. That flexibility applies to the allocation of purchase flows over time, asset classes and jurisdictions. Regarding the allocation across countries of public sector bond purchases, each country's share in the ECB's capital (which reflects a country's share in the EU's total population and GDP) serves as the benchmark in both programmes. At the same time, purchases under the PEPP will be conducted in a flexible manner. In addition, Greek government bonds can be bought under the PEPP, whereas they are not eligible for purchases under the APP as they do not satisfy the credit quality requirements. Finally, the self-imposed limits regarding bond holdings, restricting the Eurosystem's securities holdings to a maximum share of each issuer's debt and of each issue of a particular security, do not apply for holdings under the PEPP.

The left-hand panel of chart 4 shows the volumes of Eurosystem purchases under the APP and PEPP and projected additional purchase amounts until the end of June 2021. Between the onset of the crisis and the end of June 2020, the Eurosystem had bought about € 150 and € 350 billion under the APP and PEPP respectively, with total net purchases under both programmes accounting for over half of the Eurosystem's total assets at the end of June.

More liquidity on more favourable terms under the longer-term refinancing operations

From the beginning of the crisis, monetary policy measures have also aimed at providing banks with ample liquidity on favourable conditions to support a smooth flow of bank credit to firms and households. In that context, the terms of the third series of targeted longer-term refinancing operations (TLTRO III), launched in September 2019, were eased¹. The ECB's TLTROs incentivise lending to the private sector, as banks can borrow more liquidity and at more favourable rates the more credit they provide to the private sector. In response to the crisis, borrowing conditions under TLTRO III were loosened in three ways. First, the ECB allowed banks to borrow larger amounts of liquidity. Banks' total borrowing allowances under TLTRO III were hence scaled up by two thirds², while per operation borrowing limits were abolished. Second, banks could more easily qualify for a lower interest rate. If banks maintain their levels of credit provision during the pandemic crisis phase, they qualify for the lowest borrowing rate. For banks not beating that newly introduced benchmark, the old lending performance benchmark applies, but is reduced, given the challenging circumstances due to COVID-19. Third, the pricing structure of TLTRO III was adapted, in two steps, to be ultimately lowered by 50 basis points during the pandemic period. The entry rate thus dropped

1 For more details, see the ECB's press releases: <https://www.ecb.europa.eu/press/pr/html/index.en.html>.

2 Banks were allowed to borrow up to 50 %, instead of 30 %, of their outstanding stock of private sector loans as at the end of February 2019, excluding loans to households for house purchase.

to 50 basis points below the main refinancing operations (MRO) rate, or currently -0.5% . For banks that maintain their levels of credit provision during the crisis phase, the rate was lowered to the DFR minus 50 basis points, or currently -1% .

TLTRO operations only take place on a quarterly basis. In order to bridge the period leading up to the June TLTRO III operation, the ECB therefore also announced a new series of weekly longer-term refinancing operations, the so-called bridge LTROs. Priced at DFR, these operations provided euro area banks with liquidity on somewhat less favourable terms than the TLTRO III, but they have no conditions attached in terms of lending performance. All operations matured at the end of June 2020, on the settlement day of the fourth TLTRO III operation.

In order to provide an effective backstop for shorter-term liquidity needs after the expiration of the bridge LTROs in June, so-called Pandemic Emergency LTROs – PELTROs – were introduced at the end of April. Seven PELTRO operations are scheduled about once a month between May and the end of 2020, at the MRO rate minus 25 basis points. All operations mature in the third quarter of 2021.

Given these highly favourable borrowing conditions, banks took up considerable amounts of liquidity with the Eurosystem during the first months of the crisis. The total take-up under the third and fourth TLTRO III operations amounted to € 1.4 trillion, i.e. 14 times the amount taken up under the first two TLTRO III operations (see chart 4, right-hand panel). The bulk of this amount was taken up in June, when the more favourable conditions applied. The net liquidity injection in June was smaller however, as the bridge LTROs were repaid on the same day. Euro area banks had borrowed a total of just below € 390 billion under these bridge LTROs, mainly concentrated on the initial operations. PELTRO take-ups under the May and June operations remained rather limited, amounting to € 16 billion.

