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The Response to COVID-19 in the Euro Area

Reiner Martin

Lead Economist / Joint Vienna Institute

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Outline

1. Setting the Scene
2. The Monetary Response
3. The Supervisory and Regulatory Response
4. The Fiscal Response
5. Conclusions and Discussion

Setting the scene – the euro area at the start of COVID-19

Macroeconomic and monetary policy background

- Recovery after GLC and the EA sovereign debt crisis was well on track with relatively low cyclical heterogeneity within the EA
- Fiscal space remained, however, uneven. Some ex-crisis countries having particularly high public sector debt (e.g. Greece)
- Monetary policy very accommodative including QE

Financial Sector

- Resilience of banking sector strongly improved
- Some key risks remained, e.g. low profitability and high NPL ratios

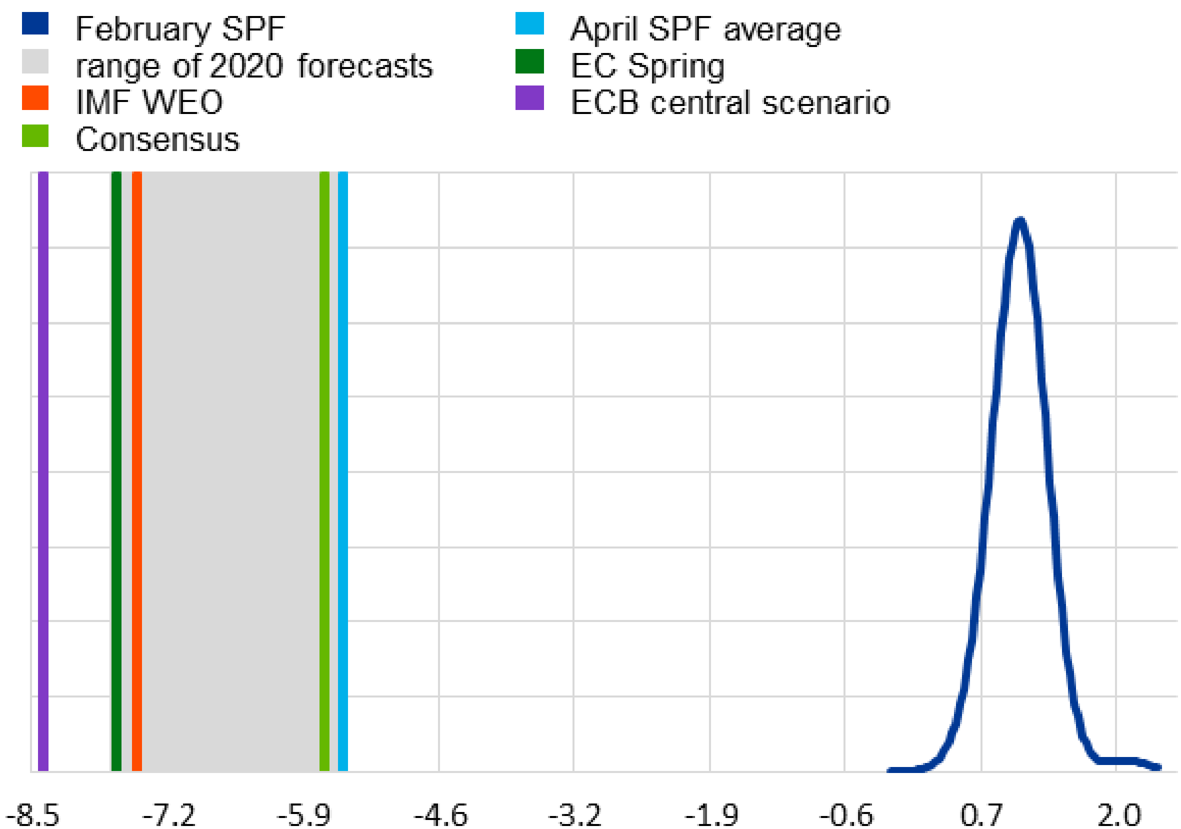
Institutional Structure

- Some progress on crisis management framework, notably ESM
- Banking Union partly in place (SSM and SRB)

But COVID-19 is an economic challenge like no other!!

