3. Monetary policy

3.1 A speedy and massive monetary policy response on a global scale

Central banks have been confronted with multiple challenges raised by the COVID‑19 crisis…

Faced with the COVID‑19 crisis, central banks have had to meet several major challenges, forcing them to intervene vigorously and often almost simultaneously. To start with, there was a sudden bout of turbulence on the financial markets as early as February, triggering a clear tightening of borrowing conditions. Some business financing markets, like those for commercial paper, were even paralysed completely. More generally, the reassessment of risks by investors led to a flight to quality, to the notable detriment of emerging economies and in favour of safe-haven assets like US Treasuries, leading to a shortage of dollars outside the United States. Consequently, the central banks' first objective was to stabilise the markets, which contributed to preserving the transmission of monetary policy. Secondly, as a result of lockdown, non-financial corporations have had to face acute liquidity needs. To avoid a credit crunch scenario, which would have amplified the economic damage, the central banks encouraged lending by the banking sector. Thirdly, the shutdown or slowdown of business activity risked turning into an economic depression and generating downward pressure on prices, pushing inflation even further away from its targets. The monetary policy stance was thus relaxed. In a highly uncertain environment, decisive action on each of these fronts was essential to boost confidence among economic and financial stakeholders.

Action by the monetary authorities prevented the crisis from escalating into an economic depression

In many respects, these challenges are of a different nature from those faced during the global financial crisis in 2008‑2009. This time, the shock is exogenous to the economy and mainly affects non-financial corporations and households, while the previous crisis had basically resulted from problems emerging from the financial sector. Since then, at the instigation of the prudential authorities, financial institutions have strengthened their liquidity and solvency positions substantially.

On the monetary front, the advanced economies' central banks were already following a flexible policy before the crisis, in a context where inflation was still way off target. The combined effect of a long period of sluggish growth and low inflation in the wake of the financial crisis, on the one hand, and a structurally low natural interest rate, on the other hand, had brought key interest rates down to their effective lower bound and stepped up central banks' recourse to so-called unconventional instruments, vastly inflating their balance sheets as a result. Among the major central banks, only the United States' Federal Reserve had started a normalisation process. The challenges that this situation threw up prompted the central banks from several advanced countries to carry out an in-depth review of their monetary policy strategy. Box 2 comments on the way in which the Federal Reserve and the ECB have dealt with this issue.

… and deployed a wide range of instruments

The multiple facets of the COVID‑19 crisis led central banks to put all the instruments in their arsenal into practice.

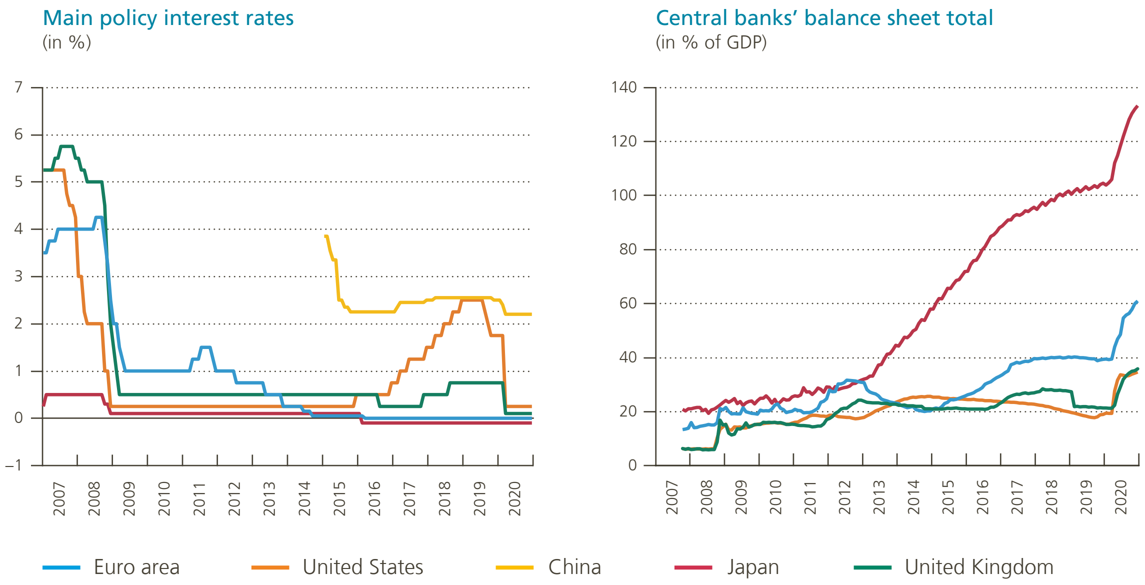
For instance, in the advanced and emerging economies, the central banks have cut their key interest rates, at least where there was still scope to do so. That was the case in the United States and, to a lesser extent, in the United Kingdom and China. In the euro area and Japan, interest rates were already at zero or even negative. In their communication, they have clearly indicated that interest rates will continue to remain low until the inflation targets have been met.

With a view to stabilising the markets and increasing liquidity in the economy, many central banks – with the notable exception of those in Switzerland and China – stepped up their (net) purchases of financial assets, primarily of sovereign bonds. The Federal Reserve and the Bank of Japan even committed themselves to unlimited bond purchases. Some central banks, including those from around twenty emerging economies, launched securities purchase programmes for the first time. In Australia and India, they were restricted to government bonds, while the central banks of Canada and South Korea extended them to corporate bonds and commercial paper. These last two instruments have also been acquired *en masse* by the central banks of the major advanced economies, with a view to facilitating the financing of large enterprises and SMEs. In the United States, the Federal Reserve also bought up debt securities of States and counties. With the same objective of stabilising the markets, it also set up a credit line for money market mutual funds, as these funds were subject to requests for reimbursement at the beginning of the crisis, at a time when the money markets were highly illiquid.

And to ensure the continuity of funding for non-financial corporations and households, the central banks resorted to targeted loan operations. This liquidity, granted at particularly advantageous conditions, should enable the banks to continue their corporate lending business. As the crisis has exacerbated the risk of non-repayment of loans by companies, governments have mitigated this risk by providing their guarantees. The Chinese, Japanese and British central banks, among others, have put in place new facilities specifically targeted at SMEs. The Federal Reserve set up programmes for buying

Chart 1

The central banks of the major economies have greatly relaxed their monetary policy in response to the COVID-19 crisis



Sources: BIS, CEIC, Eurostat, OECD, Refinitiv.

Table 8

Monetary and foreign exchange policy instruments used by central banks in the major advanced and emerging economies

Instruments	US	Euro area	UK	Japan	China	India
Interest rates						
Rate cuts	✓	×	✓	×	✓	✓
Negative rates	×	✓	×	✓	×	×
Loans/Liquidity	✓	✓	✓	✓	✓	✓
Asset purchases						
Sovereign bonds	✓	✓	✓	✓	×	✓
Corporate bonds	✓	✓	✓	✓	×	×
Foreign exchange markets						
FX swaps	✓	✓	✓	✓	✓	×
FX intervention	×	×	×	×	×	✓

Source: BIS (Annual Economic Report 2020), NBB update.

up loans granted by banks to a wide spectrum of companies. Thanks to these initiatives, the range of financial support to the non-banking private sector has been unprecedented.