A comprehensive package to ease collateral requirements

To ensure that banks gained the full benefit from the more favourable conditions under the ECB's longer-term refinancing operations, additional measures related to their collateral requirements were essential. Since collateral availability tends to come under pressure during crises, in a context of worsened financial market conditions, the ECB introduced a comprehensive package of collateral easing measures, to ensure banks continued to have access to sufficient liquidity to support their lending activities. Overall, these measures extended the range of assets eligible as collateral and allowed the ECB to tolerate more risk on its balance sheet. For example, the extended collateral framework permits banks to pledge as collateral smaller business loans, such as loans to small and medium-sized enterprises or self-employed workers, that benefit from state guarantee schemes in many euro area countries. In Belgium, too, banks could pledge as collateral the loans covered by the guarantee scheme for firms and self-employed workers as agreed between the financial sector and the government at the end of March.

Dollar swap lines enhanced, euro swap and repo lines (re)activated

In response to a tightening global dollar funding market, the Federal Reserve, the ECB, the Bank of Japan, the Bank of England, the Bank of Canada and the Swiss National Bank agreed to ease the terms of their standing dollar swap lines¹. In particular, the Federal Reserve reduced the pricing of the swap arrangements and increased the frequency of the 7-day operations to daily from weekly², while it was agreed that longer-term, 84-day operations would be offered every week. In addition, non-euro area central banks could also access euro liquidity, as the ECB established new euro swap lines with the central banks of Bulgaria and Croatia, while reactivating its

¹ Swap lines are agreements among central banks to exchange their currencies. The ECB's swap line with the Federal Reserve, for example, enables the ECB and all national euro area central banks to receive US dollars from the Fed in exchange for an equivalent amount of euros.

² As from July 1, this frequency was again reduced to three times per week, in view of the improved US dollar funding conditions and lower demand for the 7-day operations.

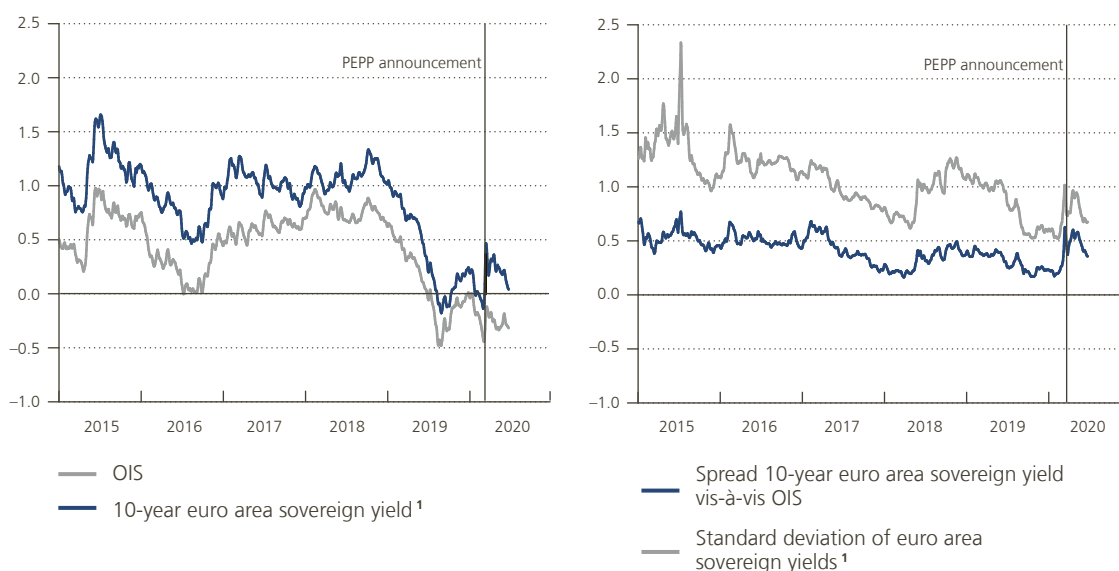
swap line with the central bank of Denmark. A repo line, which exchanges euros for collateral, was introduced with the central bank of Romania. Complementing these bilateral euro swap and repo lines, finally, a Eurosystem repo facility for central banks (EUREP) was set up at the end of June, providing precautionary euro repo lines to central banks outside the euro area. The facility addresses pandemic-related euro liquidity needs until the end of June 2021.

4. Financial conditions stabilised and bank lending met record-high liquidity needs

Chart 5

The ECB's asset purchases curbed stress and fragmentation pressures in euro area sovereign bond markets

(%, 5-day moving averages)



Sources: ECB, Refinitiv.

