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**MOVING FORWARD:
Monetary Union after Covid19
A Yearbook on the Euro 2021**

**Edited by
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IE Business School**

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FOREWORD

Fundación ICO and Fundación de Estudios Financieros jointly decided in 2012 to publish an annual review of the Euro, the Yearbook, with the aim of expanding knowledge and raising awareness of the importance and role of the single currency, and to suggest ideas and proposals for strengthening its acceptance and sustainability.

This partnership translates into the regular production of an annual publication to inform readers of the changes that have taken place in the monetary, banking, fiscal, economic and political union, highlighting progress, limitations and possible shortcomings.

The report we are presenting here, now the eighth in the collection, is titled *Moving Forward: Monetary Union after Covid-19. A Yearbook on the Euro 2021*. It contains thirteen articles, split into four different parts: (i) the European response to the Pandemic; (ii) issues in Monetary Policy; (iii) issues in Fiscal Policy and (iv) issues in Regulation.

The first section provides the political, economic and financial context for the changes. In essence, what were policymakers thinking and how they reacted.

The second section digs into monetary policy and reflects the rapidly changing circumstances of the year and the responses to the uncertainty, with an emphasis on the long-term consequences of structurally low interest rates, the rethinking of monetary strategy and the threats to central bank independence.

The third section is about fiscal policy, and is dominated by Next Generation EU, but goes beyond to question the political economy of reform, the challenges and opportunities for fiscal union and the role of a proper regulation of State aid in fostering a stable and fair union.

The final section is about financial stability and regulation, a very active policy area this time around, and complements a detailed European account of actions taken with the necessary international perspective.

The report includes an executive summary that presents a critical analysis of the different contributions and postulates ten propositions, called the Ten European Lessons, for completing the Monetary Union. They constitute the main messages of this Euro Yearbook 2021.

We continue to believe that it is necessary to explain Monetary Union and to raise awareness of its implications. The Euro Project is too often taken for granted, but it still needs to be better understood and improved. This is the task assumed in detail throughout this report with the goal to ensure its sustainability.

The review was led by Fernando Fernández Méndez de Andés, a Professor at IE Business School. He, in turn, has been assisted by a team of experts with close ties to academia, policymaking and the financial community. We would like to express our gratitude to each of them and congratulate them on a job well done.

Fundación de Estudios Financieros and Fundación ICO are confident that the Euro Yearbook 2021 makes an important contribution to the current debate regarding Monetary Union and European integration and will prove useful and interesting to all readers.

Fundación de Estudios Financieros

Fundación ICO

EXECUTIVE SUMMARY

FERNANDO FERNÁNDEZ, IE UNIVERSITY¹

1. SOMETHING IS MOVING IN EUROPE WITH THE PANDEMIC

That Europe needs a crisis to move forward has been a Brussels motto for years. And what a crisis we had in 2020! The longest, most global and most severe crisis ever experienced in peacetime. But it may not have been in vain. Europe as an idea, as a political project, and as a monetary union, has come out united and stronger. Something that could not have been taken for granted at the onset of the crisis, when the old nationalist instincts ran amok. But the Union overcame its division: thanks again, as it is only fair to recognize now that she is about to say goodbye, to the leadership of Chancellor Merkel and the French-German unity in fundamentals. European governments, and their citizens, demonstrated a commitment to economic and political integration and internal cohesion, not without the usual internal exasperating discussions. Financial markets at least have taken to believe so unanimously, as evidenced by the overwhelming reduction in sovereign spreads across the Eurozone and the unprecedented low level at which they stand today.² Domestic policies are no longer the matter of economic and financial interest, as the very determined European authorities have for all practical purposes ensured that they will adopt whatever policies are necessary to help Member States overcome the crisis and meet their debt obligations. Mutualization of European debt is a reality; at least, markets believe so without question. Excessive optimism? Only time will tell, but this is the state of the Union in closing the year of the pandemic. A drastic change from last year.

Things are never so straightforward in Europe, as our readers surely know by now. 2020 will go down in History for the Covid-19 pandemic, but also as the year that changed

¹ Fernando Fernández Méndez de Andés is professor of Economics and Finance at IE Business School and editor of the Yearbook since the first issue.

² At the time of writing this Executive Summary, 10-year bond spreads over the Bund were at around 120 bp for Greece and Italy, or about 60 bp for Portugal and Spain.

the European Union. And not precisely because of Brexit, the first ever departure from the Union, which appears simply as an anecdote in the midst of the structural and emotional changes brought about by the health emergency. The pandemic seems to have set in motion the European Union's long and surely non-linear march towards a fiscal union. It appears that this was the crisis needed to implement the basic design of a common fiscal policy. The year that risk sharing raised to a new level as the EU agreed to issue common European debt on a large scale to provide for common European public goods, i.e., public health first, but also, most significantly, European economic stabilization. The year that Euro federalists wrote the political agenda.

This was otherwise a terribly sad year; a year when the world rediscovered its fragility and most countries adopted policies of prolonged confinement, drastic lockdowns of economic and social life which have been restored as the year comes to its end. Policies that have had serious repercussions in economic activity and employment. Human face to face interaction was reduced to its bare minimum, mobility virtually disappeared, international trade came to a halt, and citizens of all places, cultures, ages and education rushed to the web looking for a surrogate way to continue their lives and work, to pretend to "keep calm and carry on." Economically, what started as an exogenous shock in far-away Asia that created sporadic disruptions in supply chains soon metamorphosed into a severe output and employment crisis, in part because of policy induced lockdowns, and has finally resulted in a lasting demand crisis due to fear, to simple fear of contagion and the inability of the authorities to regain the confidence of the people. Politically, a year when governments showed little leadership and failed. Unable to respond intelligently and with conviction to the health crisis, most of them adopted mediaeval policies, erected barriers and sacrificed basic liberties in the useless pursuit of health security. A year when demagogues and prophets of the apocalypse sprung up like mushrooms, and doomsayers had their heyday announcing new and inevitable catastrophes if capitalism was not radically reformed, consumption was not curtailed, and the human being became a different species. A year that inspired me to avidly reread Hayek's classic, *The Road to Serfdom*.

Finally, after a period of confusion, precipitation, wrong-headed and selfish policies,³ and even worse public communications, authorities around the globe came to a coordinated policy response. A policy that in economics can be described as "full speed ahead and we will worry about the consequences later." Public policies to support jobs and companies have increased global total debt in 2020 to a historical high of 365% of world GDP (Institute of International Finance 2020). Nevertheless, the cost of servicing this debt has been kept to a minimum, thanks to the concerted and unprecedented easing of monetary conditions all over the world. Despite current generalized optimism, note

³ Protectionism, a permanent temptation in Europe, showed its face this year behind the grandiose names of economic sovereignty and strategic priorities. Particularly with respect to foreign investment, especially after President von der Leyen encouraged Member States to protect their industries and companies from acquisition by unwelcome foreigners. An attitude that, if imitated, could precipitate the nationalization of European subsidiaries worldwide.

that markets and authorities have been proved wrong before and financial conditions may not always remain so accommodative. Depending on the speed and intensity of the recovery, the process of debt restructuring, public and private, will prove inevitable and require tremendous creativity from policy makers (IMF Policy Paper 2020).

The good news from Europe is that this time the Union joined the expansionary club without delay or hesitation. Covid-19 has revived the social contract in all advanced economies, for now. The role of the State seems to have grown way beyond its obvious social insurance responsibility – when, paradoxically, it has been the private sector that has demonstrated its extraordinary efficiency in bringing to the market not one but many vaccines in the shortest ever period of time. But of all policy changes induced by the pandemic, what will stick once the crisis abates? (McKinsey 2020). Of all emergency programs implemented by the European Union in the crisis year of 2020, which ones will become a lasting part of Union architecture?

This question is pretty much what this Yearbook is about. The European Union has seen unprecedented monetary and fiscal expansion, extensive use of its countercyclical tools, discretionary regulatory moratoria and forbearance, and the introduction of untested new instruments and facilities, most notably Next Generation EU but also a common unemployment insurance program, SURE, and a revamped European Stability Mechanism, ESM. The crisis has undoubtedly served to advance the integration of the Union, its federal ambition. And this Yearbook describes in detail all these exciting developments, which have encountered far less political opposition than anticipated. Fear is a powerful incentive. Most of the political discussion has in fact only been the inevitable temptation to use the pandemic for unrelated opportunistic national political gains.

But this Yearbook also tries to address the question lingering in every European politician's mind: how much of this will stay once the recovery is on a solid footing? How many of the emergency policies we have witnessed in 2020 are simply the necessary response to an unprecedented global health emergency, and how many will become part and parcel of the standard toolkit of the European Monetary Union on its road towards an ever-closer Political Union? Are we closer to a “Hamiltonian” moment, as repeatedly argued in Europhile circles this year? As we shall see, the answer is not unequivocal, as it never is with the European project – always a bicycle on the go but never quite there yet.

After all that has happened this year, it is difficult to remember the world before Covid-19. But the prevailing political mood in Europe was grim and frustrated, after 2019 was lost in transition (The Euro in 2020), and the European momentum was drained away by Brexit and populism. Nationalism in policymaking was pervasive and completing monetary union was no longer a priority. So much so, that the incoming von der Leyden Commission had settled for a softer and friendlier list of priorities. The economy, however, was to bring good news, as Europe was clearly emerging from the Great Financial Crisis, GFC, with more employment and growth and a better fiscal outlook. It was back to business as usual, and therefore back to relying on the confidence and understanding of financial markets while the Union made up its mind on its future status. The alternatives were still a complex form of single market with one currency and very complicated rules

for risk sharing and risk reduction, both public and private, or a full monetary, banking and fiscal union. The existential question lingered on.

That was the state of the European debate when the pandemic hit the continent with unexpected violence. Europe was totally unprepared for a shock of this nature, blinded by a certain sense of moral and political superiority and an almost absolute confidence in the strength of its welfare state and its superb public health system. Unsurprisingly, it wasted far too much time, and the consequences were terrible in terms of human lives and economic costs. In hindsight, the pandemic made all the more evident the old European problems, notably four: (i) a long and protracted decision-making process that offers plenty of opportunities for free-riding and brinkmanship; (ii) the absence of a federal emergency facility to cope with the unknown, a facility that would have entitled the Commission to seize emergency powers to deliver a quick common response to a public health emergency; (iii) the inability to finance the response through an emergency budget financed with European debt; and (iv) insufficient instruments to avoid the recurrence of the banking-sovereign doom loop if the health shock resulted asymmetric.

But at the same time, the EU reaction to Covid-19 was surprising in its unity and decisiveness. And it is only fair to say that the von der Leyden Commission, and the President herself, have risen to the challenge. As early as 20 March, the Commission approved a flexibilization of State Aid rules to make room for the support measures implemented by Member States. And on 23 April, the EU Council adopted an extraordinary package of €540 billion that included: (i) a new ESM facility, called Pandemic Crisis Support, to finance emergency healthcare costs (personnel, equipment, medical goods and supplies, etc.) caused by the pandemic, with no macro conditionality; (ii) the European instrument for temporary support to mitigate unemployment risks in an emergency, known as SURE, to ensure that Member States could face the incremental expenses of unemployment benefits created by the health emergency and lockdown policies; and (iii) a Guarantee Fund at the European Investment Bank which would operate as a backup for loan guarantees extended by national development and promotional banks (KfV, ICO and the like) to avoid any undesired increase in sovereign spreads.

Only a month later, on 27 May, as the pandemic worsened, the Commission tabled Next Generation EU. This proposal already included the Recovery and Resilience Facility, RRF, funded by debt securities issued directly by the EU and an increase in EU's Own Resources, including some unspecified form of carbon tax, a digital tax and tax on large corporations. NGEU, linked to an ambitious Multiannual Financial Framework 2021-27, and designed to support Member States to recover, repair and emerge stronger from the crisis and accelerate their Digital and Green Transition, has completely dominated the European policy debate this year. It prompted intense discussion among Member States and within European institutions: The Council and the Parliament only sorted out their differences in late December, on the two most controversial aspects, political and economic conditionality.⁴ Euro federalists rightly underline its mutualization character and

⁴ A final agreement on the rule of law was reached by requiring a decision from the European Court of Justice before the mechanism to suspend payments could be implemented. The economic conditionality was settled in Article 17(3) of the Regulation that expressly makes disbursements

the potential to create both a Euro Area macro stabilization facility and the European safe asset. Eurosceptics, for their part, point out that it is a one-off program to respond to an emergency, and that disbursements are not entitlements but subject to significant program-specific and macro conditionality. The jury is still out, but the reader will find in this Yearbook all the technical details and many and diverse arguments to form his or her own opinion.

As for the ECB and all major central banks, 2020 was supposed to be the year for the normalization of monetary policy – the year to take stock of nonconventional monetary policies and the regulatory tsunami put in place after the GFC, and to comprehensively review that strategy. But Covid-19 changed everything. And all major central banks responded quickly by implementing the largest monetary stimulus in history. The Fed reduced interest rates to ease funding costs and support aggregate demand, while ensuring the provision of liquidity. The ECB, with no practical room to lower rates - they have been negative since 2014 – turned to non-standard measures and confirmed that it saw itself at or near the Lower Bound.

After initial hesitation and some communication slip-ups, the ECB reinforced its commitment to “whatever it takes” with speed and determination. As early as 18 March, it announced a comprehensive policy package including monetary policy, regulation and supervision measures and macroprudential instruments. On monetary policy, the ECB: (i) increased its Asset Purchase Program with an additional net €120 billion on top of the existing €20 billion per month; (ii) launched a new €750 billion Pandemic Emergency Purchase Program (PEPP) of private and public sector securities for as long as necessary;⁵ (iii) expanded the range of eligible assets under the Corporate Sector Purchase Program (CSPP) to non-financial commercial paper; (iv) announced its willingness to go beyond the capital key in the purchase of public securities; (v) continued its full allotment policy on the provision of liquidity through additional longer-term refinancing operations (LTROs) and improved terms and conditions for existing ones; (vi) launched as of May 2020 a new liquidity backstop, a series of non-targeted pandemic emergency longer-term refinancing operations (PELTROs); and (vii) introduced a tiering system in the costs of bank reserves at the ECB, thus finally acknowledging the adverse impact of its negative interest rates policy on banks’ profitability, and therefore on financial stability.

As regards supervision policy, on 20 March the ECB adopted a comprehensive set of measures that involved smoothing the accounting impact of the deterioration in the quality of assets and the relaxation of capital and liquidity requirements. On asset quality, the most important measures adopted were the flexibilization of: (i) the regulatory treatment of assets subject to public support (guarantees or moratoria); (ii) the application of the expected loss methodology concept (IFSR 9); and (iii) the strategy for the reduction of impaired assets, which was declared to be at a “standstill”. As for capital requirements,

from the European RRF conditional upon the general EU principles of green and digital transition and, what is more, compliance with the specific Country Recommendations in the European Semester processes in 2019 and 2020.

⁵ Later increased by an additional €500.000 in December 2020

the ECB allowed financial institutions to use its P2G as a capital buffer and brought forward the use of Tier II and Tier III in meeting P2R.⁶ The obvious objective of all these measures was to avoid the credit crunch experienced in the recent GFC, which had exacerbated and prolonged the recession.

Additionally, and in what has certainly been a controversial macroprudential measure, particularly because the Federal Reserve did not act likewise, the ECB compelled all European banks to suspend all dividend payments and buybacks in order to avoid the regulatory forbearance to be distributed to shareholders and not used to build up a capital buffer to provide for the expected significant increase in non-performing loans and other impaired assets. Finally, and to complement its insistent moral suasion with concrete measures, the ECB passed accounting and supervisory changes to foster bank mergers by allowing the use of the “bad will” to finance restructuring and other merger costs, and by accepting that the level of capital of the resulting institution may remain at the average of both, and not at that of the best capitalized as previous policy required. The idea being that size is necessary to cope with the new challenging macro environment and with increased competition from digital newcomers.

In sum, the ECB has reacted swiftly and expeditiously to the Covid-19 challenge with all its diverse policy arsenal. By doing so, it has placed itself once again at the core of the European policy debate. It cannot be surprising that accusations of fiscal dominance have re-emerged. The controversy surrounding ECB action is the inevitable consequence of the lack of completion of the European monetary and banking union, and of the special position in which it places the ECB in the European policy-making-space as the only real federal agency. But beyond EMU, as central banks around the globe become more active in policies far removed from their traditional limited role of setting interest rates, the academic and political discussion on its independence and accountability is escalating. And the ECB cannot, and should not, be immune.

Yes, the European Union has responded institutionally to the crisis as never before. It has advanced its internal architecture towards an optimal currency area by moving ahead in banking and fiscal union. And we have seen interesting new developments in political union. In banking union, the resolution mechanism now has a credible financial backup⁷ and supervisory and regulatory authorities have shown the necessary determination and flexibility. But the main obstacles to having truly European retail banks remain, notably the absence of: (i) a European Deposit Insurance System, EDIS; (ii) a common bank insolvency regime to avoid gaming the single resolution mechanism; (iii) a regulatory “level playing field” for banks, BigTech firms, FinTech firms and shadow banking; (iv) a flow of liquidity and capital within cross-border groups that is free of ring-fencing measures; and (v) a common policy treatment of privately owned cooperative and state-owned banks, in particular regarding their legal status, specific governance and own-

⁶ According to Bankia Research, these measures amounted to the ECB freeing €120 billion of CET1 capital that could be used to provide loans to the private sector of about €1.8 trillion.

⁷ Finally, the December Council amended ESM regulations to allow it to be used as backup for bank resolution.

ership structure, which keeps them immune to consolidation and protects them from failing.

As for fiscal union, there have been unquestionable advances that could not have been hoped for before the pandemic, notably the launching of NGEU. Nevertheless, the political discussions have highlighted three issues looking forward that should not be dismissed in the federal heat of the moment: (i) NGEU is legally a one-off emergency package and it was only approved after that point was made crystal clear, and there is no formal presumption of it ever being repeated, despite the obvious precedent it creates; (ii) it is not the macro stabilization facility any fiscal union needs; indeed, to be enacted, the word stabilization had to be removed from its original name. The text is itself confusing, moving constantly from a structural fund to increase potential growth to a stabilization fund to help overcome the social costs of Covid-19. Both objectives may not only prove difficult to reconcile, but they will complicate its repetition in the future; and (iii) NGEU does not create a European Treasury, although it puts in circulation a very large amount of European debt. In that sense we are no closer to having that EMU minister of finance that euro federalists demand. This absence will complicate debt management, but it may also be seen as the harbinger of future institutional reforms.

Finally, on fiscal union, there has been no progress with fiscal rules during the year. Although mentioning rules these days is a non-starter, once the Commission has declared a vacation period for 2021 and likely but not certainly 2022, the fact remains that the current rules are inefficient, impractical and highly discretionary and politicized. The pendulum in academia has been gradually shifting towards simple, predictable and easily enforceable rules on public expenditure, which could be easily calibrated for Member States on the basis of their level of public debt and the speed of the reduction. But this debate has not yet become a political reality. And it should soon. It is unimaginable that EMU may move decisively to create a permanent macro stabilization facility without, at the same time, relying on a clear set of fiscal rules to avoid free riding. Hence, as I constantly remind Euro federalists, risk reduction and risk sharing, fiscal rules and macro stabilization can only move ahead in tandem.

As to political union, the year has brought significant new developments that strengthen the rule of law and the democratic nature of the EU. For the first time, access to EU funds has been made expressly conditional upon political criteria. But we have also witnessed serious problems with the decision-making process that have led to complicated legal maneuvering and procedural threats that seem difficult to reconcile with the necessary trust among members in a federation. The Union has undoubtedly reinforced its federal nature, but a fundamental agreement on a new decision-making process is a must. And, to some extent, the debate about moving towards a closer Union has come to the fore. Once again, the need for a new Treaty, a new social contract for the citizens of Europe and the governments of Member States, becomes evident.