The whole range of securities purchase measures and granting loans and liquidity has contributed to take the balance sheet totals of the major central banks to unprecedented levels.

Faced with the shortage of United States dollars on a number of non-American markets, the Federal Reserve played its role of international lender of last resort by stepping up, without limit and at a reduced interest rate, the swap lines that had been established during the economic and financial crisis with five big central banks from advanced nations (ECB, Bank of England, Bank of Canada, Bank of Japan and the Swiss National Bank) and by temporarily restoring swap lines with nine other countries with which these lines had been closed (the three Scandinavian countries, Australia, Brazil, South Korea, Mexico, New Zealand and Singapore). On 31 March, the Federal Reserve put in place a temporary repo facility enabling central banks from all countries to obtain liquidity by depositing Treasury bonds and US agency securities as collateral. In the same spirit of providing liquidity in euros, the ECB (re)activated its swap and repo lines with a series of central banks.

While the Swiss National Bank had to intervene once again on the foreign exchange markets to curb the appreciation of the franc, the central banks of many emerging countries have had to support their currency. That has notably been the case in India, Brazil, Indonesia and Turkey.

All these different measures have clearly borne fruit. The financial markets have been stabilised, so as to ensure monetary policy transmission. The banks have been able to grant considerable business and household loan volumes, even when liquidity needs were enormous. And, lastly, interest rates have come down across the whole maturity spectrum, thus helping with the easing of borrowing conditions, not only for non-financial corporations and households but also for governments, giving the public authorities wider margins of manoeuvre to implement their policy to support the economy.

BOX 2

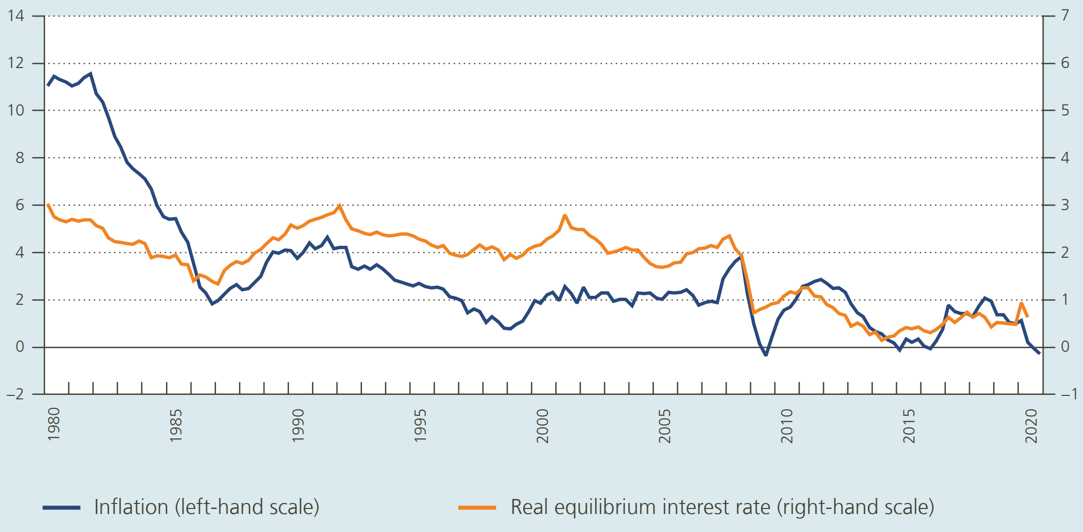
Review of the ECB and Federal Reserve monetary policy strategies

The environment in which central banks operate has changed drastically over the last few decades. One of the most striking changes lies in the decline of the equilibrium rate or natural rate, in other words, the interest rate level at which the economy is in equilibrium[1]. Over the last few decades, several structural trends – such as the slowdown in productivity growth or population ageing – have weighed on potential growth in the developed countries and, consequently, on the real equilibrium rate, too. Together with this low natural rate, the extended period of sluggish growth and inflation in the wake of the financial crisis has driven down the policy rates of developed countries' central banks towards their effective lower bound. In this situation, the central banks are also facing increasing difficulties in reaching their targets via their traditional instrument, namely steering short-term interest rates. That is the reason why they have had to resort more often to new unconventional instruments. The COVID-19 crisis has further exacerbated these challenges, in that it has exerted extra pressure on growth and inflation, forcing the central banks to turn even more towards unconventional measures. Moreover, other major changes, such as globalisation, climate change, digitalisation and the transformation of the financial environment, put tremendous challenges before monetary policy.

1 See box 1 in the Annual Report 2019, "Extremely low interest rates: a global, structural phenomenon", pp. 53-57.

The equilibrium interest rate and inflation in the euro area have fallen sharply over the last few decades

(in %)



Sources: For the equilibrium interest rate: Holston K., Th. Laubach and J. Williams (2017), "Measuring the Natural Rate of Interest: International Trends and Determinants", *Journal of International Economics*, 108, Supplement 1 (May): S59–S75. For inflation: Fagan G., J. Henry and G. Mestre (2001), "An Area-wide Model (AWM) for the euro area", ECB, *Working Paper series*, No. 42 (January).

In this context, several central banks have undertaken a review of their monetary policy strategy. They intend to submit monetary policy to a critical review, so as to be able to meet their objectives even in a constantly changing environment. At the beginning of 2020, the ECB launched a reassessment of its monetary policy framework, while the Bank of England has also announced a similar review around the same period. The Bank of Canada carries out this exercise every five years. Lastly, in the United States, the Federal Reserve launched a review of its monetary policy strategy in 2019, which it has meanwhile completed.

The United States Federal Reserve

The assessment carried out by the Federal Reserve, which started in early 2019, is the first in-depth review since the monetary policy framework was formally defined in 2012. The process, completed on 27 August 2020, led to a review of several facets of its strategy. It also decided to repeat this exercise once every five years.

For instance, the content of the Federal Reserve's dual mandate – which sets both full employment and price stability as its objectives – has been adjusted on several aspects. More generally speaking, the Federal Reserve is now targeting full employment, and this objective will be subject to a wide-ranging and inclusive interpretation, taking account of the situation of all income groups. Inflation now acts as an escape clause : the quest for full employment will only be suspended when inflation is too high. This practice breaks with tradition, when policy could also be tightened preventively whenever unemployment fell below its estimated equilibrium level, so as to nip any future inflationary pressure in the bud. As far as the interpretation of price stability is concerned, the old monetary framework above all had the characteristics of a "flexible inflation target", on the understanding that at any moment in time, an inflation rate of 2 % was targeted, regardless of the extent to which this objective had been reached in the past, under the principle of "bygones are bygones". The new monetary policy strategy is more like a "flexible average inflation target". So, after a period in which inflation has continually remained below 2 %, monetary policy will probably target a slightly higher inflation rate for some time. In so doing, the Federal Reserve is hoping to anchor inflation expectations more sustainably at 2 % and, therefore, to get inflation more rapidly back to its target. As the new monetary framework only raises the possibility of compensating for an excessively low inflation rate, that suggests an asymmetric reaction function. In an environment where the policy rate is close to its effective lower bound, the Federal Reserve, therefore, believes that a symmetrical result close to 2 % will above all need a reaction in the event of excessively low inflation.

