

Analysis



Christy Ann Petit

“An ambitious and collective response to the COVID-19 shock? ECB’s monetary policy package and recent EU policy measures”

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European economies are experiencing a major shock with the spread of the COVID-19 pandemic, an unprecedented public health challenge. This shock destabilises growth prospects, disrupts production as well as the confidence of all actors, affecting overall supply, demand and investment. The anticipated risks relate to liquidity risk, an interruption or significant slowdown of the credit flow to the economy, and instability in the markets (already observed in stock prices, bond yields and the euro appreciation). These risks could all tighten and deteriorate financing conditions in the euro area and accentuate income and revenue shortfalls for households and firms.

On 12 March, the Governing Council of the ECB unanimously adopted a comprehensive package of monetary policy measures, which prolongs an accommodative monetary policy already in place in the euro area. The ECB did not cut interest rates¹ in contrast with other central banks (the Federal Reserve lowered its rate range to between 0 and 0,25%, and the Bank of England to 0,25%). The main argument is the temporary nature of the shock and to use instead the tools from the

package. This Analysis covers the measures adopted in the ECB’s monetary policy to support households and firms, in particular small and medium-sized enterprises (SMEs), to face economic disruptions and uncertainty. The Analysis explains their meaning and relevance, also in the context of (quasi-simultaneous) other recent banking supervision, economic and fiscal measures, but it does not engage with their merit.

ECB’s Monetary Policy Decisions

The monetary policy package has as part of its rationale sustaining liquidity and funding conditions for three actors: households, businesses, and banks. The measures aim at preserving the smooth provision of credit to the real economy. At a closer glance, two measures respectively concern longer-term refinancing operations (LTROs) and targeted LTROs (TLTROs), which are part of the current non-standard measures of the ECB in monetary policy. In a few simple words, these operations provide financing to credit institutions with diverse

¹ The ECB’s interest rates are unchanged, i.e. at 0% for main refinancing operations, 0,25% for the marginal lending facility and -0,50% for the deposit facility.

maturities (for example, for TLTROs, the maturities are longer and can be up to four years). The objective is to stimulate bank lending to the real economy and generally improve the monetary policy transmission. Technically, the operations (LTROs) will be carried out weekly with a maturity on 24 June 2020, a maturity date that ensures a possible shift to TLTRO for eligible counterparties, which is the next measure.

The support for credit supply aims to avoid banks curbing their lending exactly when the demand for credit increases (both from SMEs and households). Before explaining the recalibration adopted by the ECB, it must be noted that the third series of TLTROs is being implemented for the period from September 2019 to March 2021 (under the ECB's Decision, adopted in July 2019). The recalibration of TLTRO relies on more favourable terms for banks in the existing lending operations designed within the TLTRO programmes, provided they fulfil specific conditions (not recalled here). These more favourable terms will materialise with an adaptation of the borrowing rate, to take place between 24 June 2020 and 23 June 2021. The minimum interest rate is set at 25 basis points below the average interest rate on the deposit facility, 'and in any case not higher than -0.75%' (TLTRO III conditions). A negative deposit facility rate generally means that commercial banks pay for the overnight deposits made at the ECB. The average interest rate can be understood along the same line for these operations. Regarding the borrowing rate, it means the ECB lends reserves to a bank at a rate which is below the rate applied for the deposits. In an overt-simplified example, the ECB lends at -0.75% rate (sort of 'subsidy') to Bank A which supplies credit to businesses, while Bank A holds deposits at the ECB in refinancing operations at -0.5% rate (paying for 'stocking' money). According to the ECB's Chief Economist Philip Lane, this measure increases, by more than 1 trillion euros,

the volume of funds potentially borrowed by banks from the ECB (and now the total borrowing volume comes close to 3 trillion in TLTROs).

Moreover, this ECB policy package gives an extra-satellite to the quantitative easing already ongoing with the asset purchase programmes (APP). Different programmes in place allow the ECB to buy assets such as government bonds, corporate bonds, asset-backed securities and covered bonds. The ECB added an extra temporary envelope of net asset purchases of 120 billion euros until the end of 2020 in order to maintain financing conditions for the real economy. This envelope adds to existing purchase of 20 billion euros a month and would lead to scale the quantitative easing up to 33 billion euros a month until the end of 2020 (as reported in the Financial Times).

Overall, these measures are put forward to grant unlimited and generous access to liquidity, more attractive TLTROs, in particular for SMEs, and a special APP using all the flexibility embedded in the APP framework.

ECB's communication and the use of flexibility in quantitative easing

The 'decisiveness' of the ECB in the package announced has been overshadowed by a communication error. Asked about the measures to tackle an increase in the spread of government bonds, President Lagarde replied 'we will be there (...) using full flexibility, but we are not here to close spreads'. This reply triggered immediate reactions in the markets (particularly damaging the sovereign debt market in Italy with a rise in Italian government bonds yields, and downward trends in the European stock markets). Immediately after the press conference, an interview of Lagarde on CNBC, then inserted as a footnote in the transcript of the press

conference Q&As, provided further clarifications. Ultimately, she acknowledged high spreads impair the monetary policy transmission and reiterated the necessity to ‘use the flexibility embedded in the [APP]’.