Setting the scene – the economic outlook

Current euro area GDP growth expectations for 2020 well outside the tail of February expectations

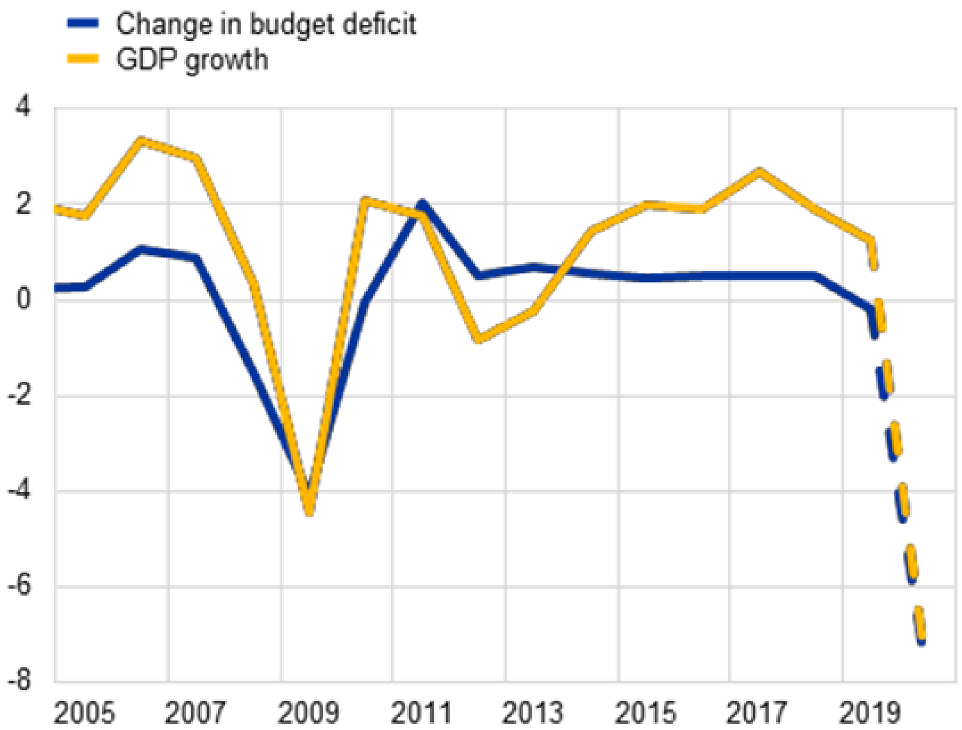


Source: ECB FSR May 2020

Setting the scene – the economic outlook

Substantial fiscal response including direct spending measures and loan guarantee schemes – in addition to automatic stabilisers

Forecast change in budget deficit and economic growth annual percentage change



Source: ECB FSR May 2020

Setting the scene – the economic outlook

- **What is the shape and timing of the recovery – ‘V’ vs. ‘L’?**
  - The nature of the crisis speaks in favour of ‘V’. Exogenous trigger, no obvious change for large-scale structural changes like after the GFC (e.g. real estate bubbles or banking sector fragility).
  - But time matters - 1 month of lockdown ‘costs’ around 3% of GDP
  - Costs likely to be non-linear – especially in relatively less flexible economies where hysteresis effects are important
  - Adverse medical developments requiring a ‘second wave’ of lockdowns or long-term failure to develop effective vaccinations / medication outside tails of (most) current forecasts

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The Monetary Response

Quantitative Easing Measures

(1) Pandemic Emergency Purchase Programme (PEPP)

- Initially 750bn EUR. Increased by 600bn EUR on 4 June
- Purchases at least until end-June 2021
- Temporary deviations to capital key allocation possible (unlike for other ECB APPs)
- maturing principal payments from securities purchased under the PEPP will be reinvested until at least the end of 2022
- Large part of net purchases will be in sovereign bonds.
- Expansion of eligible collateral to non-financial commercial paper

(2) Existing APP ramped up by 120bn EUR (to 360bn EUR)

The Monetary Response

Other Measures

(1) Pandemic Emergency Longer-Term Refinancing Operations (PELTROs)

- Fixed rate (-0.25%, full allotment, duration of up to 16 months)

(2) Targeted Long-Term Refinancing Operations (TLTROs)

- More favorable conditions (rates up to -1%)

(3) Easing of risk parameters in the ECB collateral framework

- Acceptance of government guarantees and banks' IRB credit ratings
- Increased share of unsecured debt instruments,
- Reduced collateral valuation haircuts

(4) Reactivation and enhancement of currency swap lines

The Monetary Response - a Challenge from Germany?