As this terrible year comes to an end, it is time to make an overall assessment of the global and regional economic consequences of the pandemic, in the full awareness of the very high uncertainty surrounding any outlook as long as Covid-19 hangs over the economy and social distancing remains. According to the latest IMF forecasts, global

growth is projected at -4.4% in 2020, a less severe contraction than expected in June, reflecting better and faster than anticipated outturns in advanced economies, where activity began to improve sooner than expected after lockdowns were scaled back. Global growth is projected at 5.2% in 2021. These projections imply wide negative output gaps and elevated unemployment rates this year and in 2021 across both advanced and emerging market economies (IMF *World Economic Outlook*, October 2020).

As for Europe, the European Commission reported, when this book was going to print, that “overall, EU GDP is forecast to contract by about 7% this year before rebounding by 4% in 2021, which is less than previously forecast, and by 3% in 2022” (European Economic Forecast, November 2020). These projections are not very different for the Euro Area.⁸ In either case, the level of output in the European economy would not return to pre-pandemic levels until 2023. At the same time, and despite the ambitious implementation of employment support policies, job losses during the first half of the year were unprecedented. “Nevertheless, the EU unemployment rate is set to rise further from 7.7% this year to 8.6% next year as workers should progressively re-enter the labor force. It is expected to decline in 2022 to 8.0% .”

The fiscal stance for the Euro Area, EA, is projected to be strongly expansionary in 2020 due to sizeable emergency fiscal measures taken by Member States and the effect of the automatic stabilizers. The aggregate government deficit for the Euro Area will reach 8.8% of GDP in 2020 and gradually decrease to 4.7% in 2022 as emergency measure are phased out. Consequently, the EA debt to GDP ratio will rise to 101.7% in 2020 and remain over 100% for many years without active consolidation. The Commission report underlines that significant differences in unemployment rates and public sector deficits between countries will persist, reflecting pre-existing vulnerabilities. A quick and clear reminder that European policies, no matter how ambitious and long-lasting, cannot solve domestic structural problems, inefficiencies or rigidities.

After both these forecasts were released, and as a reflection of the existing very high uncertainty, the consensus outlook has significantly changed. In the short term, the severity and widespread incidence of the second wave of the pandemic in the last quarter of the year has seriously curtailed growth projections. The second wave has resulted in renewed lockdowns across Europe and the United States, stalling the recovery of private consumption, postponing investment decisions, and reducing international trade flows. But at the same time, the medium-term outlook has improved significantly, as positive developments in the authorization, distribution and deployment of vaccines have surprised us all. Consequently, the baseline macro scenario has deteriorated for 2020 and the first half of 2021, but improved for the second part of next year, when many economists and most policymakers expect herd immunity to be a reality, and more so in 2022 and beyond. Notwithstanding this news, and will all due caveats, the pandemic has already left profound scars on the global economic and social fabric, and consequently the level of

⁸ The ECB latest GDP projections for the Euro Area are -7.3% in 2020, $+3.9\%$ in 2021 and $+4.2$ in 2022.

output and employment is not expected to recover before 2023. These are lasting scars that will be deeper in countries where the pandemic has hit hardest, have implemented most stringent lockdown measures or their economic structure or the inadequacy of the policy response has exacerbated the pandemic (André Sapir 2020).

Those scars will be felt in human and physical capital and in education, on-the-job training and fixed capital investment, hurting productivity and limiting potential output growth. Conventional wisdom is calling for a renewed economic policy strategy with a stronger role for fiscal policy, much larger public sector deficits and debts, and more state intervention in the economy. The underlying assumption is that the post Covid-19 world will be defined by very low inflation, nominal interest rates close to or below zero, high unemployment rates and suboptimal growth. Such a world would require turning back to the 1950s, to very expansionary traditional Keynesian policies. Because why worry about debt sustainability? If servicing public and private debt, despite its phenomenal growth with the pandemic, requires almost no increase in outlays, and if central banks around the world have promised full liquidity at no cost and endless quantitative easing – QE, unlimited purchases of private and public securities. But some skeptics start wondering if we are not simply returning to the old policy of monetizing private and public debt by the back door of stacking it on the constantly growing balance sheets of central banks. The ECB for instance now holds debt in excess of 60% of Eurozone GDP and more than 25% of all outstanding Spanish or Italian public debt. No wonder economists are again debating fiscal dominance, the loss of central bank independence, and the inability to change the monetary stance without triggering a significant credit event.

Hence, while economic policies are still focused on maintaining or even amplifying the extraordinary fiscal impulse, and central banks insist on extending monetary accommodation for as long as it takes, the policy debate is timidly and gradually shifting towards the difficult questions of how to implement an orderly exit strategy before financial stability is imperiled⁹ and inflation moves beyond potential asset bubbles to the goods and services market.¹⁰ To the unexperienced observer, this dichotomy may seem foolish. How can anyone talk about inflation if the ECB's latest projections place HCPI to be still at 1.2% in 2022 and 1.4% in 2023? Moreover, core inflation would remain

⁹ “Central banks have played a pivotal role in easing financial conditions in response to the covid-19 shock and helped avert a catastrophic downturn.... But these even more accommodative policies may pose substantial risks down the road by encouraging excessive risk-taking and a build-up of vulnerabilities.... Accordingly, it is crucial that monetary policymakers incorporate macro-financial stability considerations in their decision making, besides the path of output, unemployment, and inflation”. Tobias Adrian 2020.

¹⁰ “Nothing is more reassuring to an investor than the knowledge that central banks, with much deeper pockets, will buy the securities they own — particularly when these buyers are willing to do so at any price and have unlimited patient capital. The result is not just seemingly endless liquidity-driven rallies regardless of fundamentals. It also alters market conditioning and inverts traditional cause and effect. Central banks’ deepening distortion of markets will be harder to defend in a recovering economy amid rising inflationary expectations.”, Mohammed El-Erian, 2020

subdued, as substantial output and employment gaps combined with structural factors, i.e., digitalization and population aging, will prolong the downward pressure on prices.

But policymaking is about predicting the future and preventing unwelcome scenarios from materializing. It is about planning and having the tools in place before it is too late. And the two questions to start asking policymakers now relate to the limits to public and private indebtedness and the effects of “low for longer” interest rates on financial stability and the banking system. Especially if “whatever the future holds, it will be nothing like the past”, as Goodhart and Pradhan 2020 have argued in one of the most influential and controversial books of the year.

2. MONETARY UNION IN SHOCK

The 2021 Yearbook is organized around the central theme that EMU has changed deeply with the pandemic. It is not necessarily a permanent change, but it will be difficult to turn back, especially if new policies and instruments prove useful and deliver expected results. This is the two-line summary of the year, and the table of contents of this book. The book is organized in four sections. The first section provides the political, economic and financial context for the changes. In essence, what were policymakers thinking and how did they react? The second section digs into monetary policy and reflects the rapidly changing circumstances of the year and the responses to the uncertainty, with an emphasis on the long-term consequences of structurally low interest rates, the rethinking of monetary strategy and the threats to central bank independence. The third section is about fiscal policy, and is dominated by Next Generation EU, but goes beyond to explore the political economy of reform, the challenges and opportunities for fiscal union and the role of a proper regulation of state aid in fostering a stable and fair Union. The fourth and last section is about financial stability and regulation, a very active policy area this time around, and complements a detailed European account of actions taken with the necessary international perspective.

2.1. THE CONTEXT: THE EUROPEAN RESPONSE TO THE PANDEMIC

Part I of the Yearbook is intended to give context, to put EMU developments in the light of social and economic trends and fault lines evidenced during 2020. It includes three articles on monetary policies, fiscal measures and the institutional response. We start with monetary developments and finish this part with political considerations because this Yearbook has argued from its first edition, way back at the outset of the euro debt crisis, that European Monetary Union was an incomplete work in progress, and that the Maastricht Treaty fell short of delivering a sustainable union because it lacked a real banking, fiscal and political union. Therefore, we asked this Yearbook’s contributors whether Covid-19 provided the necessary crisis to start repairing institutional flaws.

Chapter 1 is an article by Luis de Guindos, the Vice President of the European Central Bank, *The monetary policy response: the role of the ECB*, which describes at length the com-

prehensive set of measures taken by the monetary authority “to arrest highly disruptive, self-fulfilling feedback loops in asset prices and illiquidity that would otherwise have precipitated a much deeper economic contraction and unprecedented deflationary risks.” The paper also explains the rationale, the thinking behind those actions. It is obvious from this quotation that, in its emergency actions, the ECB had in mind both potential risks in the outlook, deflation and recession. The use of non-conventional instruments of monetary policy has become so standard in recent years that it is probably misleading to call them so anymore. Nevertheless, the ECB has become the only major central bank to use negative interest rates systematically and consistently. They have been used in combination with asset purchases, forward guidance, and targeted long-term funding support for banks to provide the necessary monetary accommodation.

The perception of risk changed drastically by mid-March, precipitating the usual flight to safety. Equity prices had fallen about 40%, volatility had risen sharply and investment funds experienced outflows similar or even higher than during the peak of the GFC. Market stress reached traditional safe and liquid assets such as money markets and sovereign bonds. Market-based indicators of longer-term inflation expectations declined to an all-time low and departed even further from the ECB price stability definition. Moreover, the widening of sovereign yield spreads threatened to disrupt monetary policy transmission and trigger a repetition of the debt crisis.

There was no time to waste and, de Guindos rightly asserts, this time the ECB acted swiftly and without delay. It responded to the events with a twofold monetary policy designed “to adjust the monetary policy stance and to safeguard monetary policy transmission, making sure that the stance is passed through the financial system to households and firms.” As early as March 2020, the Governing Council decided on a comprehensive set of monetary policy measures that are described extensively.¹¹ They involved both the recalibration of existing instruments and the additional launching of new ones; most notably, a new pandemic emergency purchase program, PEPP, which has the dual function of easing the monetary stance and of stabilizing financial markets. Interestingly enough, the ECB did not consider it appropriate to move further into negative interest rate territory. As President Lagarde made clear, “Indeed, asset purchases – by compressing longer-term bond yields – can induce an easing of financial conditions that can partly compensate for the diminishing scope for conventional rate cuts” (Lagarde 2020). In my own more direct words, the Euro Area is close to its lower bound in terms of interest rates, but there is ample room for additional monetary accommodation through other non-price policies that have shown their effectiveness.

At the same time, this chapter recognizes the limited capacity of monetary policies to address structural factors and real sector crisis like this one. Thus, it emphasizes the need to accompany monetary accommodation with prudential policies and fiscal measures. Consequently, the SSM, Single Supervisory Mechanism, provided significant capi-

¹¹ A very useful summary of all the actions taken by the ECB can be found in Figure 13 in this chapter.

tal relief to banks to avoid any danger of a credit crunch; and national macroprudential authorities relaxed the countercyclical capital buffer (CCyB). The fiscal response also constituted a positive surprise. It included: (i) immediate fiscal support to cover medical equipment, employment protection and subsidies to firms to keep them open; (ii) deferrals, including the payment of taxes and social security contributions; and (iii) liquidity provisions and guarantees.

According to the ECB's estimates, the measures taken: (i) stabilized financial markets - the 10-year euro area average sovereign yield was reduced by between 45 and 70 basis points and the impact was around twice as high in riskier countries as that of the euro area average; (ii) injected abundant liquidity and allowed for substantial credit growth - taken together, the June and the September TLTRO resulted in a combined net liquidity injection of €706 billion; (iii) grew credit substantially - the annual growth rate of loans to firms stood at 7.1% in August and September 2020, 4.1 percentage points higher than in February; (iv) brought bank lending rates close to their historic lows, around 1.5% for non-financial corporates and 1.4% for mortgages in September 2020; (v) at the same time, slowed the increase in the default rate of euro area high-yield firms, which rose from 1.73% in February to 4.21% in October; and (vi) had a very positive macro impact and contributed in cumulative terms around 0.8 percentage points to the annual headline inflation rate and 1.3 percentage points to real GDP growth between 2020 and 2022.

Obviously, concerted and unprecedented policy action has not prevented a historical contraction in output and substantial incomes losses: it couldn't have. But it has been able to avoid massive unemployment and a new financial crisis, at least for the time being. These policies have bought precious time for the healthcare industry and the scientific community to deliver a vaccine promising light at the end of a long and terrible tunnel. But there is no free lunch, and the extraordinary monetary expansion, no matter how necessary and successful, raises unavoidable questions for the future action of central banks. Will the size of their balance sheets ever come back to levels similar to those prevailing before the GFC and Covid-19? If the answer is yes, how and at what cost? If the answer is "not in the foreseeable future", will market forces still have enough room to determine prices in disaggregate financial markets? Or will we live a long era of central bank dominance? Which is just another way to ask, will the debt ever be paid? Obviously, these are the questions for the post-pandemic world and its corresponding policies.

In chapter 2, Jonás Fernández, a Member of the European Parliament Committee on Economic and Monetary Affairs, asks the question, *The Fiscal response: A step forward towards debt mutualization?* In his opinion, the euro area lacks a fiscal pillar since its foundation. The adoption of the single currency and the creation of the ECB have not been complemented by a budgetary tool for stabilization. Therefore, the Union has left sole responsibility for managing the cycle to monetary policy and to national fiscal policies. Fiscal rules were only designed to limit potential free-riding, to ensure that Member States could not end up distorting or impeding the functioning of the common monetary policy. This is common and accepted knowledge. But the author takes a step further and argues that as a result of the euro-debt crisis, "the monetary union evolved towards a fixed exchange rate model, emulating the Bretton Woods agreements."

The policy response to that crisis is summarized in two lines of action: (i) reinterpreting the contents of the original Treaties that made bail-outs impossible, thus allowing the creation of new mechanisms to support national treasuries, namely the ESM, and (ii) strengthening budgetary control mechanisms to limit, at least formally, macroeconomic imbalances, and particularly the evolution of current account and international net asset positions; these procedures also resulted in less room for discretion in national fiscal policies. The policy specifically shied away from establishing a centralized fiscal pillar for the euro area. “This response succeeded in overcoming that crisis, but with a very significant economic and social cost that could have been mitigated by deepening the mutualized nature that is the euro area’s mission.” Consequently, this chapter calls for fiscal mutualization. In the absence of which, the policy toolkit of the European Union will be unable to respond effectively to external shocks, and their asymmetric impacts will erode its public support and question its survival.

The author argues, however, that, this time, the Union has put in motion a political process that may result precisely in that Euro Area central budgetary instrument, although nothing is yet guaranteed. To reach that conclusion, Jonas Fernández reviews political developments in the EU during the five-year economic recovery prior to the pandemic, and concludes that the nature of fiscal policy changed in three significant ways that have now facilitated the adoption of a more “federal” response: (i) renewed flexibility in implementing the Stability and Growth Pact; (ii) the Juncker Plan, an instrument for European investment backed by the Community budget through the European Investment Bank, and (iii) a European Investment Stabilization Function (EISF), not yet approved nor implemented, but whose thinking inspired the current debates: a long-term loan designed to stabilize public investment, the interest on which would be paid jointly through a fund set up with ECB profits corresponding to each Member State.

When the pandemic shocked Europe, each Member State initially took individual actions, but by April, national governments were able to rapidly agree on similar fiscal policies, guarantees and support programs to sustain employment and businesses. And the European Commission contributed by suspending the application of the Stability and Growth Pact and by quarantining state-aid regulation. Furthermore, ministers of finance introduced the ESM special credit facility mentioned earlier,¹² and the Commission the SURE program.¹³ Finally, the European Council agreed to the requests of Parliament and the Commission and approved Next Generation EU, issuing common debt. NGEU introduces mutualization and thus, the author believes, recognizes the inadequacy of the previous policy of addressing EMU’s structural problems by using a fixed exchange

¹² A credit facility that Jonás Fernández criticises because it is not a transfer, and because it leaves responsibility for meeting its obligations to Member States and is only mutualised in case of default. But it has not been utilised for its stigma effect and Member States have enjoyed unlimited financing at unprecedented low cost thanks to the ECB. The ESM has thus resulted redundant and fiscal discipline irrelevant, including with a medium-term perspective.

¹³ This support was limited to a single liquidity facility, without assuming joint responsibility for the amortisation of these liabilities, again if no country defaults.

rate model that required budgetary supervision of Member States and the monitoring of current account imbalances. Such supervision has never been effectively implemented; I might add. However, Jonás Fernández also acknowledges that this new instrument is only temporary and therefore “we cannot therefore yet speak of a ‘Hamiltonian’ moment in the European Union.”

But the author is optimistic about a change in the nature of EU fiscal union, given that: (i) the European Council has proposed the approval of new European taxes to service the repayment of this debt;¹⁴ (ii) these taxes are by definition permanent, and although they are not ear-marked and money is fungible, the proceeds constitute a source of recurrent income that could support future issuances of euro-debt instruments, should it be decided to make NGEU permanent; (iii) the fact that debt is issued before these new taxes are introduced somewhat alters the nature of the European debate on taxation, which so far required unanimity in the Council - because once the debt is issued, governments are forced to decide whether to create these new taxes or face repaying EU debt with their own national budgets; and finally, (iv) the likelihood of retaining NGEU will critically depend on efficient use of the fund. Efficiency is required not only to cushion the current shock, but also to steer the micro reforms that would increase the growth potential of Member States and of the Union.

It seems difficult to me to think of a permanent macro stability facility for EMU, or, in the author’s preferred wording, a central budgetary mechanism, without discussing fiscal discipline, budgetary rules. In 2021 the Union is scheduled to debate the future of such rules. To Jonás Fernández, “the design of institutions works substantially better than the decentralized application of rules of cooperation between Member States.” Allow me to express my skepticism that fiscal union may advance in so heterogenous an EMU without a compromise between mutualization and discipline or a commitment to clear and enforceable fiscal rules that will give confidence to creditor countries. Political discretion and institutions are necessary in a federal union, but will never substitute for basic trust, and for trust to prevail in EMU, fiscal rules are and will be necessary, because transferring fiscal sovereignty goes to the heart of our national democracies.

The first part of the Yearbook finishes with a chapter by Cristina Manzano assessing *The Political reaction: How did the European Institutions respond to the crisis?* She offers a well-documented journalistic account of events leading to the European Union’s introduction of the largest economic package in its history, creating a stronger and more united Europe. For a Union typically criticized as bureaucratic, distant and boring,” the chronicle of the fight against coronavirus lies between a mystery tale and a psychological drama.” But it was not always obvious that the EU policy response would be a success. Arrogance and complacency met with lack of preparation. Panic spread all over Europe.

¹⁴ Certainly, without new taxes, NGEU would have remained a joint issuance, with each country receiving financing depending on the damage suffered, and with each one returning it according to its proportion of the overall EU GDP. There would be a degree of joint indebtedness, but the advantages of pooling this debt would be limited to having the same interest rate for all Member States, writes Fernández.

The Single Market was under threat. The Schengen Treaty was suspended. The Monetary Union was again in check. Health nationalism became widespread. Lockdowns, quarantines and travel bans left more than 625,000 EU citizens stranded outside its borders. Many more were locked in their home country with freedom of movement indefinitely suspended. After initial protectionist measures, nationalistic temptations, foreigner-bashing and political and communication blunders, the Commission finally reacted by announcing initiatives aimed at tackling both, the health and the economic crisis.

On 25 March, the leaders of nine EU Member States sent a public letter to Charles Michel, the President of the European Council, urging for a determined and strong response, including a common debt instrument. The French President, Emmanuel Macron, asked Europe to “think the unthinkable”, including financial aid funded by mutualized debt. The pressure for mutual action reached Germany. In an unusual editorial published in five languages, *Der Spiegel* openly supported Eurobonds: “The German government’s rejection of Eurobonds is selfish, small-minded and cowardly.” A few weeks later, Macron and Merkel announced their own plan, the Franco-German axis at work again. The significance of their plan was not the money - the €500 billion now looks a bit like petty cash – but its nature: (i) the EU would issue bonds directly in its own name, guaranteed by its own revenues, instead of using funds raised by national governments; (ii) the creation of a fiscal federation raised the need for a Euro Treasury office; and (iii) the concept of EU borrowing in the markets, instead of simply using the EU budget, opened the way to dream of the long-demanded EMU macro stabilization facility.