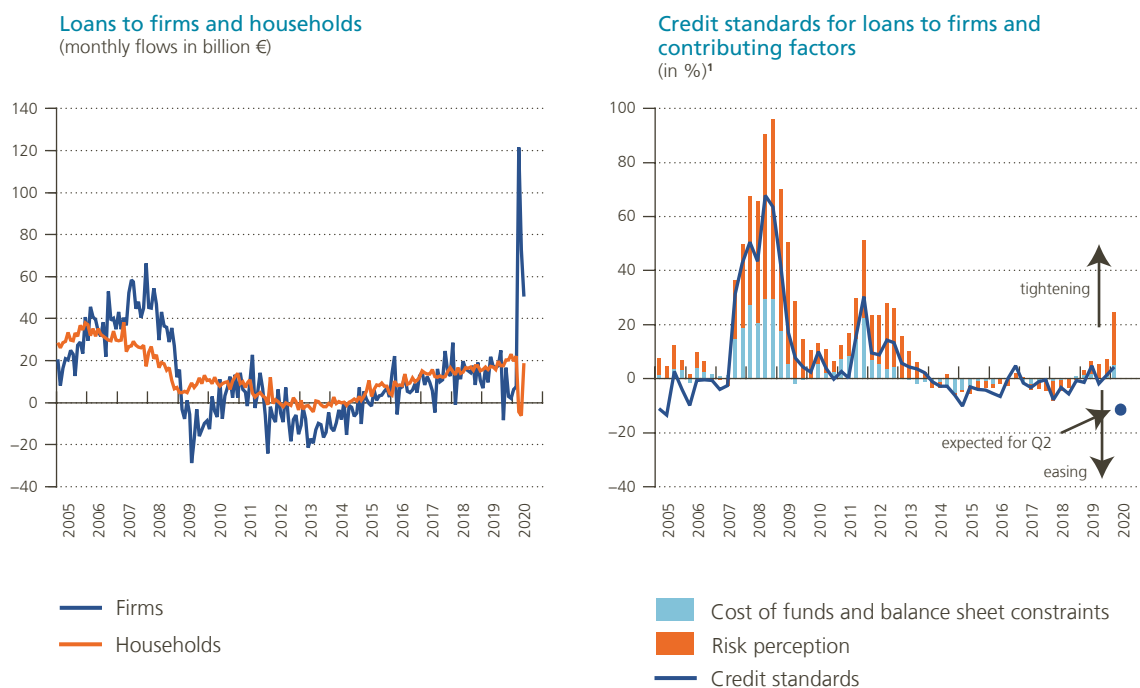
1 GDP-weighted, based on eleven euro area countries: Germany, France, Italy, Spain, Netherlands, Belgium, Austria, Portugal, Finland, Ireland and Greece.

The ECB's asset purchases are a key tool for keeping borrowing costs low and ensuring that easy financing conditions get shared evenly across the euro area. As the virus spread across Europe, and the public sector was expected to issue sizeable amounts of additional debt on financial markets, sovereign bond yields moved up in all euro area countries. In the process, they also decoupled from the corresponding OIS rates¹ as illustrated in chart 5. Apart from this common shock, illustrated by a higher GDP-weighted euro area sovereign yield, the crisis also induced fragmentation across the euro area, as some countries, like Italy and Spain, were hit harder by the crisis but also had higher debt levels to begin with. The increased dispersion in euro area government bond yields since the start of the crisis illustrates this (chart 5, right-hand panel). The introduction of the PEPP – with its large crisis envelope and built-in flexibility – significantly mitigated both common stress and fragmentation pressures: the euro area sovereign yield moved closer to OIS rates while the dispersion in national sovereign yields came down after 18 March.

¹ Euro area OIS rates are priced on the basis of the expected future path of the ECB's policy rates and, hence, are an important basis for financing conditions in the euro area.

Chart 6

Spike in bank lending to firms



Source: ECB.

¹ Net percentages refer to changes over the previous quarter and are defined as the difference between the sum of the percentages of banks responding that credit standards tightened/the given factor contributed to a tightening and the sum of the percentages of banks responding that credit standards eased/the given factor contributed to an easing.