European Central Bank

The ECB launched the review of its monetary policy strategy on 23 January 2020. Owing to the COVID-19 crisis, the original schedule of course had to be changed and finalisation of the whole process, which was planned for the end of 2020, has been postponed until the summer of 2021. Although the ECB and Federal Reserve monetary policies face the same challenges, the ECB's starting point differs somewhat from that of its American opposite number. In the last few years, interest rates and inflation expectations have generally been lower in the euro area than in the United States. And, as the ECB's review was started at the height of the coronavirus crisis, a series of additional focus points have been highlighted, such as the interaction between monetary policy and fiscal policy.

▶

In the light of the major developments that have taken place since the ECB's last strategy review, back in 2003, the institution has intentionally opted for a wide-ranging review. However, the ECB's mandate itself, and the price stability objective in particular, is not being questioned, because that would require an amendment to the Treaty on the Functioning of the EU. Instead, the review seeks to examine how best to accomplish the ECB's mandate within the limits of the EU Treaty, but in a radically changed environment.

This question led to a series of themes being singled out, which are being investigated in several working groups. One of the first themes concerns the definition of price stability used by the Governing Council. It is currently described as an annual increase in the harmonised index of consumer prices (HICP) below, but close to, 2 % over the medium term. Other aspects of the definition of price stability are under review during this exercise, such as any possible downward impact resulting from the current asymmetric nature of the formulation and what wording will best contribute to anchoring inflation expectations in a low-interest-rate environment. The composition of the consumer price index (notably whether to include costs associated with owner-occupied housing) forms an integral part of the debate.

Another theme focuses on how to gain a better understanding of the – often inevitable – trade-offs with other policy objectives and how to best support these objectives. Without undermining the foundations of the ECB's primary objective, the Treaty actually stipulates that monetary policy must also support the EU's general economic policy (notably geared towards sustainable development, social progress, competitiveness and full employment). In this respect, several questions arise, such as: How to take account of any second-round effects of monetary policy, like its impact on financial stability or its redistributive effects? How efficient are traditional and unconventional monetary policy instruments? What are their side effects and do they bring more advantages than disadvantages? How can monetary policy help stem climate change?

Lastly, throughout this exercise, particular attention is being paid to inclusion and communication. For instance, the ECB does not just want to hold a general debate on the most appropriate way of communicating on the subject of monetary policy, but it is also keen to hear from all interested parties (citizens, academics, parliaments and civil society organisations) in this process. Like its American counterpart, it is inviting all stakeholders to air their views at "listening events" organised by the ECB (in October 2020) as well as every national central bank in the euro area – including the NBB, in January 2021.

3.2 The ECB Governing Council rapidly deployed an arsenal of measures to cope with the COVID-19 crisis

As the convergence of inflation in the euro area towards its objective – a level below, but close to, 2 % – had already slowed down considerably in 2019, the ECB Governing Council had adopted from September that year a series of measures to relax monetary policy. The deposit facility rate, the main policy rate, had been cut to –0.5 %. A decision had also been taken to resume, from November 2019, net securities purchases under the Asset Purchase Programme (APP), to the tune of €20 billion a month. The indications given via the Governing Council's communication – forward guidance – guarantee that the accommodative policy stance will be maintained until inflation in the euro area firmly converges to its target. In order to support the banking transmission channel in a negative interest rate environment, two additional measures were adopted. On the one hand, the operational modalities for the third series of targeted longer-term refinancing operations (TLTRO III) were made looser than originally planned. On the other hand, from the end of October 2019, a two-tier system for remunerating reserves had been set up, under which part of the reserves held by the euro area banks with the Eurosystem are exempted from negative deposit facility rates and remunerated at a rate of 0 % [1].

Despite the already highly accommodating monetary policy stance at the beginning of the COVID-19 crisis, the financial and macroeconomic impact of the crisis called for an additional and forceful reaction from the ECB Governing Council. Just like other central banks across the globe, in this way, the ECB was pursuing three principal objectives: stabilising the financial markets to preserve monetary policy transmission, guaranteeing a generally easy policy stance and supporting lending to the private sector.

The ECB's action sought to stabilise the markets, guarantee favourable borrowing conditions and support lending

Purchases of private and public sector securities constitute the main instrument the Eurosystem has to meet the first two objectives. Faced with the rapid deterioration of the situation on the financial markets from the end of February 2020, the ECB Governing Council decided, at the beginning of March, to raise by €120 billion the amount of net securities purchases under the APP until the end of the year. With a strong contribution from purchases of securities from the private sector and the extension of eligible asset categories to non-financial commercial paper, support for lending to the private sector was stepped up. As it very quickly became clear that the scale of the crisis would be far bigger than initially envisaged, the Governing Council took the decision, on 18 March, to also launch a new temporary crisis programme, baptised the Pandemic Emergency Purchase Programme (PEPP), with an initial envelope of €750 billion. The programme was then extended during the course of the year, in two phases. At the beginning of June, the amount was initially revised upwards, to €1 350 billion, against a backdrop of a deteriorating outlook for economic activity and inflation in the euro area. At the same time, the period of the purchases made under the PEPP has been extended, from the end of 2020 to 30 June 2021,

1 See box 2 of the Annual Report 2019, "Innovating monetary policy decisions in 2019: the two-tier system for remunerating reserves", pp. 68-70.

while it was also decided to reinvest, at least until the end of 2022, the principal of the securities acquired under the PEPP as they reached maturity. A second wave of coronavirus across Europe in the autumn of 2020 and persistently low inflation prospects drove the Council to further expand the programme's envelope in December, to bring it up to €1 850 billion, as well as extending the period of asset purchases at least until the end of March 2022. At the same time, the period for reinvesting the principal of the securities bought under the PEPP has been extended by one year, until the end of 2023 at least.

In 2020, the Eurosystem acquired some €330 and 750 billion worth of private and public sector securities respectively under the APP and the PEPP. The Eurosystem thus bought up almost all the additional debt issued by the euro area countries in 2020. While both programmes are generally subject to the same rules, asset purchases under the PEPP – which is a crisis programme – nevertheless enjoy greater flexibility. This flexibility takes different dimensions, notably the distribution over time between the different asset classes and between the euro area countries. For instance, purchases made under the PEPP were on a much wider scale at the beginning of the pandemic, owing to the severe tension on the markets, but quite modest in the second half of the year. Purchases of commercial paper through this programme were mainly concentrated in the early months of the crisis. In this respect, the Eurosystem to some extent served as a safety net for a market that is an important source of finance for businesses, but one that the crisis had almost entirely paralysed. Between the months of March and May, more than € 35 billion worth of commercial paper was acquired through this programme, almost half the entire market. As the market recovered, asset purchases under the PEPP declined.