For Euro federalists, always looking for a defining founding moment, this proposal became their “Hamiltonian” moment. However, at no point did the Macron-Merkel plan involve the EU assuming the totality or even a fraction of the individual sovereign debts of Member States or converting them to joint obligations of the federal union. The comparison is thus an exaggeration, but it signifies a real turning point. Events precipitated after the Franco-German pact, and on 23 April, the Council asked the Commission “to urgently come up with a proposal that is commensurate with the challenge.” A month later, on 27 May, Ursula von der Leyen presented the Commission plan. It was Europe’s moment. The original NGEU plan was far-reaching and original in its approach: €750 billion, to be distributed between grants and loans. In addition, the plan was to be linked to the EU budget for 2021-2027, bringing up its financial capacity to €1.85 trillion. As is well known, and discussed in this Yearbook, some of the original aspects of the plan were modified in the subsequent political negotiations with the Council and Parliament, but the essential mutualization nature stayed in place. And it entails a momentous change in EU policy.

On 1 July, Germany took over the rotating presidency of the EU. For the German Chancellor, Angela Merkel, it was a personal challenge. Her role during these existential times of EU crisis gave her back her position as Europe’s indisputable leader. At stake was her legacy. Europe will miss her. It is an irony that a German politician raised beyond the EU borders has turned out to be the standard bearer of the European dream, both in fiscal union and the rule of law. There has also been a “Von der Leyen’s moment”. Her leadership, having been much questioned, proved instrumental. She and her team were

able to deliver the Council's mandate: to translate a loose plan and mere good intentions into an ambitious and feasible practical proposal.

The chronicle of the July European Council Summit is full of tension, of long sleepless hours in which the future of the EU was hanging in the balance. The major differences were still (i) the size and distribution (grants/loans) of the package and the MFF, (ii) the criteria to allocate funds to each country, (iii) the conditionality and its timing, and (iv) the procedure to ensure the rule of law. But finally, EU leaders put truth into Jean Monnet's sentence: "Europe will be forged in crises and will be the sum of the solutions adopted for those crises." Not a grand *ex ante* technical and political design, but the result of compromise and commitment. The deal was done, but as usual in this institutionally excessively complicated EU, not completely so. The agreement still needed to be approved by the European Parliament and then Member States had to approve their Own Resources Decision. It has taken another six months.

Finally, this chapter also shows how EU plans to become greener, more digital and stronger have permeated the Covid-19 political response. The Council resolution of July recognizes climate transition as one of the top priorities of the EU. It sets: (i) a climate target of 30% to the total amount of expenditure from the MFF and NGEU; (ii) a general principle that all EU expenditure should be consistent with Paris Agreement objectives; and (iii) a new EU 2030 emissions reduction target by the end of 2020. Together with the Green Deal, digitalization has always been the main goal of a European Commission calling for strategic sovereignty.¹⁵ All in all, 20% of the NGEU plan will be invested in digital. While Europe is a world leader in the fight against climate change, its shortcomings in the digital realm are more than evident, be it in the absence of a real digital single market or in the lack of technological champions. Public-private partnerships will thus be essential to reach the resources required in that effort. Cristina Manzano finally reflects on the claim that the European Union is an economic giant and a political dwarf. The EU excels in soft power, but soft power alone does not go far. The new Commission had already expressed the need for a "geopolitical Europe". Strong words that need to be carefully translated and implemented into concrete policies and programs.

2.2. UNPRECEDENTED MONETARY EXPANSION: "LOW FOR LONGER" AND ITS CONSEQUENCES

Part II of the Yearbook is about monetary policy and contains three articles that discuss issues beyond the response of the ECB to Covid-19. Issues that all central banks and money and banking economists are examining. First, the consequences of a long period

¹⁵ The pandemic has prompted a reconsideration of the strategic needs of the European Union. A discussion about the concept of strategic is necessary, since it often helps to disguise protectionist attitudes and calls for a "Fortress Europe". Similarly, calls for national champions and a redefinition of EU competition policies have to be analysed very carefully, in full awareness of the dangers involved in moving from a growth friendly environment to a business friendly one.

of negative interest rates and ever-expanding CB balance sheets; the consequences for the effectiveness of monetary policy and for financial stability, and for the profitability and solvency of financial institutions. Second, prior to the pandemic, major central banks were immersed in an in-depth review of their traditional monetary strategy. This review was suspended and later modified to take into consideration the new circumstances, and in particular the widening of CB functions and responsibilities. Finally, the section concludes with a study of fiscal dominance, with an assessment of whether unconventional monetary policies have basically resulted in pure debt monetization.

In chapter 4, Alejandra Kindelán and Concepción Sanz, from Santander Research and Public Policy, address the issue of “*Low for longer*”: *The consequences of negative interest rates*. Interest rates have been falling since the eighties. At the end of 2020, the yield on more than 50% of all long-term European sovereign bonds was negative. Against a backdrop of declining inflation expectations, the ECB set negative interest rates in June 2014. Other major central banks (Denmark, Japan, Sweden¹⁶ and Switzerland) had done the same. But the Federal Reserve and the Bank of England have refused to enter negative territory, even this year to fight the pandemic.

Financial markets expect negative interest rates in the Eurozone to be the new normal for many years to come. Exactly for how long is a key question, according to Kindelán and Sanz. And that is the central claim of their chapter: if rates remain negative for too long, they “may lead to changes in decision-making behavior with regard to savings and investments” and result in material changes in the effectiveness of monetary policy, the profitability and solvency of banks, and the way consumers go about their finances. Not only the effectiveness but even the desirability of negative interest rates could come into question. How long is too long is still to be determined.

To many economists, the decrease in nominal interest rates is only the consequence of the secular decline in the natural interest rate¹⁷ as a result of excess savings over investment. The increase in the propensity to save is explained by (i) population aging, and (ii) the accumulation of current account surpluses by emerging countries. The decline in investment has been related to (i) the fall in expected return on investments as a result of lower potential growth, and (ii) the expansion of new technologies that have lower tangible capital needs. Others have linked falling interest rates to the increased preference for safe and liquid assets. In sum, central banks have been forced to lower policy rates in order to adapt them to the new economic environment.

For others, though, it is the action of central banks determining financial cycles that has played a major role in the reduction of real interest rates. Monetary policy deter-

¹⁶ The Bank of Sweden experimented with negative rates during 2015-2019. “It is evident that the policy’s effect on the inflation rate was modest, and that it contributed to increased financial vulnerabilities.” Andersson and Jonung (2020).

¹⁷ The natural interest rate is the rate consistent with price stability and with a full employment economy. Under a neutral monetary policy, the nominal interest rate gives rise to a real interest rate that is in line with the natural interest rate. For a discussion on the limitations of this definition see *The Euro in 2020*, Executive Summary.

mines the cost of borrowing, which affects the financial cycle, which in turn has a lasting impact on the economy and, therefore, affects real interest rates. These economists question the use of the natural interest rate as a guide to monetary policy, because (i) its definition as an equilibrium interest rate ignores the implications for the pricing of financial and real assets, and (ii) the natural rate cannot be independent of monetary policy itself.

Monetary policy used to be a simple task. Managing very short-term interest rates was its sole and sufficient instrument. To this effect, the balance sheet of the ECB needed to be just about 13% of the EA GDP. Today, after the GFC, monetary policy has many more instruments (i.e., liquidity injections, TLTROs, purchases of various types of financial assets, QE, negative interest rates (NIR) and forward guidance) and the size of the ECB's balance sheet has increased to 54% of EA GDP. But this complexity has not turned monetary policy unequivocally more effective. The use of these tools creates distortions in the functioning of financial markets and may offset each other. When the ECB injects liquidity to banks, it replaces money markets. In rolling out QE, it becomes the benchmark operator in some markets, in particular in the public debt market. And it relieves governments of their budgetary constraints, raising accusations of monetary financing. Moreover, negative interest rates and balance sheet expansion may, with the passage of time and the change in conditions, have the opposite effects to those originally intended.

This chapter notes that the combination of negative interest rates, quantitative easing and forward guidance has impacted banks' profitability in different ways, by (i) generating structural excess liquidity in the financial system, (ii) triggering the reduction of interest rates and (iii) flattening the yield curve. It also reviews the different effects on banks. On the negative side, (i) charging interest for excess reserves has created excess structural liquidity, (ii) NIR and QE compress net interest income because interest rates on loans fall more than the cost of deposits, and (iii) QE places downward pressure on long-term interest rates, eroding the transformation of maturities. On the positive side, monetary expansion (i) fosters economic growth and therefore bank credit volumes, (ii) reduces the level of non-performing assets, and (iii) generates capital gains on banks' fixed-income portfolios.

All this is well known theory, but what do we know for a fact? Bank Lending Surveys have consistently recognized the favorable effects on liquidity position, market-financing conditions and lending volume, but they are particularly critical of the impact on net interest income. These qualitative assessments have been ratified by the ECB's empirical studies until 2019. However, the time horizon during which interest rates will remain negative is very significant, if only because income from investment portfolios dries up unless interest rates keep falling. Moreover, if credit volumes do not grow and asset quality deteriorates, the financial system faces the perfect storm – witness the pandemic – and the transmission channel of monetary policy gets clogged.

If interest rates remain negative for a long period, or even only if financial agents expect them to remain negative for a long period, financial institutions are forced to rethink their business: raising services fees, increasing their risk exposure through more aggressive lending and more active asset portfolios, or even by focusing on activities other than lending. And through mergers and acquisitions to gain size and pricing power.

Any of these options has serious monetary and welfare policy implications, either because it weakens the credit channel or because it poses risks to financial stability or impairs competition. Eventually, the economy could reach the reversal rate.¹⁸ At this point, the monetary policy strategy would have to be entirely reconsidered. Increasing rates in those economic circumstances seems very risky. That is the reason why many central banks have stopped short of entering into negative territory. Because there is no simple exit strategy. And it would require full cooperation from fiscal and structural policies. Institutional perfection is not to be taken for granted.

In chapter 5, Maria Demertzis and Marta Domínguez-Jiménez, from Bruegel, write about *Fundamental uncertainty and climate: The two issues to guide the ECB's strategy review*. The authors believe that the strategy review of monetary policy relaunched by Lagarde in September provides a major opportunity for the ECB to carry out a paradigm shift in the way monetary policy is conducted in the Euro Area. They propose to use it to tackle two key challenges: fundamental uncertainty and climate change. These challenges are of a very different nature.

The first challenge is to conduct monetary policy in the context of fundamental uncertainty. We live in a poorly understood “new normal”. Central banks have resorted to untested tools with unknown potential effects that further contribute to uncertainty. These policies have raised questions beyond the effectiveness of monetary interventions. Questions that, according to the authors, include the solvency of the ECB itself, as well as that of the banking sector, in the face of growing debt levels and concerns about medium-term debt sustainability. These measures were necessary, nobody questions that. However, the ECB policy of preventing excessive financial fragmentation, “only postpones but does not solve the problem of debt sustainability,”¹⁹ and has had the effect of reducing spreads to levels that do not necessarily reflect the real cost of debt, to reflect its fundamental risks. And it raises doubts about the evolution of sovereign spreads in the medium-term, potentially threatening ECB independence.

That markets unanimously believe that real rates will continue to remain negative for the next 30 years, their entire horizon, is highly unusual. How can the real cost of capital be negative, effectively, forever? Under this scenario, the debt overhang will not pose problems in the future. But if the Euro Area is subject to inflationary pressures, “a very unlikely scenario in the immediate future,” then the ECB might find that the monetary policy objective is in direct conflict with financial stability. I personally find very little comfort in assuming, once again, that “this time is different,” and inflation has been forever banned.

¹⁸ The interest rate at which expansionary monetary policy becomes contractionary. This would happen if (i) banks raise lending rates to compensate for the cost of deposits, (ii) negative interest rates on deposits end up offsetting the cost of hoarding cash or (iii) capital restrictions become binding and force banks to reduce lending.

¹⁹ The authors make clear that “this is not an argument against the choices made by the ECB, rather an argument that containing the debt should also be given significant consideration.”

Furthermore, monetary policy relies on unobservable variables that have become increasingly difficult to estimate or even understand. Current forecasting models are constructed “to revert to the mean”, but they do not function well when the fundamental equilibrium shifts (much less so if it is unknown). To improve monetary policy under fundamental uncertainty, Demertzis and Domínguez-Jiménez make three concrete recommendations. First, traditional confidence intervals should be discarded and substituted by a range of possible outcomes based on an explicit set of underlying assumptions. Discussing alternative scenarios provides relevant information on the range of outcomes that the ECB is prepared for. Second, when considering alternative policies, the ECB should pick the policy that would most likely achieve the inflation range for the most extreme scenarios. Third, the price stability target should be set at 2% with a public fixed (and generous) tolerance band that is compatible with the range of acceptable outcomes in the scenarios considered. These recommendations do not seem to solve the fundamental problems noted in their chapter but provide just a marginal improvement in the conduct of monetary policy at the potential cost of eroding the credibility of central banks, precisely now that forward guidance has become a highly prized tool.

The second challenge for our authors is climate change. Financial risks arise from physical, liability and transition climate risks. Financial disclosures relating to climate-induced risks are work in progress, as is their integration with supervisory assessment and forecasting. Greening monetary policy goes one step further, as it involves explicit support for a low-carbon economy. The authors firmly advocate for the ECB to use monetary policy to accelerate the greening of the economy. A political decision, in my view, that goes way beyond the realm of monetary policy, but the authors consistently and unequivocally justify it on the basis of three arguments: urgency, power and leadership. It would make the ECB the first major central bank to adopt such measures.

If they so decide, central bankers have two powerful instruments in their toolkit for the greening of monetary policy: asset purchase programs and collateral eligibility requirements, with haircuts being adapted to reflect the carbon footprint of the asset. In many ways, this second route could be even more effective, as a much larger share of collateral is made up of corporate bonds, while asset purchases have been largely focused on sovereign issuers.

This chapter stresses that the greening of the economy is within the mandate of the ECB, supported by an extensive interpretation of Article 127 of the Treaty (TFEU)²⁰, and argues that there needs to be a clear political mandate for the ECB greening policy and explicit Parliamentary guidance on how to prioritize. And to respect the “instrument independence,” they call for an explicit ECB assessment on how to execute green monetary policy (i.e., how and to what extent there will be a shift in the ECB’s asset holdings). But I worry that such a loose interpretation of the ECB’s mandate and independence could accommodate almost any social policy popular at the time. It renders the ECB an

²⁰ Article 127 states that “without prejudice” to the main objective of price stability, the ECB can further support the general policies of the Union. Policies that could include sustainable development, and therefore the development of a low-carbon economy.

instrument of general economic and social objectives, an arm of government. This is something central banks have successfully resisted for decades, for good reason.

Finally, this chapter presents some indication of the potential impact of such a climate-related ECB strategy. There is ample evidence that the price of eligible assets sees a disproportionate increase. Thus, central bank purchases benefit the specific asset purchased and those with similar profiles. Similarly, securities eligible for collateral (with a lower haircut) would become more attractive. Thus, green monetary policy could lead to general cross-sectional rebalancing of portfolios. Although the authors focus on private sector securities, similar mechanisms would apply to public sector debt. However, the authors believe the introduction of green criteria to sovereign bonds would contain spreads in the midst of highly exceptional circumstances and should be postponed. It seems a bit unfair, since, by extension, it could be inferred that they consider the private sector already immune to the effects of the pandemic.

In Chapter 6, Rubén Segura Cayuela writes about *The Independence of Central Banks and Fiscal Dominance*, an issue of particular relevance to the ECB. He starts with the obvious: buying government debt at the lower bound is no longer unconventional policy. That alone is not monetization. The facts are well known; the cumulative balance sheets of the four largest central banks hold assets worth five times more than at the beginning of the decade, most of them public debt. Those balance sheets are unlikely to be unwound any time soon and, if anything, could grow even larger. To explain how we got here, Rubén Segura assumes the hypothesis of a secular decline in the natural rate and considers CBs to be passive agents responding to changing circumstances.

Current ECB policy is not debt monetization, because the public sector is only helping the private sector to digest an extraordinary one-off shock. And the central bank is only helping the public sector to smooth the impact over time, which is clearly within its mandate. An unprecedented external shock requires large deficits, large public debt issuances and large purchases of public debt by the CB. That, by itself, does not constitute fiscal dominance, nor does it represent the monetization of budget deficits (Blanchard and Pisani-Ferry (2020)). But it could be, if this support becomes permanent or if government difficulties prevent or postpone the ECB's tightening policies, should inflation expectations so advise. We have already discussed how unlikely this scenario appears today, but only the future will tell.

This chapter takes the natural rate argument one step further and concludes that unless the policy stance loosens further, monetary conditions would tighten over time with the continuous decline in the natural rate. Thus, the author calls for enhanced cooperation between fiscal and monetary policy. Either the ECB publicly commits to be “credibly irresponsible” and the Euro Area implements a much more forceful fiscal response beyond what is in the pipeline, or we risk fiscal dominance, and the independence of the ECB will be challenged in the future. “Without that response, it will be just a matter of time before we hear louder voices on debt cancellation or pure monetization of fiscal deficits.” But I might add, there is no reason why those voices, no matter how loud, should be listened to. Because fiscal dominance is a bad idea, and it is clearly prohibited in the Maastricht Treaty, regardless of how creative policymakers and academics may

become. And being credible while irresponsible is more of a wish than a policy guide: an exceptional vote of confidence in the ability of central banks to game the system.

Rubén Segura conventionally justifies the need for this radical policy shift in reliance on four considerations: (i) inflation has been well below-target for many years and inflation expectations are far from perfectly anchored; (ii) at the lower bound, fiscal policy is a much more effective tool when smoothing shocks; (iii) the expectation of low rates for longer should make fiscal policy more effective; and (iv) strong fiscal policy today enhances the transmission of monetary policy and increases monetary space in the future.

The chapter goes on to explain how likely it is that fiscal and monetary policies will develop in EMU along his desired lines. For the ECB, we shall need to wait for the strategy review, but early indications point in Segura's direction. Further loosening of fiscal policies remains much more uncertain and constitute his main worry. He describes fiscal policy as too timid in Europe and demands further expansion, beyond compensating for the impact of the second Covid wave. Most importantly, more "hard cash" is needed. Why the timid fiscal response so far? Because governments need to worry not only about who will meet their funding needs this year and next (the ECB through PEPP), but also about who will refinance them in the future. And the ECB has fallen short of unequivocally addressing this second question. Therefore, it would seem that Segura is asking the ECB to promise to refinance public debt for 30 years. I am not sure it could do that without major political and legal opposition. And I am convinced it would not be a good idea, because it would constitute fiscal dominance.

Segura argues that the alternative is even worse: the possibility that the ECB is forced to adopt Modern Monetary Theory, MMT, debt cancellation, direct monetization or helicopter money. But even in those extreme policy interventions, he remains optimistic that the ECB: (i) could ascertain that it would be a one-off experience; (ii) is credible in convincing the market that it is a one-off intervention; and (iii) retains most of its control over how much to do and when to stop. Let us just hope we never get that far and be careful what we wish for. The internal cohesion of the Monetary Union would be severely tested. And redenomination risk could reappear.

2.3. TOWARDS A FISCAL UNION

Part III of the Yearbook, called Towards a Fiscal Union, comments on the unprecedented fiscal response in the Euro Area. It contains four distinct articles. We describe in detail the fiscal package adopted by the European Union, present the current state of the debate on conditionality in adjustment programs and the political economy of reforms, and assess fiscal union after all these reforms. Finally, we include a chapter on state aid and bank resolution which helps to link fiscal issues to the next section on banking regulation.

Pilar Más Rodríguez, from BBVA Research, writes in chapter 7, *The EU Budget: the new MFF and the Recovery Instrument: Next Generation EU*, that the European Union's first emergency measures constituted a three-pronged approach to build safety nets for

(i) health-related expenditures, through an ESM program, (ii) employment, through SURE, and (iii) economic and business activity, through the EIB and national promotional banks' guarantees and government support. But the nature of the response changed with NGEU and the Multiannual Financial Framework (MFF) for 2021-2027, which together constitute a quasi-federal initiative. NGEU amounts to a fiscal stimulus of €750 bn, which could increase GDP by more than 4% in 2024 for some countries. A reinforced MFF 21-27, of €1,074 bn supports NGEU.