As well as avoiding upward pressures on market-based interest rates in all euro area countries, monetary policy measures in the context of the COVID-19 crisis also focused on keeping the bank lending channel intact. This has been very valuable for helping euro area firms navigate the crisis. First, as a result of the lockdown measures, a large number of firms faced a sudden and significant drop in their cash flows, forcing them to borrow on a massive scale. Second, euro area firms rely heavily on bank lending, which accounts for about half of their external financing. Available data until the end of June suggest that, at least during the first months of the crisis, euro area banks have been able to meet firms' increased liquidity needs (chart 6, left-hand panel). In March, when confinement measures were being introduced in euro area countries, non-financial firms borrowed about € 120 billion from euro area banks. To put things into perspective, it is worth noting that this number is almost double the previous monthly record, which was, moreover, recorded during the credit boom preceding the global financial crisis. As firms were mainly seeking to finance working capital, the biggest increase was initially recorded for short-term credit.

While firms were borrowing massively during the first months of the crisis, they were also hoarding cash. Indeed, deposits placed by non-financial corporations with euro area banks also increased by more than € 100 billion per month in March-May. This suggests that credit demand was driven not only by real funding needs, but also by precautionary motives, in a context of extreme uncertainty about how the crisis would play out and its impact on the economy. In this context, firms drew on previously committed credit lines to channel these funds into bank deposits.

Net lending to households, on the other hand, was negative during the first two months of the crisis, with lending flows reverting to levels observed before the crisis only in May. Rising fears of unemployment, combined with the sheer physical constraints that the lockdown measures imposed on buying a property or consumption

goods, induced households to significantly cut down on borrowing in the first stages of the crisis. Consistent with such forced saving, households' bank deposits jumped.

Belgian banks' lending followed a similar pattern. Loans to firms climbed to record amounts in March and April, with flows in March reaching the highest figure in almost twenty years. In May however, net lending to firms turned negative. Loans to households saw negative origination in April but went up again in May.

As banks lent a record amount to euro area firms, credit conditions for corporates also remained relatively easy, according to the ECB's Bank Lending Survey (BLS)¹ (chart 6, right-hand panel). Importantly, a deterioration in banks' balance sheets or cost of funds made only a minor contribution to the tightening of credit standards in the first quarter of 2020. While many banks' risk perceptions increased, the resulting tightening of credit standards remained small compared to the situation during the global financial and sovereign debt crises. On the one hand, in March – when the BLS survey was conducted –, banks were not yet able to fully evaluate the effects of the COVID-19 crisis. On the other hand, euro area banks' sounder capital and liquidity positions, as well as the introduction of government guarantee schemes in euro area countries, undoubtedly also played a role here. Moreover, the early introduction of monetary policy measures, especially related to the ECB's longer-term refinancing operations, also prevented a further tightening of borrowing conditions by providing substantial funding cost and liquidity relief for banks. Against that background, banks even expect credit standards for firms to ease considerably in the second quarter.

Conversely, credit standards for loans to households for house purchase and for consumer credit tightened somewhat more than for firms during the first quarter of 2020 and are also expected to continue tightening in the second quarter. Contributory factors here are concerns about households' creditworthiness, as a result of a deteriorating income and employment outlook.

5. Looking ahead, many uncertainties and challenges remain

So far, so good. That is the shortest possible way to summarise how authorities have managed the financial stress and economic fallout of COVID-19. Focusing on the contribution of monetary policy in the euro area, the ECB Governing Council deployed a wide range of measures. Bond purchases under the APP have been stepped up and an extra envelope of € 1,350 billion of purchases is available until at least June 2021 under the new PEPP. Significantly more attractive conditions for the TLTROs have led euro area banks to demand a total of € 1.4 trillion in these operations. A major relaxation of collateral requirements has been instrumental in allowing banks to tap central bank funding to such a large extent. This package of measures has prevented an abrupt and excessive tightening of financial conditions and fragmentation across euro area countries that would impair transmission. Thanks to synergies with government measures, more resilient banks and supervisory relief, they have also allowed banks to accommodate firms' record demand for loans to address sudden liquidity needs.