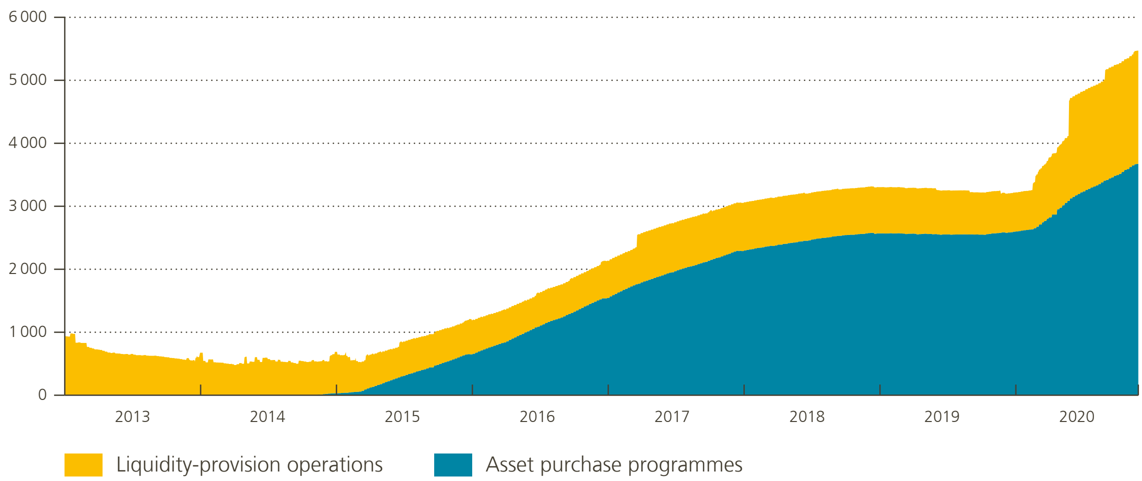
As is also the case for the APP, government bonds account for the majority of purchases made under the PEPP. For both these programmes, the breakdown of net sovereign bond purchases between the different Member States of the euro area is based on the ECB's capital key [1]. However, purchases made under the PEPP may temporarily depart from this key should market conditions so require. A relatively

1 Based on the share of each country in the EU's total population and GDP.

Chart 2

The crisis measures have considerably inflated the Eurosystem balance sheet total

(€ billion)

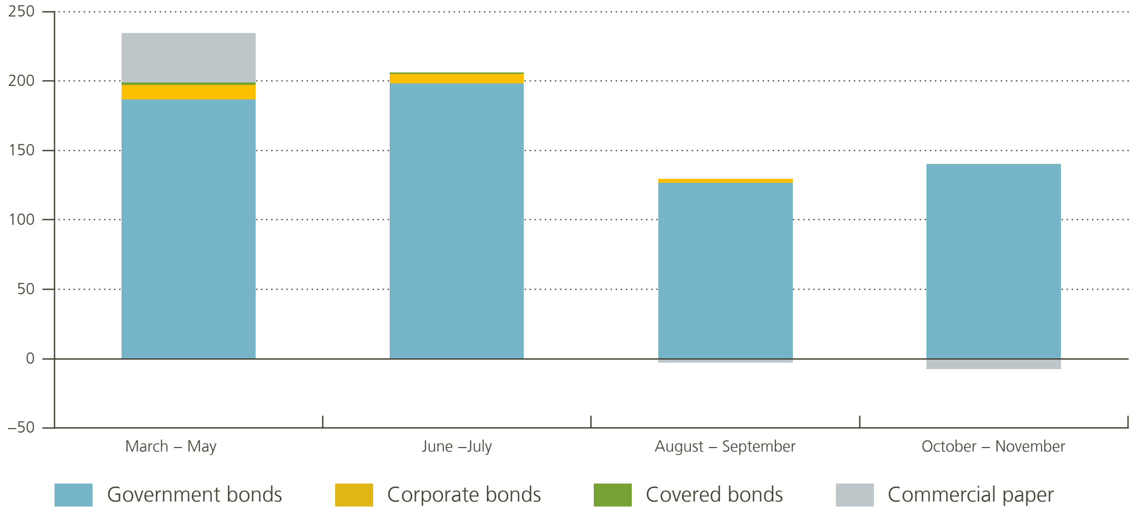


Source: ECB.

Chart 3

Securities purchases under the PEPP are flexible

(net purchases over the period mentioned in 2020, € billion)



Source: ECB.

higher volume of sovereign bonds of countries hit hardest by the crisis, such as Italy and Spain, was thus acquired, especially in the first few months of the crisis, marked by high tension on the financial markets. As these countries' government borrowing conditions gradually stabilised, under the very impact of PEPP asset purchases, these deviations from the capital key diminished.

Moreover, the flexibility of the PEPP also lies in the possibility of acquiring Greek government bonds, which are not eligible for the APP, as they do not meet the quality requirements that it imposes. Lastly, the Governing Council can review the limits that it set itself for purchases of sovereign bonds issued by a given country or given issue under the PEPP, insofar as they would constitute an obstacle to the measures the Eurosystem has to take to fulfil its mandate.

Flexibility will remain an important feature of the PEPP in future. In December 2020, the Governing Council indicated that purchases under the PEPP would be used to maintain favourable financing conditions. Depending on market conditions, the PEPP envelope will be fully or partially used during the asset purchase period, but it can be increased again if necessary. The intended favourable financing conditions should reduce uncertainty and boost confidence, so as to tackle the expected downward pressure from the pandemic on the inflation path.

Right from the start of the crisis, one of the major objectives of the measures adopted by the ECB Governing Council has been to support bank lending to households and businesses, as the banks are the source of a large part of private sector financing in the euro area. In this context, the TLTRO III conditions were once again relaxed in March, and then again in April 2020. The TLTROs are targeted in that they encourage banks to lend more to the private sector, given that they, in turn, can get liquidity from the Eurosystem at a lower cost. The borrowing conditions attached to the TLTRO III were made more attractive in three ways. First of all, euro area banks were authorised to borrow more liquidity from the Eurosystem: the total potential loan amount was increased by two-thirds, while the bid limit per operation was removed. Consequently, the maximum amount of loans that banks can contract was raised

to half their private sector loan portfolio [1]. Secondly, euro area banks could more easily access the lowest rate of interest. This measure also aims to grant loans during the crisis. All banks that managed to maintain their loan portfolio at the height of the pandemic can effectively benefit from this floor rate. Thirdly, the rates applied to the operations were lowered by 50 basis points. The loan rate for the period running from June 2020 to June 2021 was thus cut to 50 basis points below the main refinancing operations rate in force, to –0.5 %. For banks that can at least keep up their loan provision level during the crisis phase, the rate applicable over this same period was reduced to some 50 basis points below the current deposit facility rate, i.e. –1 %. Never before had the banks been able to get funds from the Eurosystem at such a favourable rate, that is also well below the market rate for similar maturities.