The MFF shapes the budget cycle of the European Union for a period of seven years. It sets the limits on the amount of money that the EU can spend, the spending programs that determine how the money should be spent, and the rules on how to finance the expenditures. The MFF is accompanied by a Decision on Own Resources and is complemented by the annual budget approved by the Council and by the Parliament. The annual EU budget must be in equilibrium. The current 2014-2020 MFF expired on 31 December, and the new 2021-2027 framework had to be negotiated in a very complex environment dominated first by Brexit and further complicated by the pandemic. On 10 November 2020, the European Parliament and EU Member States in the Council, with the support of the European Commission, reached an agreement on the largest package ever financed through the EU budget, worth €1.8 tr.

NGEU constitutes an unprecedented joint support to recovery in Europe: a central EU fiscal stimulus that amounts to 5.4% of EU GDP, according to the European Commissions (2020b), with a strongly redistributive character.²¹ It provides a great opportunity, but also a big challenge for Member States. According to Pilar Más, it will test "their capacity of absorbing such a massive support and spend it on relevant projects." Based on optimistic assumptions about the quality of the programs, the timing of disbursements and absorption capacity, the overall fiscal stimulus combined with automatic stabilizers could reach 16% of GDP in three years. On average, the mobilized investment is estimated to increase real EU GDP levels by around 1.75% in 2021 and 2022, rising to 2.25% by 2024. It would entail an increase in potential EU output growth of 1%.

Member States have to prepare Recovery and Resilience Plans, RRP, within a coherent package of reforms and public investment projects to be implemented up to 2026. These plans must be aligned to the priorities of the European Semester (i.e., economic stability, digitization and productivity, green deal and social fairness) and should demonstrate how the investments and reforms would effectively address challenges identified, particularly the country-specific recommendations adopted by the Council. Member States can submit their recovery and resilience plans from the moment the Facility is legally in force to 30 April 2021.

The discussions surrounding NGEU are extensively covered in this chapter and will not be repeated here. Key questions have been its magnitude, the funding, the distri-

²¹ According to Bruegel estimates based on European Commission and IMF data (see table 3 in this chapter), some countries could obtain up to 15% of their GNI in grants and guarantees and others less than 1%. But it should be remembered that these are mere estimates of maximum possible amounts.

bution between loans and grants, the allocation for programs²² and countries,²³ the conditionality attached and the way to enforce it, and the process and timing for disbursements. It is worth emphasizing that (i) country allocations are mere estimates of maximum potential disbursements, but they are not country entitlements; (ii) national programs need to be approved by the Commission; (iii) the approval is based on two set of compatibility criteria: with core EU priorities and with the specific European Semester recommendations for each Member State.

NGEU, writes Pilar Mas, establishes a joint funding model to support government spending and reform. It constitutes a great opportunity for Europe to move forward with fiscal integration: (i) a forward-looking and not legacy-based step towards a fiscal union; (ii) a powerful countercyclical fiscal instrument that could lead in the future to adopt regularly an EU-wide fiscal stance; and (iii) a potential precedent for a safe European asset, since it will be financed through common bonds backed by all countries that are eligible for ECB purchases. It is undoubtedly the most significant development in the institutional architecture of EMU since the creation of the Single Supervisory Mechanism and the Single Resolution Mechanism.

But it is only a promise, a potential game-changer, and its main drawbacks should not be underestimated. From a purely macro point of view, actual disbursements will come late in the cycle, most likely when the European recovery has already picked up with the boost in confidence caused by the availability of vaccines. This should serve as a reminder of the limitations of fiscal policy, namely the implementation lags that could be pervasive in a fiscal union under construction like EMU. From a conceptual perspective, NGEU is a one-off fiscal measure that combines structural adjustment with macro stabilization. Not a good policy recipe, as becomes evident in the fact that some of the EU general goals are not obviously compatible with Spanish priorities, i.e., job creation. And finally, from the institutional side, two questions remain: it is explicitly not recurrent, it is not a permanent facility, and it is not a European Monetary Union program but an EU program. It is hard to imagine the need for fiscal union outside EMU.

The discussion about NGEU is taken to a more conceptual level in chapter 8, where Antoni Roldán, the director of ESADE Geo EcPol, writes about *Why Next Generation EU might be a poisoned gift (and how to avoid it)*. He notes that for too long the focus has been on “discussing what needs to be done in the economy, but too little attention has been paid to how to make reforms actually happen.” So, this chapter is about making reforms

²² It is worth noting that each instrument of the package will be allocated differently and there will be no cross-country allocation key at all.

²³ The allocation key for 2021-2022 is based on 2019 population, the inverse of GDP per capita and the relative unemployment rate over the past 5 years. In the allocation key for 2023, the unemployment criterion will be replaced, in equal proportion, by real GDP growth in 2020 and over the period 2020-2021, initially based on the Commission’s Autumn 2020 forecasts as updated 30 June 2022 with the latest figures. This allocation has been questioned since it is based on data prior to the pandemic and therefore not suited to offset its impact.

happen, about ensuring NGEU is not another wasted opportunity and succeeds in increasing long-term growth and cohesion in Europe.

Roldán explores one stylized fact of economics. that meaningful reforms are seldom implemented in the good times, when they would theoretically be easier because of the availability of funding to compensate potential losers. And he applies his reasoning to the current situation in Europe, where the political and economic incentives for reform could hardly be worse. Politically, because of adjustment fatigue, populist and weak governments, and fragmented parliaments. Economically, thanks to the unusually low cost of public borrowing, guaranteed financing, the absence of external constraints and loose surveillance and peer pressure. But that does not mean that “we should just give up on reforms, close our eyes and hope that governments will use the massive windfall of money wisely.”

This chapter reviews the somewhat naïve but widespread expectation that EMU would precipitate structural change and productivity-enhancing reforms, and thus help less advanced countries catch up with the richer European core. And the author observes that the rhythm of reforms accelerated prior to monetary unification, precisely because nobody wanted to be left behind, and practically stalled after entering the Union. Nevertheless, most peripheral economies experienced high growth with the euro, fueled by strong credit expansion. This is a well-known effect in emerging economies implementing an exchange-rate stabilization program, because in southern European economies, that is exactly what adopting the common currency amounted to. With high growth, incentives to implement reforms vanished. Until the GFC created another period of reform, under duress and external discipline. This intense recent reform process did not last long and faded as soon as the credit limitations started to relax with the easing in monetary conditions and advances towards banking union. This is a story of moral hazard, although Roldán shies away from using that term. Consequently, this chapter reviews recent theoretical literature and empirical evidence on reforms to conclude that most of the relevant variables that have driven reforms in the past seem to go in the wrong direction in Europe today.

The pandemic is set to harm particularly the southern European economies. We have seen that poor governance, on top of structural and possibly cultural issues, appears to have been a key driving factor. Thus, the difficult question for the EU is how to make solidarity compatible with reform incentives, risk sharing and monetary and fiscal mutualization with fostering the required structural change. Because, if that is not the case, governments in the European core will struggle to justify to their domestic constituencies the support given to weaker countries. And Euroscptics could exploit this to pose a truly existential challenge for EMU.

Over the years, in line with standard practice at the IMF and the World Bank, the European Commission has focused on a specific reform strategy which Roldán describes as “do as much as you can, as best you can.” In other words, the laundry-list strategy. He argues that a more nuanced approach to reform priorities in EMU is needed and proposes moving from the failed “laundry-list strategy” towards a “more honest conversation, engaging governments and the EU institutions, to discuss not only the objectives but also

their political viability.” The idea is to arrive at a consensual identification of the two or three most pressing binding constraints for inclusive growth. And he offers a case study of how such a consensual approach could work with labor market reform in Spain.

The literature on conditionality is as vast as that of development economics and economic growth. Lately, it insists on the ownership of reforms by the governments receiving external funding and the idea of simplification and prioritization (Rodrik, Hausmann and Velasco (2008) (IMF Policy Paper, PPEA2019012)). These ideas are in line with Roldán’s proposal but are very difficult to make operational and effective “in the field”. Because at the end of the day, who decides the priorities if vested interest and short-term political gain condition national governments? Who sets benchmarks and structural performance criteria? And the “smoking gun” question, should disbursements be subject to a priori conditionality, no matter how ideally reached, or compliance be assessed only ex post? These are, in my view, very hard political - not technical - questions, which can only be answered by creditors, deciding on what terms to make funds available, and debtors, deciding if and when to use them. With the additional difficulty in the European Union that it is a political union of Member States, not just a credit cooperative, and that its decision-making process is extremely complex, and its legitimacy constantly questioned but crucial.

Fiscal union remains the unfinished business of euro architecture. With every crisis, the evidence of structural flaws in the architecture of the economic and monetary union becomes more evident. Therefore, we asked Enrique Feás, at Elcano Royal Institute, to explicitly address in chapter 9 *The State of The Fiscal Union in The Eurozone: Are We Closer to A ‘Hamiltonian’ Moment?* In a simple world, a fiscal union would be easy. In a loose political union like the EU, fiscal union requires: (i) a clear fiscal framework, (ii) economic policy coordination, (iii) common automatic fiscal stabilizers, (iv) a common discretionary public investment tool, and (v) a safe euro asset. This chapter reviews developments in all five aspects. In an economic and monetary union, the stabilization function of monetary policy can only be exercised jointly. But EMU was created on the premise that countries would cope with asymmetric shocks by their own means. There are three possible channels to respond to these shocks (the income, credit, and public policy channel), but it is well known that, in the Eurozone, none of them is particularly strong (Hernández de Cos 2018).²⁴

Feás recognizes the broad consensus that the current fiscal framework is inefficient and overly complex and should be rebuilt and simplified. The European Court of Auditors (2019) has pointed out that “the Commission has so far only limited assurance that the EU requirements for national budgetary frameworks are properly implemented and applied.” Larch and Santacroce (2020) estimate that, on average, budgetary policies have been compliant in just over half of cases, with largely persistent differences across

²⁴ The income channel is not very high because of low internal labour mobility. The credit channel is very weak because of the lack of euro-wide retail banking and cross-equity holdings. The public policy channel in the eurozone, obviously, has nothing to do with that of a federal state. That would require a common treasury with a sufficient budget.

countries. The European Fiscal Board (2020) insists on the need for a clear debt anchor and a credible expenditure rule that allows for country-specific adjustment speeds to reach the debt anchor.

The coordination of economic policies within the EU takes place through the European Semester, which has not been particularly successful in enforcing its recommendations. There is no specific EMU mechanism. However, NGEU provides the Semester with strong leverage to become binding, if the political will exists, by linking it to the approval of funds. “The introduction of a component of intergovernmental control by the Council of the EU (a controversial issue) can be considered reasonable,” writes Feás, as no individual country has a veto right and therefore the process remains European in nature. In line with the previous conclusions on the political economy of reforms, it constitutes an interesting precedent in creating adequate incentives, a good combination of carrots and sticks. And a good reminder that there can be no further fiscal mutualization without discipline, as this Yearbook has been systematically arguing.

The pandemic is a perfect reminder that common shocks can have profound asymmetric effects. Therefore, EMU requires standard fiscal tools to stabilize national economies. There are two possible solutions: (i) a budgetary buffer built in good times, that would be available to countries experiencing economic downturns, typically called a “rainy day fund,” and (ii) an unemployment insurance system. As we have indicated, the pandemic brought SURE. It is not a complementary insurance scheme, but the author believes it could one day become a permanent mechanism to soften the impact of unemployment asymmetric shocks (that would necessarily include rules to prevent moral hazard). But that is not yet on the political agenda, I am afraid.

Automatic stabilizers are useful, but large enough crises will always require discretionary public measures. The problem in EMU, especially for countries with high levels of debt, is that these policies cannot be carried out without eventually questioning debt sustainability. Precisely for that reason, the EU put in place the Juncker Plan in the previous crisis. But it was only a temporary measure. Although in 2017 the Commission proposed a European Investment Stabilization Function (EISF), it was never approved, stuck in the conditionality versus moral hazard debate, as we have already indicated. The Recovery and Resilience Facility within NGEU is, precisely, an investment instrument, but once again a one-off initiative.

In a monetary union, countries issue debt in a currency that is not strictly their own, which makes them vulnerable to the whims of financial markets and to the banking sovereign doom loop. This became evident in the 2010 euro-debt crisis. As our readers know (2013 Euro Yearbook), this source of instability can only be fully overcome if and when the Euro Zone enjoys a safe common asset, like any other lasting monetary union. But the Union has been unable to gather the necessary political support for such a transfer of fiscal sovereignty. Economists and policymakers have put forward a wide array of proposals to reduce sovereign risk with some sort of hybrid derivative, either by fostering risk diversification or by creating different senior tranches of debt. This literature is fully covered in this chapter. None of these proposals has gathered enough political support, and none seems to have solved the fundamental problem that hybrids perform in crises

as the worst of their components. Furthermore, the debate came to a standstill when Merkel was quoted saying there would be no Eurobonds as long as she lived.

However, extraordinary times call for extraordinary measures, and at least three types of European assets have emerged with the pandemic. First, the ESM Pandemic Crisis Support, a sovereign credit line for healthcare expenses guaranteed by the capital of the issuing institution. Second, the SURE instrument, common debt issued for employment purposes, backed by voluntary guarantees from MS. The third ‘European bond’, and the most important, will be the debt issued by the Commission to cover the expenditures of the NGEU. NGEU debt is not only guaranteed by future European budgets, but also repaid from the budget. The European Council considers this a very exceptional case. The proceeds to repay the common expenditure will come from new “own resources”, a temporary 0.6 p.p. increase in the ceiling of own resources until the debt is cancelled. And if these new resources are not enough, funds will come from Member States on a pro rata basis according to the Gross National Income (GNI) key. If, at that moment, any MS cannot honor its obligations, no country will pay for it. And in that extreme case, NGEU could only be considered a deferred payment, a zero-interest rate loan with a transfer component. Many authors have made an issue of this feature (see also chapter 2), but I honestly find it politically irrelevant (albeit technically appealing) given the highly unlikely probability that a Member State would decide not to meet its obligation to the Union, because of the uneven capacity to retaliate.

More significant is the point raised in this chapter about the absurdity of the apparent lack of interest for this credit tranche, precisely among those countries that have been the most vocal advocates of a safe asset. The price of this euro asset will be linked to the EU credit rating, but also to the depth and liquidity of the issue: the larger, the more appropriate as an experiment of what a Eurobond could be in terms of an investment asset and as collateral for the ECB’s monetary policy and to reinforce the role of the euro as an international reserve asset. If the first real Eurobond were to fail for lack of use, it would be difficult to explain why.

Chapter 10 provides another link between fiscal and monetary policy. Antonio Carrascosa, a former Board Member at the Single Resolution Board, writes on *How to improve small and mid-sized bank crisis management?* The EU, in line with the requirements of the Financial Stability Board (FSB), has issued a set of banking resolution rules that apply mostly to large banks. For smaller banks, national, non-harmonized rules are applicable.²⁵ Carrascosa argues that an incomplete banking union creates unfair competitive advantages and studies the different alternatives to achieve a homogeneous and fair treatment for the creditors of a bank in distress, independently of the home country of the bank and the applicable rules (resolution or liquidation). He proposes, due to its swift implementation potential, to increase the share of resolution versus liquidation cases, since we have a single resolution framework in EMU. And he puts forward differ-

²⁵ Namely: national insolvency proceedings and the national transposition of the Deposit Guarantee Schemes Directive (DGSD), Directive 2014/49 of the European Parliament and of the Council of 16 April 2014.

ent flexible ways for the Single Resolution Board, SRB, to assess the public interest that justifies resolution: (i) apply a regional or local scope to the concepts of critical functions and financial stability; (ii) consider the classification of a bank as domestically systemically important as a key element of the public interest assessment; and (iii) rule that all banks under the remit of the SRB would have a positive public interest assessment and therefore be eligible for resolution. But the author warns that moving banks to resolution implies doubling the necessary MREL buffers, which would be difficult and costly for many small banks.

Theoretically, a better alternative would be the harmonization of national insolvency proceedings, with the view to soon reach a European liquidation regime with the same tools as the existing SRM. This has been a recurrent demand of the IMF Art IV consultations with the Eurozone, but it is systematically resisted by MS because of entrenched differences in the national treatment of creditors. The author favors a European administrative liquidation regime for banks, again because of efficiency, but acknowledges that it implies increased litigation. An efficient administrative European regime would (i) minimize the typical value destruction of a liquidation, (ii) harmonize the treatment of bank creditors regardless of jurisdiction and whether the bank is resolved or liquidated, and (iii) reduce incentives to the use of State aid.

A third possibility would be to rely more on a Deposit Guarantee Scheme (DGS) to prevent bank liquidations, and to facilitate a more flexible and efficient way to use its funds in liquidation. The DGS Directive only allows the transfer of deposits of a bank in crisis with the support of a DGS. But all remaining assets and liabilities should be liquidated, thus reducing financial needs in liquidations and impeding the pay-out of deposits to many depositors. But the directive has been transposed loosely in many Member States and Carrascosa asks for a European Regulation. He also insists that moving forward with EDIS, the European Deposit Insurance Scheme, could be helpful to avoid the bank-sovereign loop as a constant threat in liquidation.

Finally, the chapter comments on the use and abuse of State aid to avoid the resolution or liquidation of a bank. The European resolution framework was designed precisely to minimize the use of taxpayers' money and therefore runs contrary to the logic of State aid. Moreover, some State aid rules are not aligned with those of bank resolution (i.e., the divergence in the burden-sharing rules), and therefore could lead, as they in fact have, to a preferential treatment of some banks' creditors in a precautionary recapitalization. But State aid rules are here to stay, as I think they should, and they have been useful, for instance, in coping with the pandemic. The European Commission adopted in March a temporary framework for State aid, which has been extended until 30 September 2021. It entails an exemption from the traditional burden-sharing rules applied widely in the GFC. Although this exemption framework has not yet been used with banks, Carrascosa is critical of that possibility. For my part, I find it a necessary escape clause, just as the one existing for the fiscal rule, since the presumption that there will no public money to rescue banks is an illusion in a systemic crisis like, potentially, the one that could result from Covid-19. The trick in this context is to arrive at a common use and authorization of State aid that does not create unfair advantages for more audacious Member States.

2.4. DISCRETIONARY FORBEARANCE

Part IV, the closing part of the book, discusses financial regulation. It sets out to answer a simple question: did the lessons learned in the recent Global Financial Crisis help prevent another episode of financial instability as a consequence of the pandemic? To that effect, it includes three articles that look at the European, North American and international experiences. All three have a unique perspective: how did the supervisory and regulatory authorities react? What are their commonalities and specificities? And what can we say about the future of the financial system?

In chapter 11, Christian Castro and Ángel Estrada, of the Bank of Spain, write on *Financial Stability and Banking Regulation in the context of the Covid-19: Some early Policy Reflections*. In their opinion, the GFC left some clear messages for policymakers that have proven useful this time around: (i) the importance of acting pre-emptively and having counter cyclical regulation; (ii) the need to correctly align bank's incentives as an institution, to those of the different stakeholders; (iii) the essence of measuring risk properly in prudential indicators; (iv) the fact that size and complexity of financial institutions matters; and (v) that financial health of individual financial institutions is only a precondition to ensure system-wide financial stability.

The benefits were patent at the onset of the Covid-19 crisis. Banks entered this crisis with more and better capital, and higher liquidity reserves than in the last financial crisis. Just before the Covid-19 outbreak, the BCBS agenda was mostly focused on the implementation and evaluation of the agreed reforms, most notably the “output floor”, and on the analysis of emerging risks and of new financial actors. But then, the Covid-19 hit hard. This chapter describes the most important measures taken by the different actors - the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the European Commission (EU Com), and the European Banking Authority (EBA) - and we will not repeat them here.