- **The German Constitutional Court ruling**
  - On May 5, 2020, GCC ruled that ECB overstepped its mandate by not providing a "proportionality assessment" of its Public Sector Purchase Programme (PSPP) which started in March 2015.
  - GCC has no authority over European institutions
  - Response to GCC likely to come from German authorities, in particular the Bundesbank (German Central Bank); European Parliament may become a 'go-between'
  - No immediate negative market impact – but the issue needs to be solved to avoid institutional standoff and long-term market uncertainty
  - On a positive note – GCC ruling may trigger a broader debate about the imbalance in euro area economic policy, which is so far heavily tilted towards the ECB

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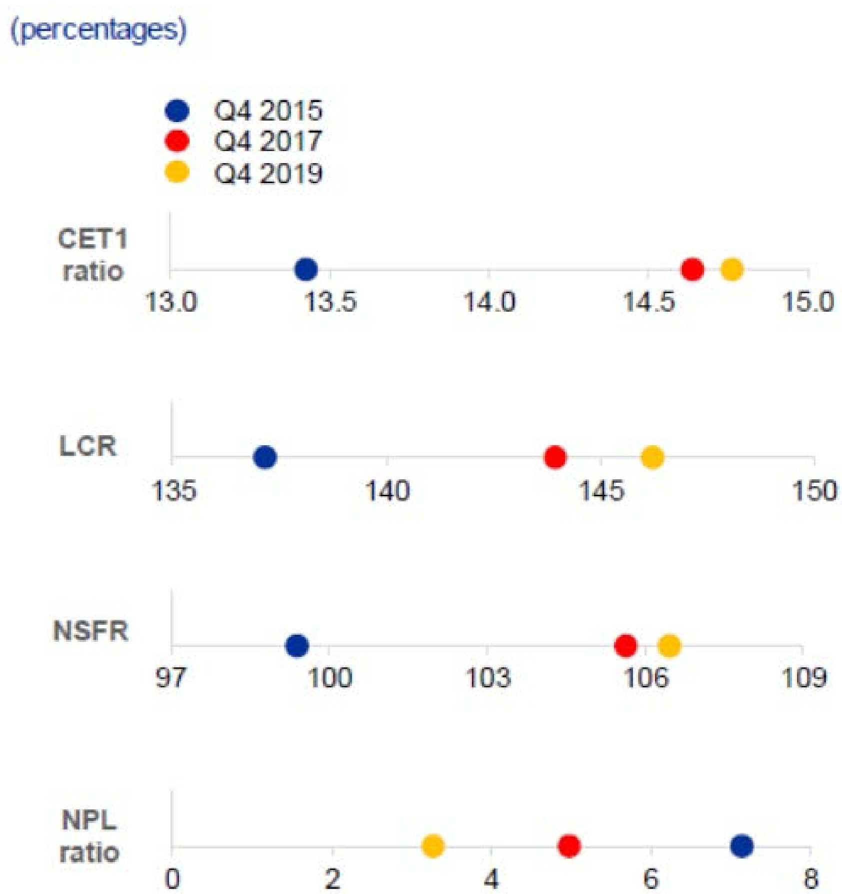
The Supervisory and Regulatory Response



Bank regulation ratios all improved:

- CET1 capital ratio
- Liquidity coverage ratio
- Net stable funding ratio
- NPL ratio