With the repercussions of the crisis on the euro area economy being felt for much longer than predicted, the Governing Council decided in December to extend the favourable conditions applied to TLTRO III, so as to support bank lending over a longer period. The lower interest rates will remain in force for another year, until June 2022. All participating banks will therefore be able to benefit for longer from a 50-basis-point cut in the main refinancing operations rate in force. Banks that want to benefit over this extended period from the minimum interest rate – that is, 50 basis points below the deposit facility in force – will nevertheless have to keep their loan portfolio at least at the same level for a longer period. Furthermore, three additional TLTRO IIIs were announced, so that one operation will be held each quarter in 2021. In

1 Outstanding loans to the non-financial private sector at the end of February 2019, excluding mortgage loans.

The widening and easing of liquidity-providing operations helped shore up bank lending

order to allow banks that have practically exhausted the loan ceilings authorised under the TLTRO III operations to continue to obtain liquidity under these additional operations, the total loan facility was once again raised, from 50 to 55 % of eligible loans.

The TLTROs are held every quarter. To cover the period preceding the June 2020 TLTRO III (the first one being held at the most favourable conditions), the Governing Council decided at the beginning of the crisis to set up additional weekly liquidity support operations. These additional longer-term refinancing operations or so-called bridge LTROs all reached maturity on the June TLTRO III settlement date. Finally, with a view to providing an effective safety net to meet shorter-term liquidity needs after the expiry of these additional LTROs, longer-term pandemic emergency refinancing operations (Pandemic Emergency LTRO – PELTRO) were also introduced. Between May and the end of 2020, seven operations of this type took place, at a pace of roughly once a month. All of them will reach maturity in the third quarter of 2021. In December, the Governing Council decided to propose four extra PELTROs in 2021, with a one-year maturity.

Thanks to the more flexible implementing arrangements for the TLTRO III and the additional refinancing operations, the banks borrowed a record amount from the Eurosystem in 2020. Under the four TLTRO IIIs held in 2020, some €1 750 billion worth of liquidity was borrowed, most of which – around €1 300 billion – in June, in the first of the TLTRO III operations that offered the most advantageous conditions. That said, the net liquidity injection turned out to be more modest at the time because the additional LTROs and the TLTRO II loans had meanwhile been reimbursed, respectively to the tune of some €390 and 370 billion in total. And finally, the amount borrowed in 2020 under the PELTROs remained quite small, at just €25 billion.

The easing and widening of the Eurosystem refinancing operations have been backed up by a third set of measures covering requirements in terms of collateral. Banks wanting to borrow funds from the Eurosystem have to put up sufficient guarantees to do so. In a crisis period, the volume of collateral available may suffer from the deterioration of conditions on the financial markets. The measures adopted by the ECB Governing Council, which will remain in force until June 2022, have notably ensured that a wider range of securities can be put up as collateral and the Eurosystem can accept more risky securities onto its balance sheet. These measures come on top of those adopted by the national authorities and imply, for example, acceptance of a State guarantee for loans granted to SMEs and the self-employed that can be enjoyed in many countries, including Belgium.

And finally, the system of swap lines and repo operations between central banks have ensured that there is sufficient liquidity available throughout the world. New swap and repo lines have been established between the ECB and non-euro-area central banks, or existing facilities of this kind have been reactivated. The Eurosystem has thus been able to continue to provide enough liquidity in euros on an international scale by exchanging euros against, respectively, another central bank's currency or euro-denominated guarantees. Alongside these bilateral swap lines and repo operations, a Eurosystem repo facility for central banks (EUREP) was set up in June, to which non-euro-area central banks can subscribe and which covers their potential liquidity needs until March 2022.

Table 9

The ECB Governing Council has adopted a wide range of measures in the COVID-19 crisis

	APP	PEPP	TLTRO III	Bridge LTROs	PELTRO	Easing of collateral requirements
What does it involve?	Purchases of public and private sector securities, including commercial paper since March 2020	Purchases of public and private sector securities; same asset classes as under the APP, but including Greek government bonds	3-year liquidity-providing operations for euro area banks, easing of conditions as the banks lend more to the private sector	Short-term liquidity-providing operations for euro area banks		Easing of requirements for collateral that banks have to put up to borrow liquidity from the Eurosystem
What is the objective?	Guarantee a generally accommodative policy stance, and stabilise the financial markets		Support lending to the private sector	Cover the period before the June 2020 TLTRO III operation	Emergency solution for short-term liquidity needs after closure of additional LTROs	Increase available collateral for euro area banks in times of crisis
What amount?	Additional envelope of € 120 billion between March 2020 and the end of 2020, on top of net monthly purchases of € 20 billion	Envelope of € 1 850 billion between March 2020 and the end of March 2022; use of the envelope depends on conditions prevailing on the market	€ 1 750 billion borrowed in 2020	€ 390 billion borrowed in 2020	€ 25 billion borrowed in 2020	–
What is the horizon?	Net purchases began at the end of 2014; duration will depend on the convergence of inflation in the euro area towards its objective	Net purchases between March 2020 and at least until the end of March 2022	Ten quarterly operations between September 2019 and December 2021	Weekly operations between March 2020 and the end of June 2020	Seven monthly operations between May 2020 and the end of 2020; four additional quarterly operations in 2021	Measures in force until June 2022
How long will this measure stay on the Eurosystem balance sheet?	Reinvestment of the principal of matured securities until there is lasting convergence of inflation towards its objective	Reinvestment of the principal of matured securities at least until the end of 2023	The last operation will mature in December 2024	All operations reached maturity at the end of June 2020	The 2020 operations will mature in the third quarter of 2021; the 2021 operations have a maturity of 1 year	Measures in force until June 2022
At what interest rate?	Prices/rates in force on the market, may be below the deposit facility rate		Between the main financing operations rate and the deposit facility rate, with a reduction of 50 basis points between June 2020 and June 2022	Deposit facility rate	25 basis points below the main financing operations rate	–

Source: ECB.

3.3 The crisis measures stabilised the financial markets and supported lending

In light of the sharp economic downturn triggered by the COVID-19 crisis and taking account of the likely prospect of a slow and incomplete recovery, one of the main objectives of euro area monetary policy has been to guarantee easy borrowing conditions. Under the impact of the measures introduced in recent years by the Governing Council, and notably the September 2019 decisions, the entire risk-free yield curve[1] in the euro area, right up to the longer-term segment, had moved sharply downwards, even before the coronavirus crisis, while still flattening out. The crisis measures pushed the curve even further downwards in the course of 2020.