During the first phase of the pandemic, the policy response sought to contain its impact on the economy by helping financial institutions to maintain lending to the real economy without compromising their resilience. Initial measures in this context can be classified in two broad categories: (i) those seeking to free up banks and supervisory operational capacity, basically by allowing the use of contingency buffers and relaxing or postponing certain regulatory requirements, and (ii) those encouraging usage of the flexibility embedded in existing standards to avoid undesired mechanistic reactions - most notably, measures allowing the smoothing application of the Expected Credit Loss, ECL, accounting framework. But once the initial shock has been averted, Castro and Estrada warn that policy responses should adjust and become more selective to prevent financial stability risks.

Given the broad range of support measures adopted, the prudential treatment of non-performing and forborne exposures has become a central area of attention in the Covid-19 crisis. The EBA clarified that the public and private moratoria signed until September 2020 that fulfilled certain characteristics do not have to be automatically classified as forbearance measures. Hence any significant increase in the credit risk of banks

exposures should be based on the identification of significant changes over the total expected life of the exposure.

All in all, policy intervention has so far been a success.²⁶ In Spain, for instance, as this book went to print, credit continued flowing to the economy and markets have stabilized. On the corporate side, there have been no massive exits, ratings downgrades or marked increases in NPLs. Banks' balance sheets have not yet reflected a sharp increase in credit risk, though it can be expected that loan impairments will materialize in coming quarters as the contingency measures are unwound. Going forward, prudential policies have the challenging task of striking the right balance between facilitating economic recovery and promptly recognizing possible deteriorations in credit quality so as to avoid the need for abrupt adjustments.

Castro and Estrada, from their vantage point when assessing the consequences of the Covid-19 crisis, underline three broad implications for prudential policy. First, credit risk may have been anaesthetized but it has not vanished. Banks should be ready to promptly recognize, on their balance sheets and income statements, any possible deterioration in the quality of their credit portfolios, even when these risks will take some time to materialize. Similarly, banks should carefully assess repayment capacity, adequately classify customers and allocate provisions in advance. Second, policymakers and banks will have to deal with significant inter-temporal trade-offs that largely depend on the duration and severity of the pandemic. As a result, the pandemic generates a range of possible macro recovery scenarios that should be integrated with decision-making. And third, the mix and type of policy actions need to adapt to the evolution of the pandemic.

And the authors conclude by identifying short-term challenges and initial lessons for a longer perspective. Among the former: (i) to ensure that buffers remain usable when most needed, which needs to consider that banks may be reluctant to use their buffers if the underlying binding constraint is not the regulator but the market; (ii) to avoid cliff effects when unwinding support policy measures; (iii) to identify and tackle channels of heightened risk transmission from the economy to the financial sector, which in our context require responses that can only be addressed at the EU level. Finally, this crisis would bring regulators and policy makers to (i) explore making buffers more releasable and risk-varying, (ii) assess the adequacy of introducing certain simplifications to the capital framework and, eventually, consider giving greater weight to the usability objective in the design of the buffers, and (iii) maintain an active and coordinated communication strategy to complement the regulatory and supervisory actions.

In turn, the banking system should prepare for a post-Covid environment of 'lower for longer' interest rates and an increasing activity of outsiders in financial intermediation.

²⁶ The ECB published in late July the results of its sensitivity analysis on the impact of the Covid-19 shock on 86 Euro Area banks over a three-year horizon. Its results suggested that the Euro Area banking sector on the whole would be able to withstand the Covid-19 shock, although the reduction in banks' capital under the most adverse macroeconomic scenarios would be significant. But, obviously, these are aggregate results that do not preclude specific problems at some institutions.

The first issue suggests that banks should continue to make efforts to improve profitability, including by means of consolidation and by investing in a more efficient use of customer information. The second implies that regulatory authorities will need to be more proactive to close any regulatory gaps, thus contributing to a level playing field and avoiding an excessive regulatory burden.

Chapter 12 brings into the European debate potential lessons drawn from the US Federal Reserve experience with the pandemic. It specifically addresses *How strong and liquid banks helped the Federal Reserve prevent a financial crisis this spring*, and is written by Bill Nelson, Francisco Covas, Gonzalo Fernández-Dionis and Adam Freedman of the Bank Policy Institute. Between mid-February and the end of March, the financial system experienced a shock as bad as September 2008. However, this shock did not cause a financial crisis, thanks to the rapid and massive response of the Federal Reserve, but also, the authors argue, to the strength of the banking sector going into the crisis. To prove the point, they construct a *financial stress index* to determine the probability that a situation warrants emergency intervention by the Fed.²⁷

The striking difference is that this index remained elevated for nearly 6 months after Lehman but fell sharply within a few weeks after the coronavirus shock (see exhibit 1 in this chapter). As of 12 June, the index gives a probability of approximately only 1% that current conditions are consistent with emergency Fed intervention. The authors use their financial conditions index to illustrate the market's post-Covid-19 response to Fed actions. The main drivers of big increases in the index were news about the pandemic, not news about the Fed or financial institutions. Indeed, markets reacted negatively when the Fed cut rates to zero on 3 March. However, Fed and legislative actions resulted in a sustained decline in the index: namely, the Fed's sweeping announcements on 23 March and the introduction of the CARES Act on 25 March.

This chapter gives a detailed account of the US Fed response to the pandemic (see Table 2 for a complete comparison of Fed emergency facilities used now and in the GFC, and Table B in the Appendix for a detailed timeline of policy interventions). They can be summarized as follows: (i) monetary policy accommodation - in a series of swift policy decisions spanning two weeks, the Fed lowered its target rate by 1.25 p.p., including an emergency cut of 1 p.p. on 15 March, reaching 0-0.25%, but refusing to bring rates into negative territory; (ii) swift asset purchase programs - in just three weeks beginning on 15 March, the Federal Reserve bought \$1 trillion in Treasury securities; (iii) Fed Emergency Facilities, which, in another contrast to the GFC, remained mostly unused;²⁸ and

²⁷ The index is constructed by calculating the average level, volatility, and correlation of a dozen standard measures of financial stress such as implied volatilities, risk spreads, and off-the-run spreads and use those three variables to fit a logit model for Fed emergency intervention. Details on the model and the data are provided in this chapter.

²⁸ The three facilities that reportedly helped ease conditions the most were the Primary Dealer Credit Facility, the Money Market Mutual Fund Liquidity Facility (MMLF) and the Commercial Paper Funding Facility (CPFF). All three are direct copies of facilities opened in the wake of the Lehman failure, although much less used this time.

(iv) the Federal Reserve eased terms on the discount window and central bank swap lines.

Thus, while the Fed responded quickly and forcefully, the conditions did not, in the end, require much emergency lending, in part because simply opening the programs helped calm financial markets. Additionally, the Fed provided ample regulatory relief in different formats: capital, liquidity, CECL (current expected credit loss), forbearance (CARES Act loan forbearance program), and restrictions on bank pay outs, although, contrary to the ECB, dividends were not suspended but only limited in relation to capital and past profits.

Moreover, bank resiliency was tested using three scenarios designed to capture the potential impact of Covid-19: A V-shaped recovery; a slower U-shaped recovery; and a double-dip recession or W-shaped path. In aggregate, loan losses would potentially range from \$560 bn to \$700 bn implying an aggregate capital ratio decline from 12.0% to between 9.5% and 7.7%. Under the more severe scenarios, most firms would still remain well capitalized, but several would approach minimum capital requirements. Following the publication of these results, the Fed urged banks to re-evaluate their long-term capital plans and announced a second round of stress tests in 2020. Two new macro scenarios, which were even tougher than the severely adverse scenario used in the June 2020 exercise, were published on 17 September, and also the yield curve was flatter in the second stress tests, creating more headwinds for bank profitability.

A critical difference with the GFC is that, back then, banks contributed to extend and amplify the disarray, whereas now they are part of the solution, write the authors. As is well known, banks were then weakly capitalized, held few liquid assets, and were exposed to losses from private mortgage-backed securities and other structured products. Since then, much has been done to heal the banking sector and make it safer and more resilient. Thus, according to the data provided in the Fed's May 2020 Supervision and Regulation report, large US banks have doubled their capital ratios and quadrupled their liquidity holdings. And they are rigorously tested each year for their ability to withstand a massive downgrade of the economic outlook.

To compare banks' contribution to financial market stress during the two periods, this chapter provides a counterfactual representation of the financial stress index discussed above. And they conclude that "approximately 42% of the sharp increase in the index that followed the Lehman collapse reflected a widening of bank credit spreads. In contrast, increases in bank credit spreads contributed only 17% of the jump in the index during the Covid period." In March 2020, just as in August 2007, banks were again hit by massive draws from lines of credit, but this time the consequences were quite different. Between 12 February and 1 April 2020, bank loans increased by over \$700 bn, in large part because banks were funding drawdowns from lines of credit as businesses sought to stockpile cash. By contrast, Fed lending peaked at about \$130 bn at the beginning of April. And, despite these massive draws, banks faced no material liquidity challenges, and counterparty concerns remained largely subdued. In March 2020, there was a profound liquidity shock, but, with no counterparty or own-liquidity concerns to amplify it,

it quickly subsided. This chapter therefore concludes quoting Fed Vice Chair Clarida, “banks are a source of strength and credit for the economy. And that’s important.”

Chapter 13, the last chapter of the 2021 Yearbook, takes a global perspective. Fernando Restoy, at the Financial Stability Institute, looks at *Banking supervision after the pandemic*. He starts by assessing that the response from regulators to this pandemic has been remarkable: the boldest and the most synchronized ever. Possibly for the first time, they have explicitly assumed a macro-stabilization role. Interestingly, these measures were not aimed at containing excessive credit growth but, on the contrary, to ensure the flow of credit to the private sector. This global action to avoid a credit crunch marks the big difference from earlier crises. Regulators’ actions covered all key elements of the prudential framework, including capital requirements, asset classification, capital distribution and the supervisory strategy.

Yet these actions will need to be followed up by effective supervision of individual financial institutions. This task will face three significant challenges: (i) substantially riskier business conditions for banks, which affect nearly all sources of risk (credit, market, liquidity, counterparty, operational, etc.); (ii) regulatory measures to support credit flows to the real economy involve complicated supervisory work and could make banks’ financial health more difficult to assess;²⁹ and (iii) the pandemic makes it more difficult for supervisors to conduct on-site missions, and hence to assess a bank’s risk profile, even if new technology has helped.

The overall short-term challenge for supervisors is to achieve the right balance between the macro and micro-objectives of prudential regulation. Arguably, the most relevant Basel III macroprudential instrument was the CCyB. But it has been practically useless, given the starting low or zero level in most jurisdictions. Thus, authorities have resorted to essentially microprudential instruments. There is a limit on what microprudential policies can do to support aggregate credit developments without jeopardizing the safety and soundness of individual financial institutions. No doubt that banks’ practices should remain consistent with a sound evaluation of asset quality and with an adequate disclosure of their expected losses. But market expectations may well play against it, under considerable supervisory forbearance. The challenge, therefore, is to keep a supportive macroprudential policy while, at the same time, continuing to closely monitor individual financial institutions. Well-designed stress tests could certainly help. Yet the conduct of such exercises is today particularly complex given prevailing uncertainty. Finally, it would seem wise to step up contingency planning for resolution.

²⁹ The flexibility provided for the classification of assets as non-performing or forborne makes it challenging for supervisors to monitor the evolution of asset quality. The extreme case is in jurisdictions, particularly in emerging market economies, that have gone as far as freezing the classification status of all credit exposures prior to Covid-19 (IMF and World Bank (2020)). And most countries have suspended the application of the objective past-due criterion to identify non-performing exposures (NPEs) for all loans that benefit from payment deferrals, thus relying exclusively on the more subjective unlikely-to-pay criterion.

While these measures are necessary, they will not be sufficient to address the broader longer-term challenges faced by the banking sector worldwide. In particular, short-term uncertainty exacerbates the challenges generated by technological disruption and persistently low profitability in some jurisdictions. Similarly, operational risks associated with remote working during lockdowns add to the trend of increasing reliance by banks on technology and third-party providers. Over the longer term, climate change and energy transition policies³⁰ could further affect banks' financial strength. This chapter encourages supervisors to take this opportunity to accelerate their response to these structural vulnerabilities. And it makes a strong point, following Restoy 2018, about excess capacity in the banking industry in Europe, and the large proportion of institutions that operate under only limited market discipline. In these circumstances, he argues, supervisors should be entitled to adopt a proactive strategy to facilitate an orderly consolidation of the industry. Supervisors appear to have listened to his arguments while competition authorities have not shown themselves to be overly concerned.

Moving on to regulatory challenges, this chapter makes interesting observations. First, as shown in the actual stress tests conducted in major economies, the financial system seems generally able to absorb the pandemic's impact even under the severe scenarios. But also, the crisis has shown that some components of the post-crisis reforms have had some unanticipated effects: namely (i) the expected credit loss provisioning has led to a destabilizing procyclicality; and (ii) the Basel III buffer system has not proven as flexible and efficient as expected.

To judge how the buffer system is performing in the current crisis, it is necessary to acknowledge the wide variety of approaches followed in different jurisdictions. That heterogeneity arises in part from the different interpretations and calibrations of the Basel Pillar 2 and the differences in national or jurisdictional overlays (supervisory buffers (SB)) above the Basel III capital stack. In particular, in jurisdictions such as the EMU, the UK and the USA, supervisors expect banks to meet additional buffers, which are calculated as a function of the capital depletion that banks would suffer in an adverse scenario of different types of supervisory stress test. Those jurisdiction-specific buffers are set annually for each institution as part of the supervisory cycle and can be used to absorb unexpected losses.

Restoy observes that since the only purely macroprudential tool, CCyB, has proven practically useless, regulators had to rely mainly on microprudential instruments (such as the capital conservation buffer (CCoB), or the supervisory buffer (SB), to meet a macroprudential objective (Carstens (2020)). The result has not so far been entirely satisfactory, as banks have generally been reluctant to use the buffers, whether because of the impact on the pricing of hybrid instruments that qualify as capital or because of a purely

³⁰ Restoy takes a more cautious approach to green regulatory policy than the one shown by Lagarde at the ECB. Regarding climate change, he writes: "no international consensus yet exists on how to embed these risks into regulatory and supervisory requirements. It seems logical to accept the principle that prudential regulation should not promote green finance as a way to fight climate change. Instead, this should be addressed by other policy instruments such as carbon taxation".

stigma effect. Under conditions of fundamental uncertainty, investors may penalize any capital reductions below the regulatory benchmarks, even if this is supported by supervisory guidance. Therefore, as chapter 11 also argued, supervisors' willingness to accept a temporary use of the buffers may not suffice to ensure credit supply.

To address this, Restoy notes several options. One conservative approach would be to work on the actual penalties faced by banks, i.e., constraints on the remuneration of holders of equity or other instruments, if they use existing buffers. A more ambitious approach would be to establish a larger macroprudential buffer that could be released at discretion during bad times. Such a buffer would replace the current CCyB and would have a positive level in normal times in order to accommodate unexpected shocks. This approach would imply a de facto increase in the average capital ratios over time and there seems to me no obvious reason why it would not suffer the same practical limitations as the CCyB. In any case, it would entail some transfer of powers from microprudential to macroprudential authorities, an issue that is particularly significant in EMU, where the microprudential responsibility is centralized at the SSM (ECB) while macroprudential responsibilities remain largely decentralized. Moreover, for international banks, the host authorities would have more influence on capital requirements for the group.

3. THE TEN EUROPEAN LESSONS FOR 2021

The European Monetary Union has responded to the extraordinary challenges posed by the pandemic with surprising diligence, effectiveness and cohesion. It is now the time to move forward and consolidate some of the decisions taken in those turbulent moments. This book has been conceived and produced as a comprehensive policy paper to guide and illustrate the European debate on the future of EMU in the post-Covid 19 world.

To that effect, the topics of the different chapters were selected and changed as the crisis evolved and different priorities and policies were formulated. Readers will find that our basic purpose has been to explain and assess the quantum leap in European policy-making that has taken place in 2020: its merits, but also its challenges for the future. In so doing, we have been forced to leave out topics that will undoubtedly dominate future monetary debates, namely the discussion surrounding Central Bank Digital Currencies, CBDC, and specifically the *æ*euro, which we covered in our previous Yearbook. But the range and depth of the policy measures introduced in 2020, and the nature of their implications, left no alternative.

On that basis, we kept to our commitment to select the different authors to reflect the diverse perspectives, interests and positions on the most relevant policy debates. We have never searched for unanimity, and this edition is no exception, full of rich debates among our authors on the rationale and implications of the policies implemented. But we have also kept to our basic principle to contribute, to the best of our knowledge and ability, to help complete the Euro project, to make it stable and permanent. I want to thank all contributors for their insights and proposals, which cover all current policy debates.

And this is not an exaggeration. The issues are on the table, opinions and proposals are plenty. We have done our job to lay them out. The task ahead is to draw adequate lessons from this most unexpected year, and to make the necessary permanent and institutional changes to the architecture of the European Monetary Union to ensure it is prepared to cope with fundamental uncertainty. Economic policy can never fully isolate society from external drastic shocks; politics in general can never achieve such an ambitious goal; but it should at least help not to repeat the same mistakes and to be better prepared for the “known unknowns”. So, we close this executive summary of the Yearbook, as has now become customary, with a snapshot of our “Ten lessons for the European Monetary Union from the Covid crisis”. Those lessons are also, to some extent, our wishes for the future.

First, political will. EU institutions have regained popular support and proven its usefulness. Let us not waste the momentum and use the opportunity with determination to complete the monetary union. The common effective response to the pandemic has shown that boldness pays in a political climate too long dominated by overly cautious leaders. The Treaty of Rome was a radical move that shocked many in Europe. A post-pandemic world characterized by the US-China confrontation leaves no room for a timid Europe that shies away from conflict. Quoting president Macron with some liberty, “the European Monetary Union is a political project, not just a market one.” The time has probably come to move from words to a new Treaty.

Second, this year has also witnessed the first ever separation from the European Union. A terribly sad moment but also a moment of pride, because it ended in agreement, as it should, between two old friends who decide to part but need each other, for the benefit of both and of the world. For the European Union, Brexit provides the opportunity to fully institutionalize the Monetary Union, to reaffirm that it is the end game for all EU Member States, and that current monetary arrangements should only be considered transitory. Only then can EMU aspire to correct the inefficiencies embedded in the current decision-making process and acquire the legitimacy necessary for the transfer of sovereignty involved.

Third, the European Central Bank is in the midst of the review of its monetary policy strategy. There are plenty of well-informed opinions on what the review should accomplish and many pressures from interested stakeholders. Before widening its mandate, the ECB, as the monetary authority of the Euro Area, should make a clear statement on three fundamental issues: the inflation target and the necessary revisions to the current rule, the effectiveness of the monetary policy toolkit with negative interest rates for very long periods, and, perhaps the most uncomfortable but also the most critical issue over the medium term, its ability to conduct monetary policy for the Euro Area without a European safe asset. As long as it operates without it, the ECB will necessarily take quasi fiscal decisions, and be criticized for it.

Fourth, the ECB needs to define an exit strategy for its negative interest rate policy, before fiscal dominance becomes unavoidable. Quantitative easing was the only alternative to respond to the pandemic: to accommodate and smooth over time the financial consequences of the exceptionally loose fiscal policy that the health and economic emergency demanded. But the size of the ECB balance sheet cannot increase indefinitely.

Nor can the ECB permanently suppress the government budgetary time constraint. To do so will not only amount to fiscal dominance, but it will also erode central bank independence, precisely at a time when some apparently new but very old theories, and populist governments everywhere, are demanding that central banks again become the most powerful instrument of the executive power.

Fifth, Europe needs a strategy to deal with potential sovereign debt restructurings. This is a crucial issue in any lasting monetary union where governments can no longer count on printing their money to meet their financial obligation. The Maastricht Treaty was signed under the pretense that there would be no bailouts, that misbehaving governments would be left to rot or adjust at their own cost. The Euro debt crisis showed that contagion was pervasive and threatened to implode EMU. But the solution reached - an ESM adjustment program and ECB bravado - was only temporary. This time, the ECB has taken upon itself the obligation to hibernate sovereign debts and to compress spreads to historical minimums, but this is again only a temporary solution. It postpones but does not solve the problem. A clear and credible strategy needs to be agreed by the European Council, the Commission and Parliament, because it is not within the mandate of the central bank.