Monetary policy in a post-pandemic low-growth and high-debt world

However, the challenges ahead for monetary policy are manifold. The risks around an already subdued macroeconomic outlook are on the downside. First and foremost is the risk of the virus flaring up again and forcing economies back into lockdown. Its economic costs could be amplified, for instance as rising corporate insolvencies could lead to adverse real-financial feedback loops. Regarding inflation, the outlook might be even more uncertain, as it depends on the extent to which COVID-19 has damaged the supply or the demand side

¹ The April 2020 Bank Lending Survey was conducted between 19 March and 3 April, 2020.

of the economy. While the virus outbreak is perceived to be disinflationary in the months ahead, the assessment is more complicated over the medium and longer term, as explained in section 1.

Both adverse demand and supply factors complicate life for monetary policy, be it in a different way. Were growth to remain weak because of subdued demand, the resulting low inflation calls for more monetary easing. With policy rates close to the effective lower bound, and non-standard measures already being used in a very active way, delivering the required support to demand is far from easy. If supply factors are behind low growth, inflation will rise and this makes the lower bound problem less pertinent as there is room to raise policy rates. However, in such a configuration, monetary policy has less scope to support economic growth, and the debt-overhang challenge caused by COVID-19 might become more pressing.

Indeed, COVID-19 will increase debt in all sectors of the economy, but the public sector will see the biggest rise as it supported private incomes when GDP plummeted. According to the European Commission spring forecast, the euro area gross government debt-to-GDP ratio is predicted to increase by some 13 percentage points between 2019 and 2021, towards 99%, with several countries expected to post increases of almost 20 percentage points. This raises questions on the sustainability of such high levels of public debt and the interaction with monetary policy.

In this context, a crucial variable is the difference between the interest rate that governments pay on their debt and the growth rate of the economy, as explained in more detail by Blanchard (2019) and Baert *et al.* (2020). That difference, which can be expressed in either nominal or real terms and which we label here as $r-g$, determines the dynamics of the debt ratio for a given primary balance. A negative value for $r-g$ facilitates debt management, as a negative snowball effect endogenously reduces the debt ratio as time passes. If such an environment proved to be permanent, the debt ratio would even stabilise with a primary deficit, but possibly at extremely – and undesirably – high levels (see further). In contrast, a positive differential requires governments to engineer a primary surplus to prevent snowball effects from rendering debt unsustainable.

Chart 7 illustrates that markets currently expect $r-g$ to be supportive for the sustainability of many euro area governments' debts. Except for the current year during which economies will experience a sharp contraction in nominal growth, forward bond yields are clearly below forecasts of economic growth in Belgium and Germany. Italian growth, however, barely surpasses the yield on Italian government bonds. It is worth noting that the present outlook for $r-g$ is clearly more friendly for debt dynamics than during the Great Financial Crisis of 2008 or the sovereign debt crisis of 2011-2012.

It is important to underscore that these debt-friendly $r-g$ numbers are not driven by a monetary policy that sacrifices price stability to preserve governments' debt sustainability – a choice that would not be allowed by the Treaty. Rather than being driven by a form of “fiscal dominance”, today's low interest rates reflect a depressed natural rate of interest and too low inflation. If the latter factors return to normal, central banks with a clear price stability mandate, like the ECB, will restore normal interest rates and the alleged coordination between fiscal and monetary policy will be history.

Against that background, there should be no reason for complacency on the part of governments, and prudence in setting fiscal policy is of the essence. First, while it is mathematically true that a permanently negative $r-g$ number stabilises debt ratios even with a permanent primary deficit, that can imply unacceptably high debt ratios. To illustrate this in a mechanical way, if the currently projected 2022 Belgian primary deficit¹ of 4.2% in the baseline scenario and the forward $r-g$ of –2.5% were to become a new steady state, the Belgian debt level would in theory only stabilise at 172%. This is a number that cannot be called desirable. Moreover, in practice, it is very likely that continued fiscal deficits resulting in such a high debt level would put upward pressure on