Source: May 2020 ECB FSR

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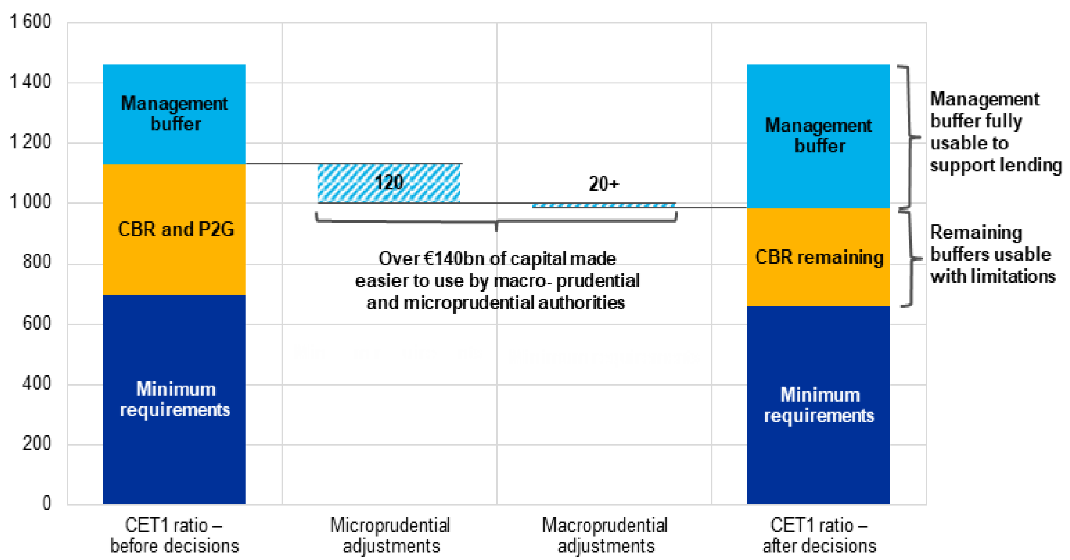
The Supervisory and Regulatory Response

CET1 capital and capital buffers in the euro area
€ billion, Q4 2019



Source: ECB May 2020 FSR

Banks in Euro Area temporarily allowed to:

- Use various micro- and macroprudential capital buffers (in sum around 140bn EUR relief)
- Partially use instruments that don't qualify as CET1 quality capital
- Operate below Liquidity Coverage Ratio

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The Supervisory and Regulatory Response

Flexibility in prudential treatment of loans

- More flexibility in classification of loans as “unlikely to pay”
- Preferential prudential treatment for new NPLs under public guarantees
- IFRS 9; use of transitional arrangements foreseen in EU law (CRR) and greater weight of past evidence when estimating long-term expected credit losses

Recommendation not to pay dividends for 2019 and 2020 and to refrain from share buy-backs

Pragmatic approach to supervisory requirements and expectations aimed to alleviate operational burden of banks

- E.g. postponement of EBA / SSM Stress Test from 2020 to 2021

The Supervisory and Regulatory Response

- **Euro area banking (financial) system in better shape now – but Covid-19 generates / aggravates financial risks**
  - Further monetary easing implies that interest margins will be compressed ‘more for longer’
  - Renewed deterioration of asset quality expected
    - Substantial asset price declines for banks and (risky) non-banks; impact of corporate downgrades
    - Corrections in commercial and residential real estate valuations
    - NPL stocks still relatively high in parts of the euro area
  - Negative spillovers of increase in public debt
  - Will banks use the capital buffers the supervisors provided them with?
  - Risks to profitability of insurers
  - Renewed run risks for ‘shadow banks’

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The Fiscal Response

<u>Adjustment of rules</u>

(1) Suspension of the Stability and Growth Pact rules

- Use of the general escape clause in the EU fiscal framework – a severe economic downturn in the euro area or the Union as a whole

(2) Relaxation of state aid rules

- Temporary allowance of various public support instruments – for firms viable as of end-2019.

Necessary framework conditions for national support measures <u>BUT</u>

- Use critically hinges on national fiscal space
  - *Fiscal stimulus so far (% of GDP): DE 10.7, FR 5.1, IT 3.2, ES 2.9*
  - *Loan guarantees (in % of GDP): DE 29, FR 14.5, IT 30.8, ES 9.4*
- Distortions of level playing field in the Single Market as side-effect