Sixth, the saga of NGEU from its original proposal in June to its formal approval in December shows that the EU decision-making process is neither efficient nor sustainable. But, most importantly, it shows that overcoming moral hazard is the stumbling block in completing EMU and that the political economy of reforms is indeed relevant. The Union needs to find a solution to the eternal debate on solidarity versus discipline. Perhaps the last-minute compromise to make disbursements from the Recovery and Resilience Fund subject to sufficient progress on specific country recommendations under the Semester Process will provide an adequate balance. This approach would also confirm the view that the Commission operates as the “auditor” that oversees compliance, while the Council is the decision-making body: in a federal union, this seems appropriate.

Seventh, NGEU demonstrated the way to create a federal fiscal facility within EMU. The Union needs to find a way to make it permanent. But also, to convert it into a real macro stabilization facility and leave the structural adjustment component to other EU instruments, like the Cohesion or Structural Funds. Mixing everything together is only a recipe for irrelevance and futility. A macro stabilization fund needs to keep a discretionary element to be timely and efficient, and therefore requires an EMU Fiscal Authority - perhaps a “Treasury”? But, in a complex political union like EMU, it is a good idea to also link this facility to some form of automatic investment and unemployment rule.

Eighth, just as the EU needs a stabilization facility to advance towards the formulation of a fiscal stance for the Union, it also needs fiscal rules for Member States. Fiscal rules that are transparent, credible, legitimate and enforceable. Economists have come to agree that an expenditure rule adjusted for debt criteria is the most sensible and efficient. Politicians need to make it operational. The Stability and Growth Pact has to be amended accordingly, without delay, and the whole process of fiscal governance in EMU radically simplified.

Ninth, EMU needs to complete banking union. Two main hurdles remain; they are not the only ones but are crucial to avoid a repetition of sudden episodes of contagion and capital flight. A European Deposit Insurance Scheme, EDIS, and a single European

Liquidation Regime for banks. Only then can we dream of having large European retail banks active across many Member States, a precondition for bank customers to reap all the potential benefits of banking union. Both are very difficult issues, due to their emotional baggage and also because they entail a visible and considerable transfer of sovereignty. That is why the political economy of reform is so important and resolving the moral hazard issue is a precondition for completing banking union.

And tenth: Basel III has proven its usefulness and its limitations. In revising it, a lot of attention needs to be paid to some unintended consequences made explicit by the pandemic. Namely, the reinforced pro-cyclicality implied by the mechanistic application of the expected loss concept and the inability to use buffer mechanisms in real life situations. They have not proven useful. Perhaps a system of adjustable dynamic provisions is a better idea to cope with fundamental uncertainty, since they are not hostage to the stigma effect that prevents the use of buffers. Adding an additional macro buffer, as is now being proposed, would only increase the cost of capital while doing nothing to address the credibility issue of supervisory forbearance at times of crisis. And a level regulatory field for all financial actors cannot be delayed any longer.

Madrid, December 2020

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PART I
THE EUROPEAN RESPONSE TO THE PANDEMIC

1. THE MONETARY POLICY RESPONSE: THE ROLE OF THE ECB

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1.1. INTRODUCTION

The year 2020 will be remembered for the coronavirus pandemic, all its human suffering and for having precipitated a very steep and dramatic recession, both at global level and in the euro area, posing exceptionally high risks, and having spawned exceptional responses in all areas of public policy, including monetary policy¹.

Before the pandemic hit the euro area, monetary policy was already confronting challenges from slowing growth and inflation continuing to fall short of the Governing Council's aim to maintain it at levels below, but close to, 2%. With the conventional interest rate instrument already close to its effective lower bound, the ECB had previously started to resort to unconventional policy instruments to reach its price-stability objective. It had phased in a broad set of novel instruments featuring forward guidance, negative rates on reserves, targeted lending operations and asset purchases. This approach had been successful in accelerating the recovery and ensuring small positive rates of inflation in preceding years, but by the beginning of 2020, the euro area growth momentum had moderated and developments in headline HICP inflation and measures of underlying inflation were muted.

The pandemic shock profoundly aggravated these challenges. Uncertainties about its course and impact sent the economy and the financial system into tailspin. With containment measures taking hold, the euro area economy experienced an extraordinary and severe but also highly asymmetric contraction. As confidence eroded, financial market

¹ I am grateful to Stefano Nardelli and Jan Felix Hammermann (ECB, Directorate Monetary Policy Strategy) for their contributions to this article.

sentiment switched into risk-off mode, threatening a market freeze with a potential to prompt a credit crunch and a wave of insolvencies.

In March 2020 monetary policy acted swiftly, recalibrating existing instruments and launching new policy tools, to arrest highly disruptive, self-fulfilling feedback loops in asset prices and illiquidity that would otherwise have precipitated a much deeper economic contraction and unprecedented deflationary risks. These measures were accompanied by prudential measures and fiscal policies, which helped protecting jobs and providing liquidity support to firms, thereby heading off a wave of insolvencies and permanent damages to productive capacities.

The comprehensive package of measures decided by the ECB proved highly effective in easing monetary policy, attenuating risk premia and safeguarding lending to firms. These were preconditions for the economy to rebound from the collapse in the first half of 2020 and to curtail deflationary risks. But with the pace of the recovery determined by the course of the pandemic, it continues to be unsteady and uncertain. Much hope hinges on an effective vaccine to be timely available and distributed. Continued policy support safeguarding favourable financing conditions will be needed until the pandemic crisis can be judged to be over. The ECB continues to be committed to protect the economy, to support its full recovery and to bring inflation back to levels consistent with price stability.

1.2. THE ECONOMIC DEVELOPMENTS IN 2020 AND THE IMPACT OF THE PANDEMIC ON THE EURO AREA ECONOMY

1.2.1. THE EURO AREA ECONOMY AND THE ECB MONETARY POLICY BEFORE THE PANDEMIC SHOCK

At the beginning of the year 2020, the macroeconomic situation still continued to be shaped by the legacy of the global financial crisis and a series of disinflationary shocks. In the wake of the shallow economic recovery and faltering inflationary pressures in 2014, the ECB had started to resort to unconventional policy instruments. It had phased in a broad set of novel, mutually reinforcing instruments featuring forward guidance, negative rates on reserves, the asset purchase programme (APP), and targeted long-term refinancing operations (TLTROs). This pivot in policy instruments had been successful in supporting a sustained economic recovery, countering deflationary risks and restoring sufficient inflationary pressure to ensure small positive rates of inflation. Yet, at the beginning of 2020, developments in headline HICP inflation and in measures of underlying inflation muted.

The decision in September 2019 to resume net asset purchases (at a monthly pace of €20 billion), to cut the deposit facility rate from -40 basis points to -50 basis points, to ease TLTRO-terms and reinforce forward guidance reflected the Governing Council's assessment that ample monetary policy accommodation continued to be warranted to

support inflation robustly converging to levels consistent with price stability and for such convergence to have been consistently reflected in underlying inflation dynamics.

The use of non-standard measures to augment monetary policy capacity had been widespread across central banks in recent years. Yet a salient feature of the ECB's instrument configuration has been the combination of negative rates, asset purchases, forward guidance, and targeted long-term funding support for banks. These instruments have proved themselves in complementing and reinforcing each other in providing monetary accommodation.

Negative interest rates on reserves lower the short end of the yield curve and, in combination with forward guidance, support controlling interest rates at maturities that are particularly influential in determining financial conditions. In the euro area, banks tend to use risk-free interest rates with maturities of one to two years as their reference for fixing loan rates. Accordingly, the greater impact on interest rates at those maturities and the negative rate policy has given the central bank a powerful instrument to enhance transmission to the loan market. Forward guidance reinforces this effect on the short-to-medium segment of the yield curve.

Asset purchases exert downward pressure on the medium-to-long term yields. Since the central bank purchases long-dated securities from private investors with cash, it encourages them to rebalance their portfolios away from cash and towards other forms of longer-duration investments, thereby supporting investment and demand. Complementary to negative interest rates, forward guidance and asset purchases operating predominantly on the term structure of interest rates, TLTROs incentivise banks to pass on low yields and very attractive central bank funding support into lending conditions for households and firms, further boosting domestic demand. In combination, these instruments have proved themselves in lowering borrowing rates for households and firms and supporting economic activity and inflation.²

Notwithstanding substantial monetary accommodation on account of these measures, incoming data at the beginning of the year reflected moderating economic growth and persistently weak inflationary pressures. Year-on-year GDP growth in the fourth quarter of 2019 had moderated to 1.0% compared to 1.4% in the preceding quarter. At the same time, over preceding years, labour markets had proven to be resilient: Unemployment had fallen from its height of 12% in the second quarter of 2013 to below 7.3% in the first quarter of 2020, an unemployment rate last seen in the first quarter of 2008, before the great financial crisis had begun to unfold. This recovery had been achieved with only limited support for domestic demand from national fiscal policies.

²See Bottero, M., Minoiu, C., Peydro, J.-L., Presbitero, A. and Sette, E. (2019), "Negative Monetary Policy Rates and Portfolio Rebalancing: Evidence from Credit Register Data," IMF Working Papers, No WP/19/44, International Monetary Fund, and Altavilla, C., Burlon, L., Giannetti, M. and Holton, S. (2019), "Is there a zero lower bound? The effects of negative policy rates on banks and firms," Working Paper Series, No 2289, ECB.

On account of the weakening recovery momentum, tighter labour market conditions failed to generate price pressure that would pass through to inflation. While inflation had slightly picked up over the year 2019, euro area HICP inflation stood at only 1.3% in December 2019, with underlying inflation remaining generally subdued, and thereby remained considerably below the ECB's price stability aim.

Meanwhile, financial market sentiment had remained quite impervious to the moderating growth momentum. Equity prices had continued to increase, not only in the euro area.

The policy easing measures decided by the Governing Council in September 2019 helped to support financing conditions for non-financial corporations, reflected also in bank lending rates close to historical lows owing to an effective pass-through of monetary accommodation. Financial markets expected the ECB key interest rates to remain on hold for at least two more years.

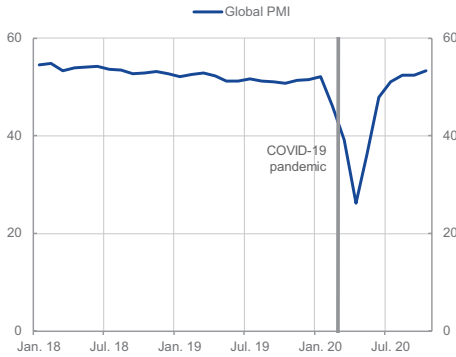
The Governing Council considered that favourable financing conditions supporting consumer spending and business investment would sustain the euro area expansion, thereby build-up domestic price pressures and thus ensure the robust convergence of inflation to its medium-term aim.

1.2.2. THE PANDEMIC SHOCK ON THE GLOBAL ECONOMY

The eruption of the coronavirus pandemic and its global propagation completely up-ended this recovery picture. It represented a major shock to the global economy and the financial system: with the last major pandemic having occurred more than a century ago, the outbreak of the COVID-19 pandemic was unprecedented in nature, with the depth, duration, and regional sweep of its impact nearly impossible to predict. Uncertainties about how measures to contain the spread of the virus would affect the course of the economy triggered an abrupt repricing of risk, threatening a freeze in financial markets.

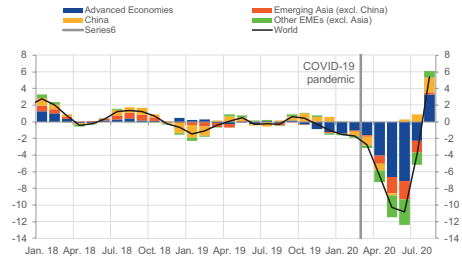
Initially, China experienced a precipitous slump in economic activity on account of containment measures which eventually percolated through all corners of the global economy. Following the spread of the coronavirus, the sharp contraction in Chinese manufacturing output in February quickly spilled over to the rest of the Asia-Pacific region, prompting a reversal in global activity indicators. Supply chains were disrupted and thereby production worldwide was upset. The global PMI for composite output dropped from 46.1 in February to 39.2 in March and even further to 26.2 in April, pointing to a dramatic slowdown in global activity and its spread across the world economy (Figure 1). The pandemic also left its mark on international trade with world merchandise imports as low as -9.4% (in terms of 3-months growth rates on three months earlier) followed by a further contraction by -4.3% (Figure 2).

Figure 1: Global PMI
 (index)



Source: CPB and ECB staff computations.
 Latest observation: August 2020.

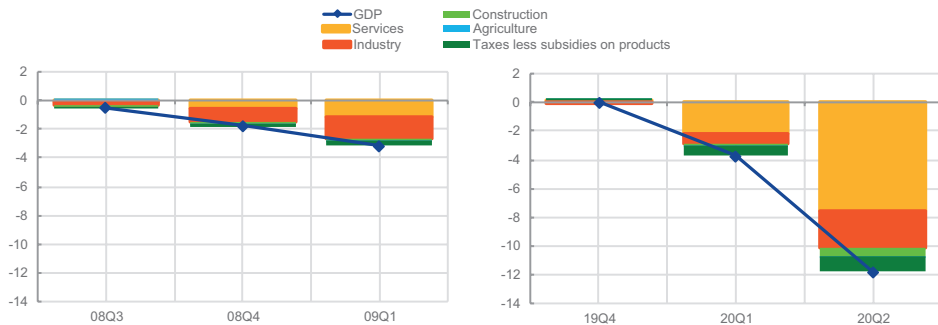
Figure 2: World merchandise imports
 (3m-3m % change)



1.2.3. THE FIRST WAVE OF THE PANDEMIC SHOCK ON THE EURO AREA ECONOMY

With the global spread of the pandemic and on account of containment measures in its wake the euro area economy experienced an extraordinary and severe contraction, characterised by highly asymmetric effects across sectors, regions, and income groups. Large-scale job and income losses threatened to occur especially in the service sector – in contrast to the Great Recession having affected the manufacturing and construction sector first and foremost (Figure 3).

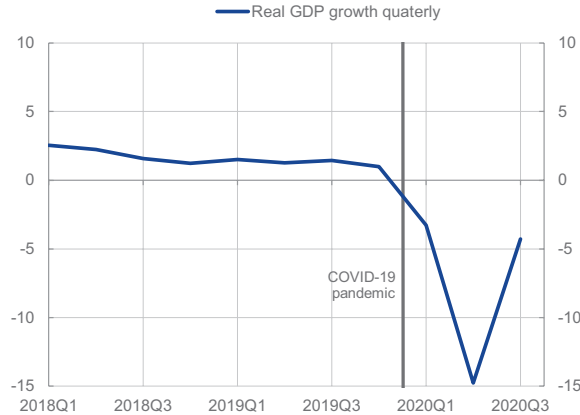
Figure 3: Sectoral gross value added
 (quarter-on-quarter percentage changes, percentage point contributions)



Sources: Haver and ECB staff calculations.
 Notes: Aggregation based on data for Germany, Spain, France, Italy and the Netherlands.
 Latest observation: Second quarter of 2020.

Euro area real GDP registered a decline of 3.8% quarter-on-quarter in the first quarter of 2020, followed by an even stronger contraction by 11.8% quarter-on-quarter in the second quarter (Figure 4).

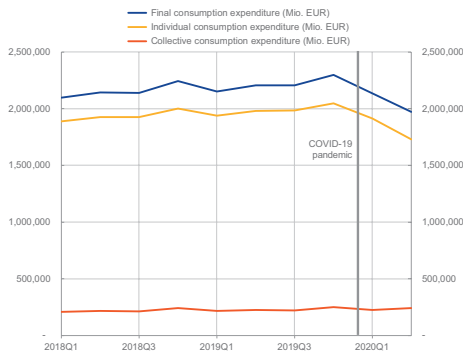
Figure 4: Real GDP growth
 (%; quarter-on-quarter)



Source: Eurostat and ECB calculation.
 Latest observation: Third quarter of 2020.

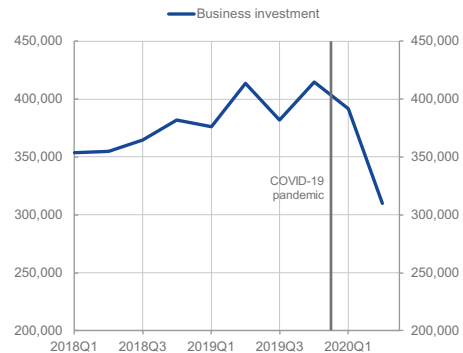
In the first half of 2020 demand by households and corporates retrenched sharply. As households cut back consumption, the household saving ratio, based on annual unadjusted flows, increased by 2.7 percentage points to 16.6%, and even more sharply to 23.7% in the second quarter, with a negative impact on consumer spending set to continue as long as uncertainty persists (Figure 5). Uncertainty about the economic outlook also led to a significant drop in business investment (Figure 6).

Figure 5: Consumption expenditure
 (in million euro)



Source: Eurostat.
 Latest observation: Second quarter of 2020.

Figure 6: Business Investments
 (in million euro)



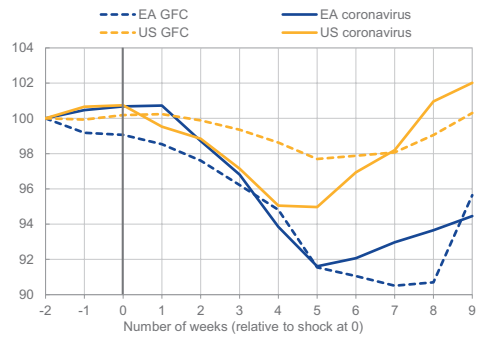
As confidence battered and business investment collapsed, financial market sentiment switched into risk-off mode, threatening a market freeze with a potential to prompt a credit crunch and a wave of insolvencies.

Sentiment towards risky assets eroded precipitously, globally, amid flight to safety. By early March equity prices across advanced and emerging market economies had collapsed by around 40% and share-price volatility rose sharply to levels higher than during the global financial crisis (Figure 7). Investment funds experienced exceptionally large outflows similar in magnitude to those last seen during the global financial crisis both in the euro area and in the US (Figure 8). Initially redemptions largely centred on corporate bond and equity funds, but market strains eventually also engulfed safe and liquid assets, such as money market and sovereign bond funds. The combination of high redemptions and low liquidity buffers prompted funds to sell both risky and less-risky assets amplifying liquidity stress, and further exacerbated by a sudden increase in margin requirements. The surge in volatility and rising margin requirements fuelled a liquidity spiral by boosting the demand for cash which investment funds and other intermediaries had to raise at very short notice.

Figure 7: VIX index derived from SPX in the US
(index)



Figure 8: Comparison of the outflows in corporate bond investment funds for the global financial crisis (GFC) and the coronavirus-related crisis
(index)



Source: ECB computations.

Notes: The RHS shows the evolution of flows (weekly data) compared to a specific shock date (21/02/2020 for coronavirus and 12/09/2020 for the great financial crisis). Results are derived from eight funds reported in 2008 for the euro area. Latest observation: 9 November 2020 (LHS).

1.2.4. THE CHALLENGES TO THE ECB MONETARY POLICY

The eruption of financial stress undermined the degree of monetary accommodation required to sustain an increase in HICP inflation to levels consistent with the ECB price stability definition. As sovereign yields represent benchmarks in pricing assets and setting lending rates for households and firms the ensuing widening of sovereign yield spreads threatened to disrupt monetary policy transmission. With the severe economic contraction beginning to unfold, market-based indicators of longer-term inflation expectations declined to an all-time low. The euro area five-year forward inflation-linked swap rate five years ahead fell as low as 0.92% on 10 March 2020, pointing to risk of inflation expectations becoming disanchored and thus to a loss of credibility of the ECB to deliver on its mandate (Figure 9).