Measures adopted in Banking Supervision

The measures in Banking Supervision adopted the same day complement the package of monetary policy measures in easing credit supply to the economy. They target capital and liquidity buffers to provide temporary capital and operational relief for the 117 banks directly supervised by the ECB in the euro area. These exceptional measures relax temporarily, and partly, prudential requirements imposed in application of a post-financial crisis banking regulation. These measures have a threefold reach: in the use of buffers constituted over last years; the composition of capital to meet prudential requirements; and operational flexibility in some supervisory measures (in a case-by-case approach). The latter means adjusting some processes and deadlines for each bank (for example, rescheduling inspections or remediation actions). The European Banking Authority also decided to postpone the EU-wide stress test to 2021 to preserve business continuity and respond to operational challenges faced by banks.

Prudential buffers were built up precisely to withstand shocks and stressed situations. Banks are allowed to operate temporarily below the level of capital defined by the Pillar 2 Guidance (P2G), the capital conservation buffer (CCB) and the liquidity coverage ratio (LCR). And the ECB also signalled to the national macroprudential authorities that these measures ‘will be enhanced by the appropriate relaxation of the countercyclical capital buffer’ still in their hands (De Nederlandsche Bank has already lowered systemic buffers). It must be noted that the use of

capital instruments (as Additional Tier 1 or Tier 2 instruments) to meet the Pillar 2 Requirements (P2R, instead of Common Equity Tier 1 only), anticipates a measure which will be in force as of January 2021 (in application of the revised Capital Requirement Directive V).

EU policy measures

The ECB called for a joint and coordinated policy action of euro area governments and European institutions. And, President Lagarde pointed at the primary responsibility of fiscal authorities several times. One day after the ECB’s monetary policy and banking supervision measures, the European Commission announced its measures, the Eurogroup’s, and the European Council’s videoconference meetings followed at the beginning of this week. Recent policy action includes leeway for fiscal measures, investment funds, and flexibility in the application of State aid rules and the Stability and Growth Pact.

Along with this flexibility, the Commission considered that the national budgets of Member States constitute the source of the ‘main fiscal response to the Coronavirus.’ Admittedly, the measures from the Eurogroup could still be ‘much larger going forward’ (Eurogroup statement). The first combined fiscal measures, at the national and European levels, reach about 1% of gross domestic product (GDP), on average, for 2020. Furthermore, the Eurogroup committed to provide liquidity facilities of at least 10% of GDP (with public guarantee schemes and deferred tax payments). The Eurogroup response stresses overall national authorities’ measures (and automatic stabilisers), European efforts to supplement national measures, and the recovery of the economy going forward.

The measures develop diverse existing and new funds. The proposed ‘Corona Response

Investment Initiative’ amounts to 37 billion euros from the Cohesion Policy and is likely to support the deployment of a European Social Fund. The Eurogroup has seconded this Commission proposal, including a further 28 billion euros of structural funds to meet expenditure in health care systems, for SMEs, and labour markets. Notably, the Commission’s announcements include putting the public health crisis within the scope of the EU Solidarity Fund. Moreover, in mobilising one billion euros from the EU budget, the Commission provides a guarantee to the European Investment Funds. This Commission-EIB Group initiative was backed by the Eurogroup, calling for its potential extension to up to 20 euros billion of working capital lending, reaching 250,000 SMEs and mid-caps in total. This would reinforce liquidity provisions to the real economy, as in the ECB’s package.

Further actions are expected in the near future, including the activation of the general escape clause (mentioned by the Commission and the Eurogroup) which allows for ‘discretionary stimulus’ as per the Eurogroup statement. The European Council, through the conclusions of its President yesterday, endorsed the Eurogroup statement and supported the Commission’s initiatives by restating a few measures (regarding State aid rules, the Stability and Growth Pact, and recourse to the EU budget). The missing player is the European Stability Mechanism (ESM) the involvement of which is being explored. ESM Managing Director Klaus Regling reported the unused lending capacity of 410 billion euros (around 3.4 % of euro area GDP) during the Eurogroup meeting.

Beyond the measures for the real economy, resources must urgently be mobilised to support the health systems put under strain, as well as social policies for workers and citizens. The ambitious and collective response is still being adopted, with a rather piecemeal approach at the

national level, and is yet to be implemented to tackle the socio-economic repercussions of the pandemic. All players stressed their readiness to use other instruments and do more, including ‘whatever it takes’, both in the Eurogroup statement and in European Council President Charles Michel’s conclusions following the videoconference of the European Council.

Christy Ann Petit is a Research Associate at the Florence School of Banking and Finance at the European University Institute (EUI) and recently defended her Ph.D. thesis ‘An integrated system for banking supervision in the Banking Union’ at the EUI Law Department. She is author of ‘The SSM and the ECB decision-making governance’, in G. lo Schiavo (ed.) The European Banking Union and the role of law (Cheltenham, Edward Elgar: 2019).



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