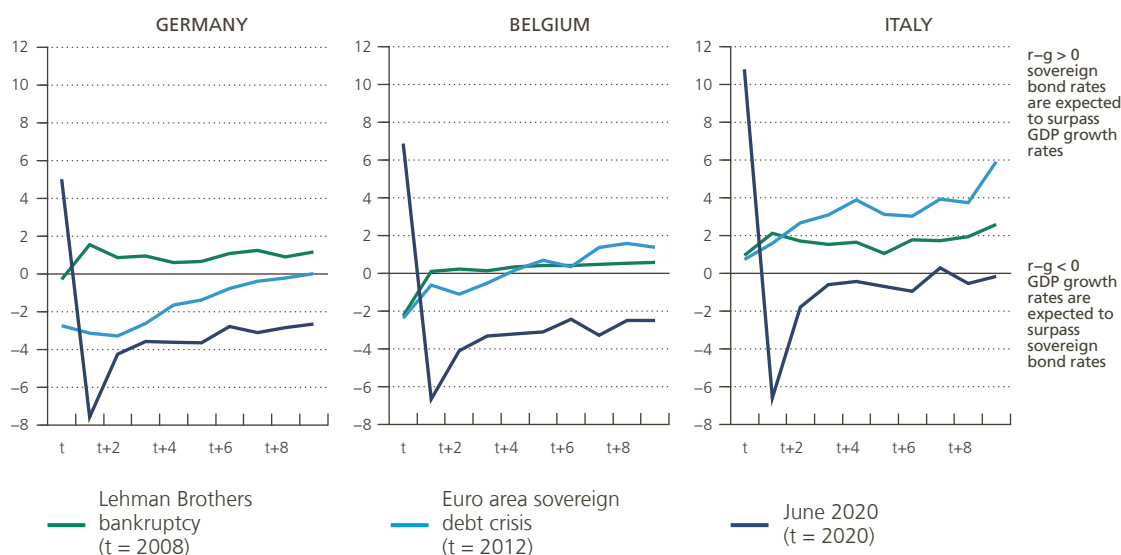
1 See NBB (2020).

Chart 7

Government bond yields are generally below growth expectations

Expected interest rate–economic growth differentials

($r-g$; percentage points)



Sources: Consensus Economics, Refinitiv.

June 2020: difference between nominal government bond rates (June 2020 average) and Consensus Economics June 2020 nominal GDP forecasts for 2020, 2021 and 2022 and April 2020 nominal GDP forecasts for 2023-2029; Lehman Brothers bankruptcy: difference between nominal government bond rates (2008Q3 average) and Consensus Economics October 2008 nominal GDP forecasts; euro crisis: difference between nominal government bond rates (2012Q1 average) and Consensus Economics April 2012 nominal GDP forecasts. The Belgian data use short-term nominal GDP forecasts from Consensus Economics while long-term nominal GDP forecasts are from the Federal Planning Bureau.

Belgian government bond yields which may in turn depress economic growth, making $r-g$ significantly less supportive. More generally, uncertainty about the future $r-g$ is large and calls for caution.

Going forward, $r-g$ could indeed become less supportive for debt sustainability: the graphs show only a central scenario for economic growth and interest rates, whereas reality may – and likely will – turn out differently. Small changes to $r-g$ have large implications for the debt ratio: if r increases by a mere 50 basis points in the above mechanical example for Belgium, the debt stabilises only at 216%. As already stated, downside risks to growth stemming from demand shocks could render the $r-g$ profile less conducive for debt sustainability as there is limited scope for interest rates to go much lower.¹ Interest rates on government bonds could also rise. Faced with adverse supply shocks, a less accommodative monetary policy stance could be justified and lower economic growth might not go hand in hand with lower interest rates, resulting in a shrinking gap between economic growth and government bond yields. Another possible driver of higher borrowing costs is the risk premium that countries pay on top of the risk-free rate. While the ECB stands ready to act as a lender of last resort for sovereigns with liquidity problems but sustainable debts – and can be relied upon to eliminate any bad equilibria and unjustified rises in yields –, that is not equivalent to unconditional backing for all sovereign debt issued by euro area Member States.

To sum up, current conditions allow for a temporary shift towards expansionary fiscal policy without threatening debt sustainability. However, the fact that sizeable fiscal space exists today does not mean that it should be exploited. That is because, looking ahead, governments should be prepared for scenarios where borrowing

¹ This is closely linked to the concept of “debt deflation”, as pioneered by I. Fischer (1933).

costs rise. In fact, monetary policy can only deliver on its primary mandate of maintaining price stability if governments can be relied upon to make the necessary fiscal choices to ensure that debts are sustainable, even when interest rates go up. Otherwise, debt sustainability considerations will interfere with the conduct of monetary policy. That can happen via – possibly extreme – stress on sovereign bond markets with adverse spillovers to the real economy and inflation, or via a form of “fiscal dominance” where the central bank, sacrificing price stability for debt stabilisation, is too slow in raising interest rates.

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