Figure 9: Break-even inflation rates

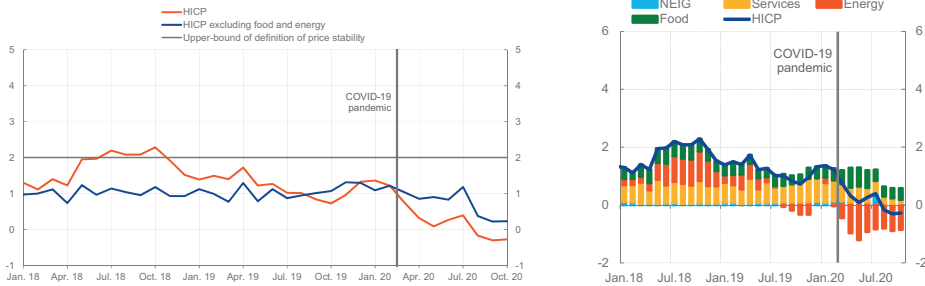
(annual percentage changes)



Source: Bloomberg and ECB calculations.
 Latest observation: Third quarter of 2020.

With recessionary economic developments tracking the path of the pandemic, HICP inflation was severely affected by the ensuing collapse in energy prices, a drop in non-energy industrial goods prices, in particular in services prices, drove inflation to historical lows, and eventually also indirect tax cuts contributed to the inflation decline. Excluding energy and food, the decline in underlying inflation revealed a dominant impact from weaker demand effects stemming from containment measures, which outweighed supply-side disruptions in some economic sectors (Figure 10).

Figure 10: Annual HICP inflation and contributions of main components
 (annual percentage changes; percentage points contributions)



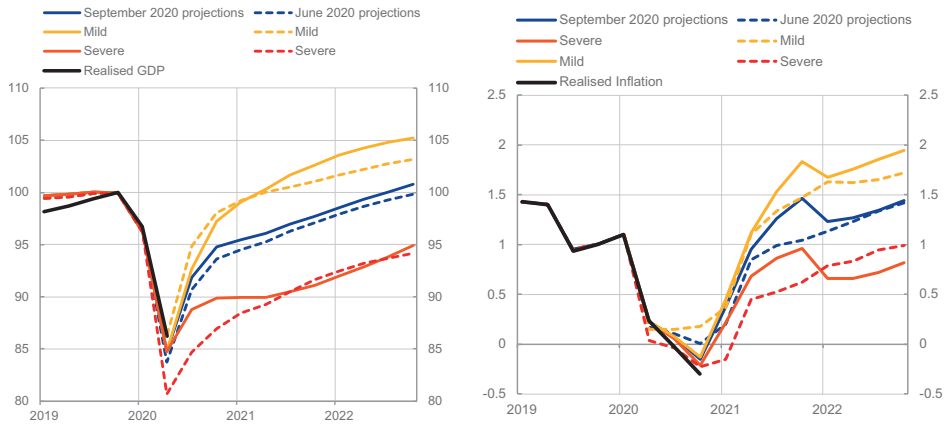
Sources: Eurostat and ECB calculations.
 Latest observation: October 2020.

As it was nearly impossible to predict the trajectory of the pandemic, its economic fallout, and its impact on inflation, in addition to its main projections, Eurosystem staff also charted two alternative scenarios of different severity of the pandemic to gauge the course of economic events. A mild scenario assumed a successful containment of the virus, while a severe scenario assumed a strong resurgence of infections and an extension of strict containment measures until mid-2021. The latter severe scenario still envisaged overall economic costs of the resurgence of infections to remain lower than those of the initial strict lockdowns. Figure 11 displays the path of the scenarios charted in June in comparison with the respective June and September 2020 Eurosystem staff projections. Under the severe scenario, real GDP was projected to drop by around 16% in the second quarter of 2020 with a weaker rebound due to likely stricter containment measures than in the mild scenario.

The impact on the labour market was also projected to be sizeable under both scenarios which anticipated a surge in unemployment to 8.8% and 11.3% in 2020 respectively. Under the mild scenario, unemployment was expected to gradually decline to 8.5% in 2021 and to 8.0% in 2022 as policies are supposed to largely succeed in preventing hysteresis effects. In the severe scenario, however, lasting effects on the labour market were assumed to be only partially contained and thus unemployment was projected to rise to 12.5% in 2021 and then decline to 11.2% in 2022. In both scenarios, however, employment was not anticipated to fully recover back to the pre-crisis level over the next two years.

Under the severe scenario, annual HICP inflation was projected to reach negative levels in the second half of the year and to average 0.4% and 0.9% in 2021 and 2022 respectively, thereby falling significantly short of the ECB price-stability aim.

Figure 11: Alternative scenarios for real GDP and HICP inflation in the euro area
 (left panel: index, Q4 2019 = 100; right panel: year-on-year rate)



Source: ECB.

1.3. THE ECB RESPONSE TO THE COVID-19 PANDEMIC

1.3.1. A TWOFOLD RESPONSE: ADJUSTMENT OF THE STANCE AND SAFEGUARD OF TRANSMISSION

The unusually sharp recession and the exceptionally high risk that the pandemic crisis entailed for macroeconomic stabilisation policies and especially for price stability required a strong policy response. The ECB acted decisively and swiftly as did governments and supervisory and regulatory authorities that also took crucial measures from all areas of public policies.

The threats to price stability emerging from the pandemic crisis required a two-fold monetary policy response, namely to adjust the monetary policy stance and to safeguard monetary policy transmission, making sure that the stance is passed through the financial system to households and firms. This response involved recalibrating existing instruments and, additionally, launching a new €1.35 trillion pandemic emergency purchase programme (PEPP).

The PEPP in particular has the dual function of easing the stance and stabilising financial markets to offset the downward impact of the pandemic on the projected path of inflation. This dual function of PEPP is ensured by its flexibility in allocating assets across time and jurisdictions, to adapt it to the unpredictable course of the pandemic and its uneven impact across economies. Specifically, allowing purchases to counter fragmentation risks was decisive in reversing the tightening of financing conditions experienced in the first days of the crisis.

1.3.2 .THE INITIAL SET OF MEASURES

As early as 12 March 2020, the Governing Council decided on a comprehensive set of monetary policy measures by adjusting existing policy instruments in the following manner:

1. **Additional longer-term refinancing operations (LTROs) to provide liquidity support to the euro area financial system**, to temporarily provide an effective back-stop to counter liquidity shortages in the banking system. These operations have provided liquidity at favourable terms to bridge the period until the subsequent TLTRO III operation in June 2020.
2. **More favourable terms in the TLTRO III from June 2020 to all TLTRO III operations outstanding during the same period** to support the continued access of firms and households to bank credit in the face of disruptions and temporary funding shortages associated with the coronavirus outbreak. In particular, the interest rate on TLTRO III operations was set 25 basis points below the average rate applied in the Eurosystem’s main refinancing operations, while the rate was lower for counterparties maintaining their levels of credit provision, and, over the period ending in June 2021, could be as low as 25 basis points below the average interest rate on the deposit facility. Furthermore, the maximum total amount that could be borrowed by banks was raised to 50% of their stock of eligible loans [as of 29 February 2019].
3. **Within the asset purchase programme (APP), a temporary envelope of additional net asset purchases of €120 billion until the end of 2020**, on top of the existing purchases of €20 billion per month, to ensure in particular a strong contribution from the private sector purchase programmes to support favourable financing conditions for the real economy.

Consistent with the previous communication, the ECB confirmed its forward guidance on interest rates and asset purchases. Key ECB interest rates were confirmed “to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon and such convergence has been consistently reflected in underlying inflation dynamics”. Likewise, the Governing Council confirmed that net asset purchases under the APP were expected to run for as long as necessary and to end shortly before the ECB starts raising the key interest rates and that principal payments from maturing securities purchased under the APP will be reinvested in full for an extended period of time past the date when key ECB interest rates are raised again and for as long as necessary.

1.3.3. THE PANDEMIC EMERGENCY PROGRAMME

While the crisis in financial markets deepened, in an unscheduled meeting on 18 March, the ECB’s Governing Council decided to launch PEPP – an entirely new asset purchase programme:

4. **The pandemic emergency purchase programme (PEPP)** has been designed to first, safeguard monetary policy transmission mechanism by stabilising financial

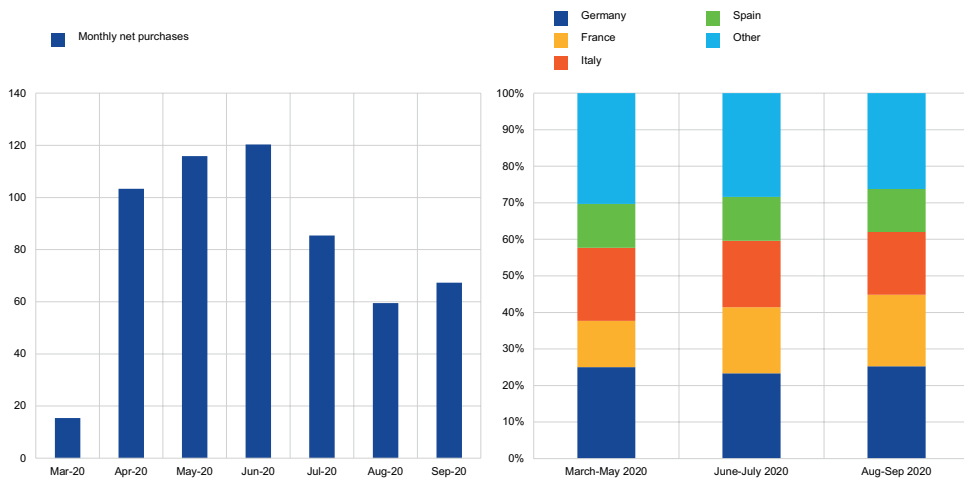
markets and, second, to counter the substantial downgrade to the inflation outlook caused by the pandemic. PEPP is temporary and comprises purchases of private and public sector securities and was initially announced with an envelope of €750 billion. While the benchmark allocation across jurisdictions was the ECB capital key of the national central banks, purchases of securities were conducted in a flexible manner to allow for fluctuations in the distribution of purchase flows over time, across asset classes and among jurisdictions with a view to counter serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the coronavirus outbreak. Net asset purchases were announced to continue until the COVID-19 crisis phase was judged to be over.

PEPP purchases started already in March with an initial amount of € 15.4 billion and increased progressively to reach a peak of € 120.3 billion in June. Purchases declined subsequently amounting to € 62.0 billion in October, when the cumulative net purchases reached € 629.2 billion. As planned, purchases across jurisdictions were conducted flexibly: for instance, the share of German securities varied from around 25.1% of total purchases between March and May to 17.2% between August and September, while the share of Spanish securities changed from 12.0% between March and May to 8.0% between August and September.

As for the APP, the Governing Council decided to reinvest the maturing principal payments from securities purchased under the PEPP. In addition, the future roll-off of the PEPP portfolio would be managed in a way as to avoid any interferences with the monetary policy stance (Figure 12).

Figure 12: Eurosystem purchases under the PEPP

(left panel: total monthly net purchases, EUR billions; right panel: geographical distribution of public sector securities purchases, percentages of total public sector securities purchases during respective period)



Source: ECB.

Notes: End-of-period book values. Figures are preliminary and may be subject to revision. The monthly purchase volumes are reported on a settlement basis and net of redemptions.

Latest observation: September 2020.

So as to enable an effective use of longer-term refinancing operations, the Governing Council also expanded the set of collateral eligible in these operations.³ In addition, already in March, central banks took coordinated action to alleviate strains in funding markets for foreign currency.⁴

All measures have been designed to be flexible and temporary, with their duration linked to the course of the pandemic crisis and targeted to stabilise financial market conditions, ensure a sufficiently accommodative monetary policy stance, and to facilitate an increase in bank funding to corporates and households.

On 30 April the ECB decided to complement its package of measures further by a series of non-targeted

5. Pandemic emergency longer-term refinancing operations (PELTROs), running as of May 2020, as a further liquidity backstop.

1.3.4. THE JUNE RECALIBRATION OF ECB MEASURES

Data releases coming in by June 2020 had confirmed an unprecedented contraction in the economy, with sizeable drop in hours worked, incomes, consumer spending, and investment. Headline inflation was suppressed by falling energy prices, and price pressures were expected to remain subdued on account of significant increase in economic slack. Also the June Eurosystem staff projections entailed a substantial downward revision of economic activity and inflation over the projection horizon, surrounded by an exceptional degree of uncertainty.

Against the backdrop of a further weakening of inflationary pressures, the Governing Council extended asset purchases and confirmed its forward guidance. The envelope for the PEPP was increased by €600 billion to a total of €1,350 billion with all eligibility criteria of asset categories reflecting the existing APP and the inclusion of non-financial commercial paper for the PEPP as well as the corporate sector purchase programme (CSPP). Furthermore, the residual maturity of public sector securities eligible for purchase under the PEPP was expanded to a maximum of 30 years and 364 days. The Governing Council

³ These easing measures expanded the use of domestic credit claims and unsecured debt instruments issued by any single other banking group in a credit institution's collateral pool as well as by waiving the minimum credit quality requirement for marketable debt instruments issued by the Hellenic Republic. The risk tolerance level in credit operations was also increased through a general reduction of collateral valuation haircuts by a fixed factor of 20% to maintain a consistent degree of protection across collateral asset types although at a temporarily lower level.

⁴ Major central banks (the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve and the Swiss National Bank) enhanced the provision of liquidity via the standing US dollar liquidity swap line arrangements. Furthermore, the ECB established swap and repo lines to provide euro liquidity to financial institutions in some EU countries (initially Denmark, Croatia, Bulgaria and later Romania) via their respective national central banks to address possible euro liquidity needs.

would terminate net asset purchases only once it deemed the COVID-19 crisis phase to be over but not before the end of June 2021, with the maturing principal payments from securities purchased under the PEPP to be reinvested until at least the end of 2022.

A summary of the manifold actions undertaken by the ECB in response to the COVID-10 pandemic crisis is provided in Figure 13.

Figure 13: Overview of ECB measures in response to the COVID-19 pandemic

Swap/repo lines ¹	Lending Facilities ²	APP/PEPP ³	Other policy measures
<p>Swap lines reactivated</p> <ul style="list-style-type: none"> With central banks of Denmark and Sweden <p>Swap lines in US dollar reactivated with Federal Reserve and other major central banks</p> <ul style="list-style-type: none"> US dollar provision through liquidity swap line Daily 7-day and weekly 84-day operations 	<p>LTROs</p> <ul style="list-style-type: none"> End in June 2020 Fixed rate tender procedure with full allotment Interest rate set at deposit facility rate <p>TLTRO-III recalibration</p> <ul style="list-style-type: none"> Interest rate set at main refinancing operations rate +25 bps⁴ from June 2020 to June 2021 Early repayment after 1 year 	<p>APP expansion⁵</p> <ul style="list-style-type: none"> Extended by €120 billion in 2020 In addition to ongoing purchases of €20 billion per month and reinvestments <p>PEPP introduction</p> <ul style="list-style-type: none"> €750 billion until Dec. 2020 Include all asset categories eligible under APP Waiver of eligibility requirements to Greek sovereign debt instruments 	<p>Temporary capital, liquidity and operational relief</p> <ul style="list-style-type: none"> Facilitating use of capital and liquidity buffers Flexible prudential treatment of loans backed by public support measures and mitigation of procyclicality in accounting Recommendation against dividend payments
<p>Swap lines set up</p> <ul style="list-style-type: none"> With central banks of Bulgaria and Croatia 	<p>PELTROs introduced</p> <ul style="list-style-type: none"> 7 operations from May 2020, maturing by Sep. 2021 Interest rate of -25 bps <p>Further easing of TLTRO-III conditions</p> <ul style="list-style-type: none"> Borrowing rate -50 to -100 bps (June 2020 to June 2021), depending on lending performance Further easing of terms and conditions <p>Temporary easing of collateral requirements</p> <ul style="list-style-type: none"> Reduction of collateral valuation haircuts Mitigation of impact of potential rating changes Wider eligibility of credit claims and eligibility of Greek sovereign debt instruments 		<p>Temporary reduction in capital requirements for market risk</p>
<p>Repo facility</p> <ul style="list-style-type: none"> Set-up new Eurosystem repo facility to provide euro liquidity to non-euro area central banks (EUREP) Set-up repo line with central bank of Romania <p>Frequency of 7-day operations in US dollar reduced to three per week</p>		<p>PEPP expansion</p> <ul style="list-style-type: none"> Increase by €600 to €1,350 billion Extension by 6 months until at least June 2021 Reinvestments at least until end of 2022 	
<p>Repo lines set up</p> <ul style="list-style-type: none"> With central banks of Hungary and other non-EU countries in South and Southeast Europe <p>Frequency of 7-day operations in US dollar to be reduced to one per week as of Sep. 2020</p>			<p>Further guidance</p> <ul style="list-style-type: none"> Guidance against dividend payments and for moderation in remuneration Clarification on restoration of capital/liquidity buffers and supervisory expectations on addressing debtor stress Expiry of some operational relief measures

Source: ECB.

Notes:

- Under a repo line, the ECB provides euro liquidity to a non-euro area central bank in exchange for adequate euro-denominated collateral.
- LTROs and PELTROs refer to the long-term refinancing operations and pandemic emergency longer-term operations, respectively. TLTROs stand for targeted longer-term refinancing operations.
- APP and PEPP refer to the Eurosystem's asset purchase programme and the pandemic emergency purchase programme, respectively.
- The term "bps" stands for "basis points".
- The ECB reconfirmed its forward guidance on the path of policy interest rates and the APP throughout this period. The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.

1.3.5. FISCAL MEASURES AND PRUDENTIAL POLICIES COMPLEMENTED MONETARY POLICY

The highly unusual nature of the pandemic crisis required a comprehensive policy response. As the crisis unfolded, it deepened its highly asymmetric impact across sectors and regions and strengthened its potential to alter spending patterns more permanently, destroy productive resources, and incur severe employment losses. All these outcomes carried the risk of triggering further adverse feedback effects between the real economy and the financial sector. Monetary policy measures therefore needed to be complemented by effective action in all other areas of public policy, including prudential policies and fiscal measures.

A number of decisions were taken on banks supervised by the Single Supervisory Mechanism (SSM) aimed at providing significant capital relief to banks with a view of enabling them to continue funding the real economy.⁵

Microprudential measures were enhanced by national macroprudential authorities which relaxed the countercyclical capital buffer (CCyB). Such measures announced in March were expected to free up more than €20 billion of Common Equity Tier 1 capital held by euro area banks. They included releases or reductions of the countercyclical capital buffer, systemic risk buffer and buffers for other systemically important institutions. In addition, some national authorities postponed or revoked earlier announced measures to avoid placing pressure on banks to accumulate capital buffers in a downturn.

As ECB analysis shows, economic outcomes can be considerably better when banks use their buffers while maintaining lending to the real economy, rather than deleveraging in order to preserve them.⁶ Using buffers can have initial negative effects on bank solvency ratios, but ultimately reduces bank losses as the economy can remain healthier in consequence of the easing of credit constraints. Taken together, acting on buffers helped the euro area banking system to sustain lending to households and companies while weathering losses accumulating from the ongoing crisis.

Fiscal policy measures were essential – and better suited than monetary policy – to avert the propagation of the asymmetric nature of the pandemic shock to sectors of the economy that were initially less directly, but still severely, affected.⁷ Some economic sec-

⁵ Concretely, the ECB allowed banks 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). Banks were also allowed to partially use capital instruments that do not qualify as Common Equity Tier 1 (CET1) capital, for example Additional Tier 1 or Tier 2 instruments, to meet the Pillar 2 Requirements (P2R). Thereby, a measure initially scheduled to come into effect in January 2021 had been brought forward.

⁶ See Altavilla, C., Barbiero, F., Boucinha, M. and Burlon, L. (2020), “The great lockdown: pandemic response policies and bank lending conditions”, Working Paper Series, No 2465, ECB, Frankfurt am Main, September.

⁷ See Woodford, M. (2020), “Effective Demand Failures and the Limits of Monetary Stabilization Policy” paper presented at the Annual Research Conference of the ECB, September 4, 2020.