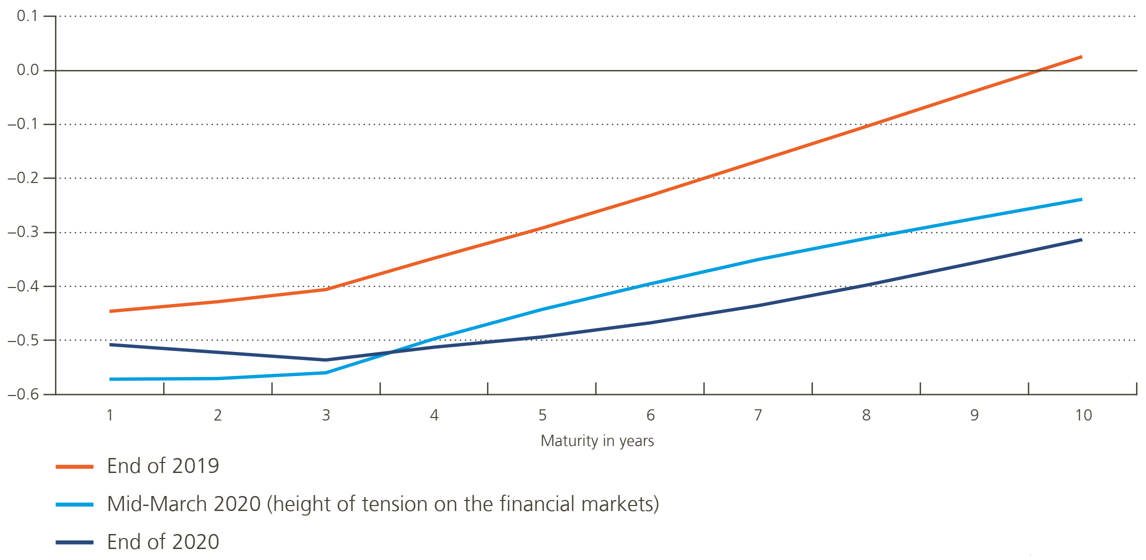
At the start of the crisis, anticipations that governments would take on a considerable amount of debt and the tension reigning on the financial markets had initially stamped an upward trend in the medium- to

1 A risk-free rate is an interest rate which excludes credit risk as far as possible and only reflects interest rate risk, i.e. the risk that the underlying asset falls in value when short-term interest rates rise.

Chart 4

Risk-free rates[1] in the euro area have fallen a bit more

(in %)



Source: Refinitiv.
1 Eonia swap rates at different maturities.

long-term segments of the curve. The crisis measures that were subsequently implemented, and notably the establishment of the PEPP, nevertheless managed to gradually bring the curve down. The short-term segment of the curve followed an opposite trend: the possibility of the Governing Council reacting with a new cut in the deposit facility rate pushed this segment downwards at the beginning of the crisis, but once this anticipation was adjusted, it went up again.

The Governing Council's forward guidance plays an important role in anchoring an accommodative monetary policy: this flexible policy will be maintained until inflation in the euro area converges firmly on its objective. Moreover, the different policy measures are inter-related in the Governing Council's communication: inflation prospects dynamics determine the interest rate path, which in turn defines the duration of net purchases under the APP, as well as the period for reinvesting bonds reaching maturity acquired under the APP. Thanks to the additional crisis measures adopted by the Governing Council in 2020, the accommodative financing conditions have also fed through to the different sectors of the economy, including those that had been the hardest hit by the pandemic.

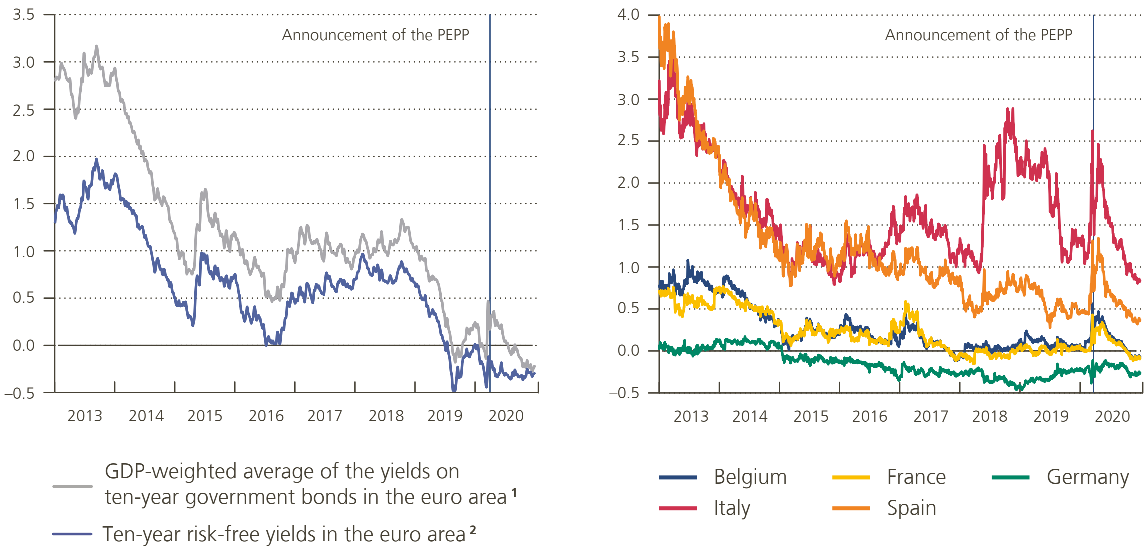
At the beginning of the COVID-19 crisis, the markets were anticipating that the rules imposed to curb the spread of the virus would be accompanied by government measures to mitigate its impact on households' and companies' income and that they would therefore go hand in hand with a big public debt issue. As of the end of February, government bond yields then started to rise in all euro area countries, effectively disconnecting from risk-free rates. In this regard, the euro area markets showed growing fragmentation, as borrowing conditions were not tightening up to the same extent in all countries. Those that initially had a higher debt ratio and were more badly affected by the crisis effectively saw their borrowing costs rise more rapidly. With its hefty and flexible crisis envelope, the PEPP appeased both general turbulence and the fragmentation on the markets: the average yield,

Chart 5

Securities purchases under the APP and PEPP brought calm to the financial markets

Government bond yields compared with the risk-free yield curve
(in %; five-day moving average)

Government bond yield spreads in the euro area
(in %; deviation from risk-free rate)



Source: Refinitiv.