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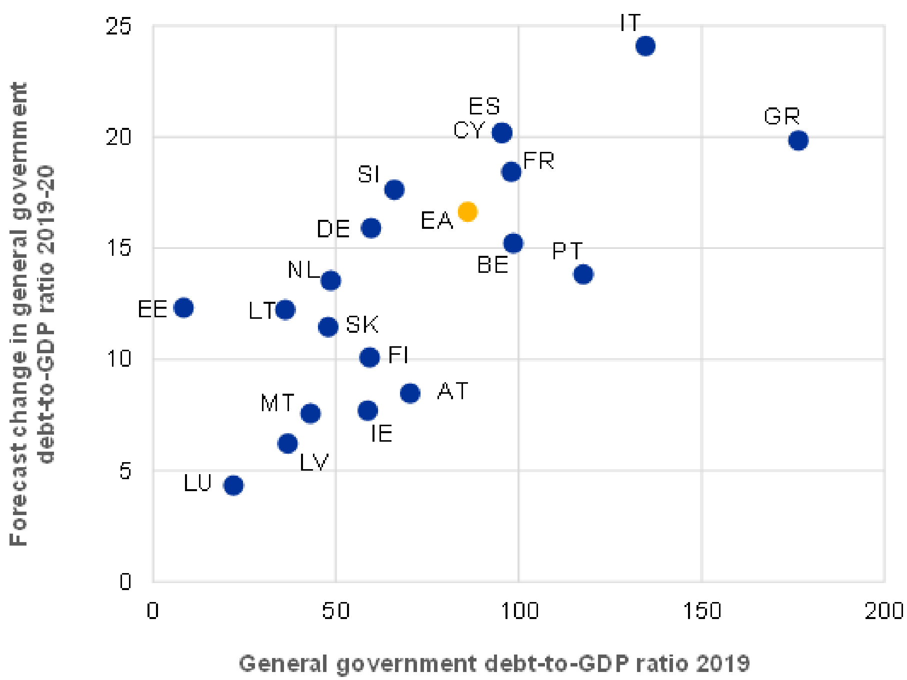
The Fiscal Response

Fiscal relief measures imply a large increase in debt levels, particularly in countries that had limited fiscal space already

Sovereign indebtedness in the euro area and expected changes in 2020 percentage of GDP and percentage points



Sources: European Commission (AMECO) and ECB calculations.

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The Fiscal Response

The 'loan package'

(1) Protecting firms: Pan-European guarantee (EIB)

- €200 billion EIB plus €25 billion national credit guarantees to commercial banks, national promotional institutions and national guarantee schemes

(2) Protecting jobs (SURE)

- European Commission loans to national governments to finance expenditures related to short time work; up to €100 billion; temporary

(3) Protecting sovereigns: Pandemic crisis support (ESM)

- Loans to countries to pay for Covid's direct and indirect healthcare and prevention costs, *no conditionality*, up to 2% of GDP; temporary

Swift policy action with unconditional ESM support as major innovation
BUT

- Insufficient to defuse perceived lack of solidarity in parts of EU

The Fiscal Response

Moving towards grants

(1) The Franco-German proposal

- €500 billion 'Recovery Fund'; grants to sectors and regions most affected by Covid-19 (3.6% of EU GDP). Financed by European Commission bonds.

(2) European Commission Budget proposal (2021-27)

- €500 billion grants plus €250 billion loans. "Recovery and Resilience" facility (€560bn); distribution to countries based on size of economy, population, Covid-damage to GDP and youth unemployment.
- Some commitment to structural reforms, budget adjustment and greening of economy needed.
- €190 bn to expand other EU programmes such as the cohesion funds.
- Issuance of long-term bonds by European Commission

Significant change compared to response to previous crisis BUT

- Still work in progress – conclusion expected in second half of 2020

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Conclusions and discussion

- **Shape and timing of the recovery will determine nature of the crisis**
  - Monetary policy plays a big role in a ‘V’-shaped, liquidity-type crisis
  - A ‘L’ or ‘kinked-V’ recovery implies a larger role for fiscal policy
- **Substantial further easing of ECB monetary policy**
  - Declining effectiveness of QE?
  - Political headwinds from Germany?
- **Financial stability challenges**
  - Aggravation of bank profitability challenges
  - Renewed deterioration of asset quality
  - Negative spillovers of increase in public debt
- **Forceful fiscal response**
  - Heterogeneity in national responses
  - EU-level response (grants) still under discussion

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Thank you for your attention!

Reiner Martin

Lead Economist

Joint Vienna Institute

rmartin@jvi.org