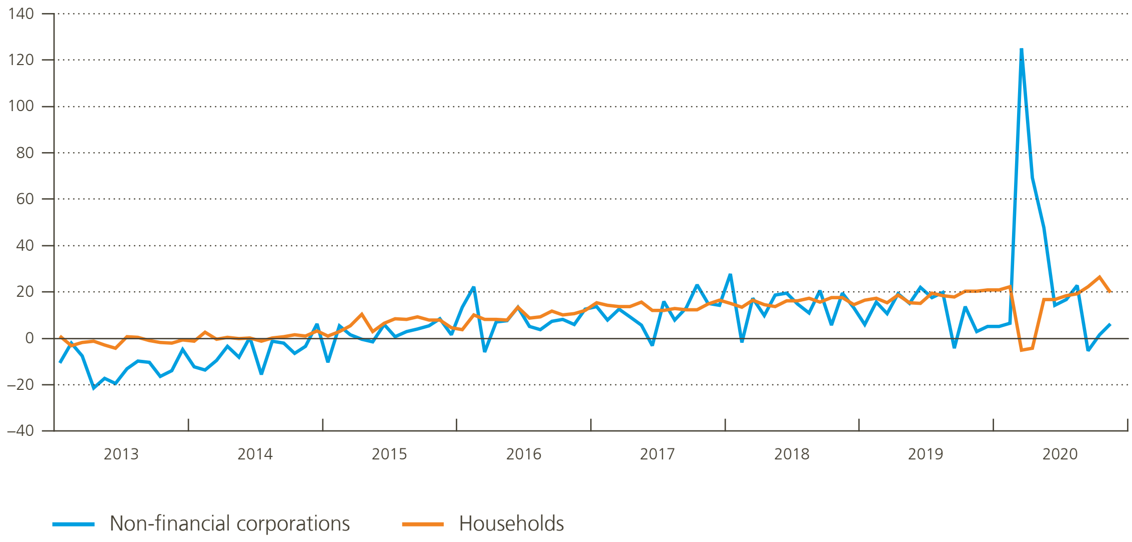
1 Based on data from eleven euro area countries, namely, Germany, France, Italy, Spain, the Netherlands, Belgium, Austria, Portugal, Finland, Ireland and Greece.

2 Ten-year Eonia swap rates.

Chart 6

Bank lending to companies in the euro area reaches record volumes

(monthly credit flows, € billion)



Source: ECB.

weighted by GDP, of government bonds in the euro area once again converged to risk-free rates, while the dispersion of government bond yields in the different euro area countries has also narrowed.

With these measures, the Governing Council not only hoped to restore calm to the financial markets, but also to keep up bank lending. The development of the crisis showed just how important that was for euro area firms. When companies were confronted with a fall in their revenue because of the lockdown, they started borrowing on a large scale from banks so as to continue to cover their operating costs. Business deposits nevertheless also rose sharply in the first few months of the crisis, which suggests that loans were also contracted on a massive scale as a precaution, in order to face any future costs. In March 2020, the flow of bank lending from euro area banks to companies reached an unprecedented level of €120 billion. In the next few months, these credit flows gradually tapered off, until they dropped back to around the level observed before the outbreak of the crisis.

Not only did the banks continue lending on a large scale to businesses, but they also lent on favourable conditions. Thus, the bank rates charged to businesses have remained at the historically low levels already seen for some years. These easy borrowing conditions are also evident from trends in the criteria governing lending to companies, as the banks reported in their responses to the Eurosystem's quarterly bank lending survey (BLS).

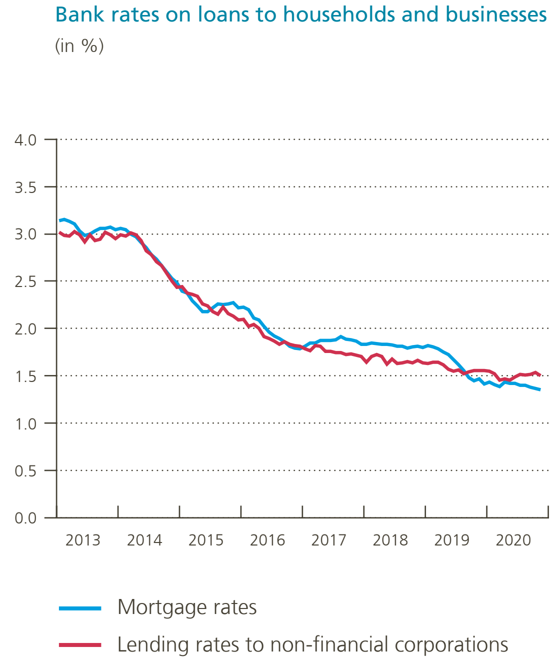
While the criteria governing lending to companies hardly changed during the first few months of the crisis, they were tightened up more significantly from the third quarter onwards. This trend is still nevertheless very limited compared with the situation observed during the global financial crisis. Furthermore, the tightening of lending criteria was not attributable to any deterioration of the balance sheet position or to higher funding costs. The banks' healthier liquidity and capital positions – thanks to the tightening of regulations after the global financial crisis –, combined with the rapid reaction of the monetary, fiscal and prudential authorities, have played a significant role here. As for the factors behind the easing of credit standards, the banks have mainly referred to the importance of State guarantees on loans to companies.

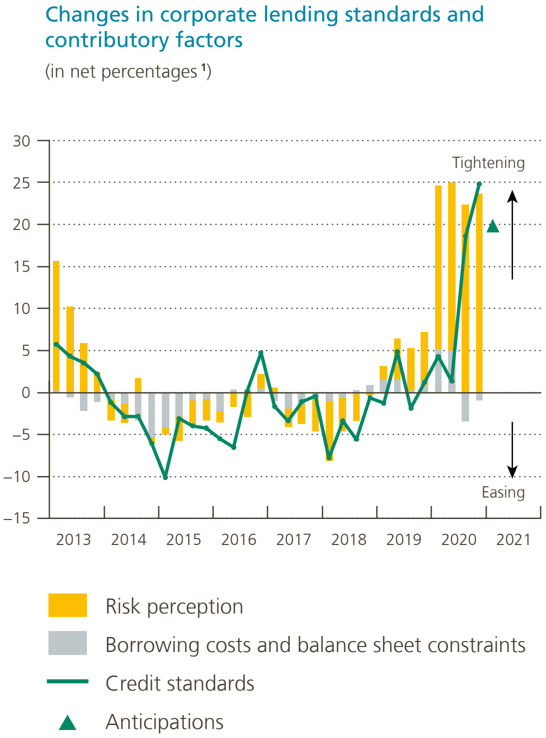
Unlike loans granted to businesses, lending to households fell sharply in the euro area in the first few months of the crisis. Households started to save massively, for fear of facing (temporary) unemployment or because they were in fact forced to save, with the lockdown measures preventing them from buying property or consuming certain goods and services, for example. In addition, criteria for bank lending to households were tightened up right from the start of the crisis. In this respect, the banks that took part in the bank lending survey notably referred to the deterioration of households' creditworthiness.

Besides, further tightening of bank lending conditions in the future cannot be ruled out. Factors like a rise in default rates among businesses and households, against a backdrop of a growing number of bankruptcies or rising unemployment rates, as well as a lower risk appetite by banks, can be mutually reinforcing in a negative real-financial feedback loop. Any premature winding-down of the support measures may further amplify such an effect.

Chart 7

Bank rates have remained low, even though lending standards have been tightened





Source: ECB.

1 The net percentages correspond to the difference between the percentage of responses from banks indicating a movement in a particular direction and that of responses indicating a movement in the opposite direction.

3.4 The scale of monetary easing raises questions

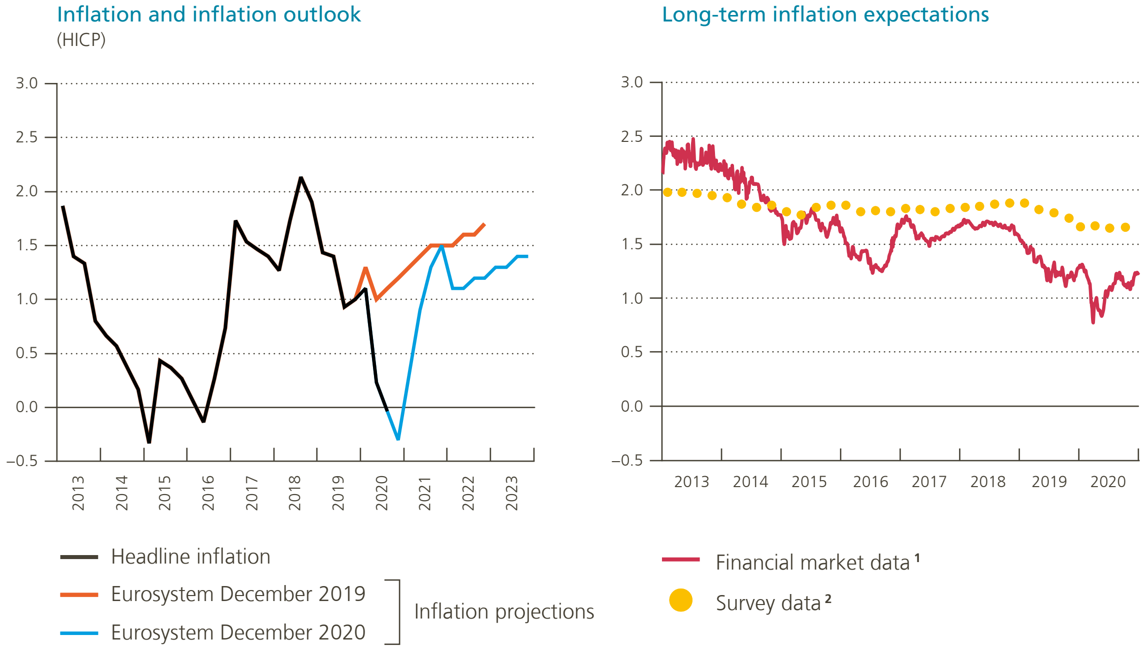
A negative real-financial feedback loop of this kind is likely to continue to put inflation under pressure in the euro area, in a context where inflation expectations are already low and have been revised downwards. The convergence of inflation towards its objective had already slowed down considerably in the euro area in 2019 and hit new tensions under the impact of the COVID-19 crisis. The fall in energy prices weighed more particularly on headline inflation. Underlying inflation also continued its decline in 2020, mainly as a result of the drop in prices for services, heavily hit by the crisis. Non-recurrent factors, including temporary tax cuts in Germany, also played a role here. According to the Eurosystem's December 2020 projections, headline inflation, which is estimated at 0.2 % in 2020, is only expected to creep back gradually up to 1.4 % in 2023. So, there is no prospect of convergence towards the aim in the next few years.

Longer-term inflation expectations, such as those drawn from surveys of professional forecasters or from the financial markets, have remained weak and below the ECB's objective. However, the professional forecasters' expectations have remained surprisingly stable, around the low levels observed before the crisis. By contrast, the markets' inflation expectations – which are derived from prices recorded by swap contracts hedging inflation risk in the euro area – dropped sharply at the beginning of the crisis. The improvement in the global macroeconomic outlook and risk sentiment, combined with the vigorous support measures, have certainly enabled some recovery since then, without however returning to pre-crisis levels. Also, in the longer term, inflation expectations for the moment seem to be more strongly influenced by the downward impact of the negative demand shock triggered by the COVID-19 crisis than by the upward pressure resulting from breaks in supply

Chart 8

Under the impact of the crisis, inflation and inflation expectations continued to come under pressure

(in %)



Sources: ECB, Eurostat, Refinitiv.

1 Five-year-on-five-year inflation expectations, based on prices recorded by swap contracts, which hedge euro area inflation risk over a period of five years, starting five years after the contract is concluded.

2 Five-year inflation expectations based on the ECB's quarterly survey of professional forecasters (average of the aggregated probability distribution for this projection horizon).

chains or, more generally, from damage incurred on the supply side.

In the current context of weak inflation and inflation expectations, the ECB Governing Council measures will no doubt be kept on for some time to come. The persistence of very low interest rates over such a long period may nevertheless pose some challenges. This situation can effectively trigger undesirable side effects, like encouraging excessive risk-taking, creating bubbles (on the residential property market, for example), hurting savers or propping up firms that would not be viable in different circumstances. While the Governing Council monitors the emergence of any such developments and strives to limit them as far as possible, the key role in this domain falls to prudential policy, which has targeted instruments for tackling specific financial vulnerabilities. These aspects are dealt with in more detail in section 5.1 of this Report.

For the national public authorities in the euro area, the monetary easing is opening up wide budgetary margins. So, in a context where their expenditure has risen sharply, they can borrow massively at highly favourable conditions. If this budgetary margin is used wisely, notably via targeted, temporary and coordinated measures, it can act as a significant lever for mitigating the economic cost of COVID-19. For the sustainability of public debt, the difference between the interest rate paid by governments on their debts and the nominal growth of the economy is particularly important. A negative gap – favoured by the current slowdown in demand and which should continue for some time yet – exerts a positive impact on government debt dynamics. Yet, this situation is not set in stone : the ECB's policy is not actually centred on maintaining public debt sustainability but on preserving price stability. Should the outlook for price stability so require, the Governing Council will then gradually reduce its monetary support, in line with its mandate.

Through these measures, the Governing Council not only hopes to maintain a globally loose monetary stance, but also ensure a smooth transmission of monetary policy, by alleviating any risk of fragmentation – which would emerge if government bond yields were to post an overly sharp increase in some countries. As mentioned above, during the crisis, this objective has mainly been attained through the acquisition of government bonds under the PEPP. However, the role of this crisis asset purchase programme should not be misinterpreted, and it is certainly not synonymous with unconditional support for all public debt issued by euro area countries. So, Eurosystem interventions cannot lead to excessive public deficits being tolerated forever.

Although the current circumstances allow a temporary relaxation of fiscal policy without jeopardising debt sustainability, it is important for the public authorities to use this margin responsibly. Monetary policy can only meet its price stability objective on condition that the public authorities make the right choices now and in the future, not least when it comes to their budgets, and also adopt measures that boost potential growth and correct any imbalances. In particular, they must make sure that their debt remains at a sustainable level, even in the event of a rate rise. If not, debt-sustainability-related considerations risk interfering with the conduct of monetary policy.

So, even in an environment where key interest rates were already close to their lower bound, monetary policy, together with fiscal policy, has largely contributed to stabilising the economy. The fear that monetary policy is powerless in this kind of situation was therefore unfounded, but its efficiency will nevertheless depend to a larger extent on the fiscal policy implemented. Without any deliberate coordination, spontaneous synergy emerged during the coronavirus crisis, as a strong fiscal response was necessary. As for fiscal policy, it is only efficient if it remains credible and does not threaten the sustainability of public debt.