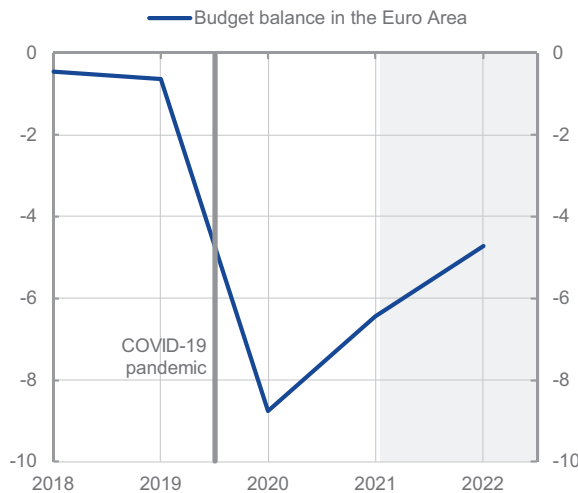
tors like services and specifically the tourism sector, and certain regions were hit much harder than the rest of the euro area requiring targeted economic policy interventions. Also, vigorous counter-cyclical fiscal policy measures at the aggregate level mitigated significantly the most adverse impact of the pandemic on the economy.

In many euro area countries, fiscal authorities responded promptly by adopting short-time employment schemes, public credit guarantees and other direct and indirect support for firms and households.⁸ These discretionary fiscal policy measures can be grouped in three categories. First, immediate fiscal impulses took the form of additional government spending for medical equipment, keeping people employed, subsidising SMEs and public investment. Second, deferrals, including the payment of taxes and social security contributions, improved the liquidity positions of households and firms. In a few countries the deferrals encompassed also servicing loans and payment of utility bills. Third, other liquidity provisions and guarantees included export guarantees, liquidity assistance and credit lines through national development banks.

All in all, these unprecedented fiscal efforts are projected to affect heavily national governments' balances. The European Commission expects the fiscal deficit in the euro area to reach 8.5% of GDP in 2020 (Figure 14) and to remain higher than 4% until 2022.

Figure 14: Euro area general government balance

(percentage of gross domestic product)



Source: European Commission Autumn Forecast 2020.

Notes: The grey shaded area indicates the projections.

Woodford discusses the limits on the extent to which interest rates can be reduced in a situation like the COVID-19 pandemic. He argues that fiscal transfers are instead well-suited to addressing the underlying problem of a failure of effective demand.

⁸ See <https://www.bruegel.org/publications/datasets/covid-national-dataset/> and <https://www.imf.org/en/Topics/imf-and-covid19/Fiscal-Policies-Database-in-Response-to-COVID-19>

At the EU level, the European Commission complemented national efforts by launching first three safety nets and subsequently the “Next Generation EU” recovery fund. The three safety nets support jobs and workers, businesses and Member States worth together €540 billion. With the “Next Generation EU” recovery fund a €750 billion instrument was added to the normal budget of the EU. Within this fund, the Recovery and Resilience Facility was designed to provide loans and grants to support reforms and investments undertaken by Member States with the objective of mitigating the economic and social impact of the pandemic. The facility aims at helping European economies and societies to become more sustainable, resilient and better prepared for the challenges and opportunities of the green and digital transitions.

1.4. TENTATIVE ASSESSMENT OF THE ECB MEASURES TAKEN SINCE MARCH 2020

1.4.1. ECB MEASURES STABILISED FINANCIAL MARKETS AND SAFEGUARDED FAVOURABLE FINANCING CONDITIONS

The monetary policy measures taken by the ECB have been effective in arresting self-fulfilling illiquidity and asset price dynamics and sustaining monetary accommodation, with PEPP having been pivotal in stabilising financial markets and safeguarding favourable financing conditions for all sectors and jurisdictions. At the same time, fiscal measures have complemented the monetary policy measures in two ways: first, by supporting overall aggregate demand, and second, by addressing the asymmetric nature of the pandemic shock in the form of policies directed to specific regions and sectors.

While individual ECB measures interact with and enforce one another, they can be classified by the main focus of their intended contributions. The PEPP has been designed with a dual goal to stabilise markets and thus ensure a smooth transmission and to ease the monetary policy stance. Following their rapid widening at the onset of the crisis, the compression of sovereign yield spreads, testifies, in particular, to the effectiveness of PEPP in safeguarding transmission of monetary policy. As sovereign yields affect the funding costs of corporates, households and banks, the success of the PEPP in lowering them has been supporting the economic recovery and the convergence of inflation towards its aim.

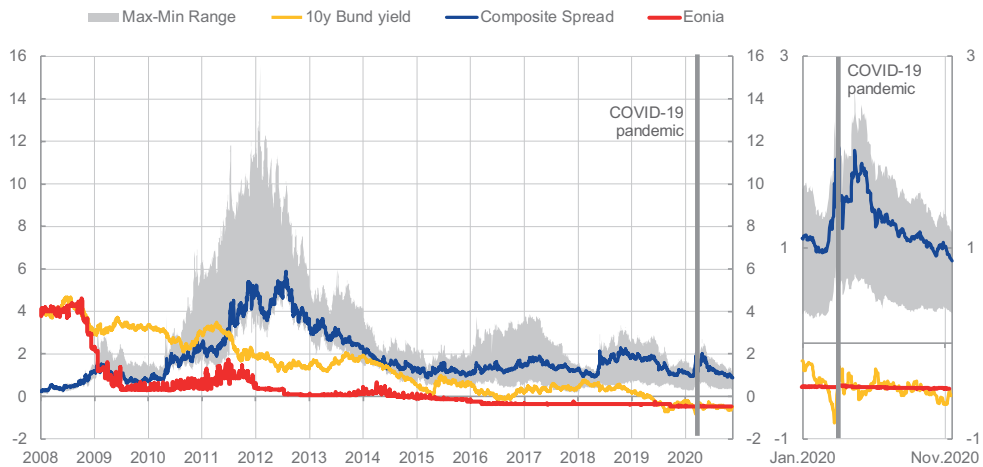
Asset purchases conducted under the PEPP and the additional March APP envelope have reduced both the term premium as well as credit risk premia in sovereign yields. Estimates based on Eser et al. (2019) – including a recalibrated version of the model that accounts for the greater yield reaction to the measures announcement in March compared to APP announcements⁹ – indicate that the 10-year euro area average sover-

⁹ The strength of monetary policy transmission depends among others also on the state of the economy. See Dahlhaus, T. (2016), “Conventional monetary policy transmission during financial

10-year yield was reduced by between 45 and 70 basis points (Figure 15).¹⁰ This impact has differed across countries, with Italian and Spanish yields showing a distinctly stronger decrease, on account of the impact on the credit risk premium, which is estimated to be around twice as high as that of the euro area average. At the time of writing, the GDP-weighted sovereign yield curve is in negative territory up to the 10-year maturity and nearly all euro area countries have negative yields up to the 5-year maturity.

Figure 15: Change in composite 10-year sovereign yields, spreads over 10-year Bunds and EONIA

(percentage points and basis points)



Source: ECB calculations.

Notes: The composite 10-year sovereign yield is constructed as a GDP-weighted average of the 10-year sovereign yields of Spain (0.34), Ireland (0.11), Italy (0.49) and Portugal (0.06). Country-specific contributions to changes in the composite spread are GDP-weighted.

Latest observation: 13 November 2020.

While in March high-yield corporate spreads reacted even more to the financial stress, spreads also declined and continued to do so after the expansion of the PEPP in June. Corporate spreads, however, have remained at elevated levels reflecting continued risks to real growth (Figure 16).

crises: an empirical analysis”, *Journal of Applied Econometrics*, Vol. 32, No 2, pp. 401-421; Ciccarelli, M., Maddaloni, A. and Peydro, J.L. (2013), “Heterogeneous transmission mechanism: monetary policy and financial fragility in the euro area”, *Economic Policy*, Vol. 28, No 75, pp. 459-512.

¹⁰ See Eser, F., Lemke, W., Nyholm, K., Radde, S. and Vladu, A. (2019), “Tracing the impact of the ECB’s asset purchase programme on the yield curve”, Working Paper Series, No 2293, ECB.

Figure 16: Corporate bond spreads in the euro area

(basis points)



Sources: iBoxx and ECB calculations.
 Latest observation: 13 November 2020.

1.4.2. ECB LIQUIDITY PROVISION TO BANKS SUPPORTED CREDIT

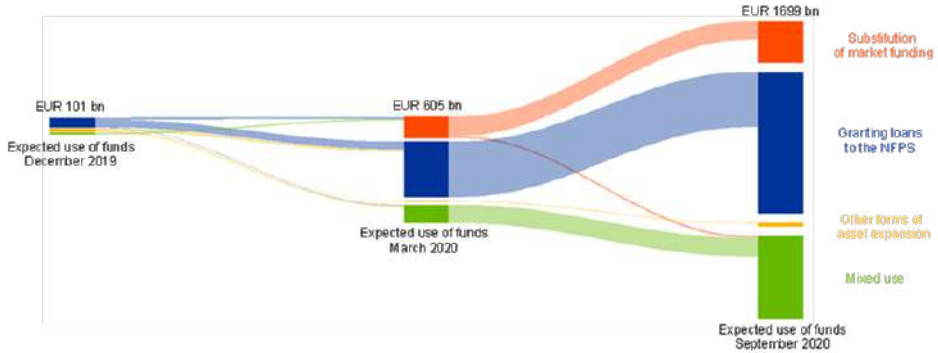
To support banks in maintaining their credit provision, the ECB has provided central bank liquidity through various refinancing operations on generous terms and over long maturities. Such operations have played a key role in supporting the bank lending channel and thereby in ensuring the smooth and even transmission of monetary policy.

The overall high take-up of the TLTRO III has been facilitated by the collateral-easing measures aimed at enabling banks to make full use of TLTRO III funding. While take-up in the September operation (€174.5 billion) was moderate compared to the unprecedented amount borrowed in June (€1.3 trillion), the overall participation had nevertheless surprised market expectations to the upside. Taken together, the June (€548 billion) and the September (€158 billion) TLTRO resulted in a combined net liquidity injection of €706 billion. The high take-up, together with the intended use (Figure 17), that banks have reported in the euro area Bank Lending Survey (BLS), indicate that the targeted operations provided sizeable support to the provision of financing by banks to their customers.¹¹

¹¹ See Lane, P.R. (2020), “Monetary policy in a pandemic: ensuring favourable financial conditions”, Trinity College Dublin, 26 November 2020.

Figure 17: Evolution of expected use of TLTRO III funds from the June 2020 operation

(left and central columns: share of respondents weighted by change in TLTRO III uptake; right column: share of respondents weighted by net liquidity injection)



Source: ECB, euro area Bank Lending Survey (BLS).

Notes: The four bars on the third column to the right measure the outstanding TLTRO III amounts in September 2020 distributed by the responses to the October 2020 BLS. The red bar measures the take-up of banks that reported that they will use TLTRO funds to substitute market funding sources. The blue bar measures the same take-up by banks that intend to use the funds for granting loans. The yellow bar collects take-up by banks that intend to use the funds to uses other than substituting market funding or granting loans (government securities, holding as cash, financing other financial entities, and others). The green bar reports the take-up by banks that plan to allocate the funds to more than one purpose. The bars in the first column to the left measure the outstanding TLTRO III amounts in December 2019 distributed by the responses to the January 2020 BLS. The bars in the second column in the centre measure the outstanding TLTRO III amounts in March 2020 and the amount of bridge LTROs distributed by the responses to the April 2020 BLS. Shaded areas report take-up of banks that change their expected use of funds between survey waves.

1.4.3. CREDIT GREW SUBSTANTIALLY AND BANK LENDING RATES WENT VERY LOW

As a result of ample central bank funding, growth in monetary aggregates over the course of 2020 has been buoyant. This was the reflection, on the one hand, of “forced” savings due to the lockdown and precautionary motives in the private sector and, on the other hand, of money creation in commercial banks from credit to the private sector. M3 growth doubled from the 5.2% observed in January 2020 and to 10.4% in September 2020.

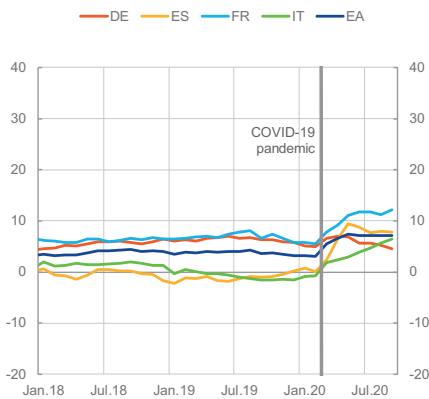
Especially monetary policy measures like the TLTROs in combination with prudential measures and government guarantees helped to ensure liquidity support to firms. Firms responded to the pandemic-related falls in firm revenues by additional debt to finance working capital turned to be crucial to forestall an immediate wave of insolvencies with permanent damages to productive capacities. The default rate of euro area high-yield firms increased only slowly from 1.73% in February to 4.21% in October. Firms’ demand for loans or drawing of credit lines surged in the second quarter of 2020, reaching the highest net balance since the start of the ECB’s bank lending survey (BLS) in 2003. As a result, credit growth has been substantial. The annual growth rate of loans to firms stood at 7.1% in August and September 2020, 4.1 percentage points higher than in February (Figure 18). While the favourable conditions of the ECB’s lending operations have been

passed on by banks to their customers, the BLS of autumn 2020 has revealed that the pandemic shock and increased risk aversion could not be fully mitigated as credit standards started to tighten.

Together with the yield curve being anchored at very low levels on account of the negative deposit facility rate, of asset purchases and of forward guidance, bank lending rates have been close to their historic lows: around 1.5% for non-financial corporates and 1.4% for mortgages in September 2020. A decomposition of the lending rate to non-financial corporations into the factors that banks consider when pricing a loan shows the impact of the initial financial market volatility of March 2020 on bank funding costs (Figure 19). Most apparent is, however, that despite a gradual increase in credit risk, the supportive conditions of the ECB funding had contributed to keeping the lending rate around their historically low levels before the pandemic crisis.

Figure 18: MFI loans to NFCs

(annual percentage changes)



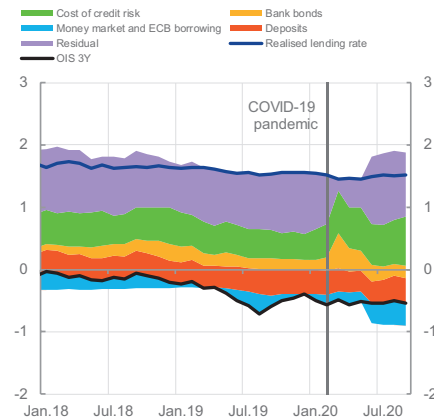
Source: ECB.

Notes: The indicator for the total cost of borrowing is calculated by aggregating short and long-term rates using a 24-month moving average of new business volumes. Loans are adjusted for sales, securitisation and notional cash pooling. MFI stands for monetary financial institutions. NFC stands for non-financial corporations.

Latest observation: August 2020.

Figure 19: Lending rate to non-financial corporations and its components

(percentages per annum)



Source: ECB.

Notes: The intermediation wedge is the distance from the base rate (OIS 3Y, black solid line) to the realized lending rate, as measured by the observed lending rate for NFCs. The margin is the residual between observed lending rates and all other components, including the floor given by the OIS 3Y rate. The blue area shows the spread between the rate faced by banks from borrowing from MFIs, including the Eurosystem, and the swap rate. As a proxy for the most relevant borrowing rate, we consider the weighted average of (a) the Euribor and (b) the MRO rate (until March 2016), and subsequently the DFR. The red area and yellow areas comprise respectively the bank deposit and bank bond spreads, both weighted by their share as funding sources in banks' balance sheets. The components of the green area are computed based on Basel II risk weights, with probability of default (PD) proxied by Moody's expected default frequencies (EDF). The grey vertical line reflects the intensification of the spread of the COVID-19 pandemic in Europe in February 2020.

Latest observation: September 2020.

1.4.4. THE MACROECONOMIC OUTLOOK IN SEPTEMBER

After the sharp contraction in the first half of 2020, euro area GDP rebounded by 12.6% quarter-on-quarter in the third quarter. Notwithstanding the strength of such rebound – the largest since the start of the series in 1995 – the accumulated decline of 15.1% over the first two quarters of the year has not fully recouped. Looking ahead, the baseline scenario of the September ECB staff macroeconomic projections factored in some resurgence of COVID-19 infection rates and a tightening of containment measures. After the expected decline in output by 8.0% in 2020. In 2021 output is projected to be growing by 5.0% and in 2022 by 3.2%. Headline inflation is expected to gradually rise to 1.0% in 2021 and 1.3% in 2022. With the second wave and renewed containment measures, these projections have to be seen with considerable downside risks.

Under a counterfactual scenario without measures taken by ECB, estimates suggest that the outlook for inflation and growth would have been much worse. In particular, asset purchases and the TLTROs are estimated to have contributed in cumulative terms around 0.8 percentage points to the annual headline inflation rate and 1.3 percentage points to real GDP growth between 2020 and 2022.¹² These internal estimates can be considered rather conservative, since they do not account for the benefit of having arrested highly-disruptive, self-fulfilling feedback loops in asset prices and illiquidity that would otherwise have precipitated a much deeper economic contraction, a pervasive destruction of productive capacities, and an unprecedented deflationary dynamic.

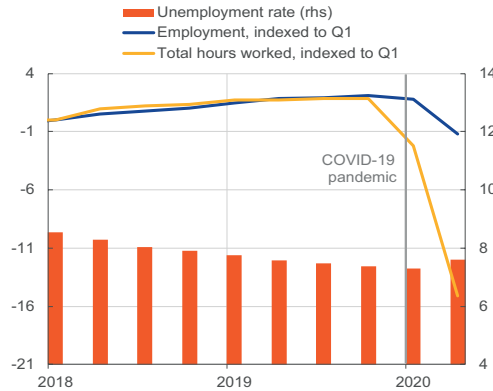
The fruitful combination of monetary, supervisory, macroprudential and fiscal measures at both the national and the EU level can be seen best by their joint effects on employment (Figure 20). Especially job retention schemes helped to contain the fallout of the pandemic. Their effectiveness is witnessed by the overall low level of unemployment, despite a recent increase. Estimates of the impact of monetary and supervisory measures indicate, however, that, with no ECB measures, firms' employment could have declined by 1.4% over the next two years, equivalent to more than one million jobs.¹³

¹² See Lane, P.R. (2020), “The pandemic emergency: the three challenges for the ECB”, Jackson Hole Economic Policy Symposium, Federal Reserve Bank of Kansas City “Navigating the Decade Ahead: Implications for Monetary Policy”, 27 August 2020.

¹³ See Altavilla, C., Barbiero, F., Boucinha, M. and Burlon, L. (2020), “The great lockdown: pandemic response policies and bank lending conditions”, Working Paper Series, No 2465, ECB, Frankfurt am Main, September.

Figure 20: Employment, unemployment and hours worked

(index, percentages)



Source: ECB.

Notes: Employment and total hours worked are index to 100 in 2018 Q1.

Latest observation: Second quarter of 2020.

1.4.5. ECB MEASURES PROPORTIONATE TO THE SCALE OF THE CRISIS

The ECB response has been targeted and proportionate to the unprecedented scale of the crisis. The ECB’s monetary policy measures are temporary as the emergency and its aftermath are expected to be reabsorbed over time. Deploying PEPP to safeguard monetary policy transmission and sustain policy easing has been key to forestall further severe downside risks to price stability.

At the same time, the ECB continually monitors the side effects of its policies. Empirical studies show that especially people in poorer and less educated income groups benefit from the ECB’s monetary policy measures because their jobs are most at risk¹⁴ The measures prevented illiquidity-driven job losses and supported new job creation through incentives for investment. In this respect, the distributional consequences would have been significantly larger without the ECB’s decisive actions.

The swift actions of micro- and macroprudential authorities with their capital relief measures was key to maintain banks’ flow of credit to the economy and to enhance banks’ capacity to absorb losses while avoiding abrupt and excessive deleveraging that would have proved detrimental for the whole economy.

¹⁴ See, among others, Slacalek, J., Tristani, O., and Violante, G., Household Balance Sheet Channels of Monetary Policy: A Back of the Envelope Calculation for the Euro Area, *Journal of Economics Dynamics and Control*, 115(C), article 103879 and Lenza, Michele, Slacalek, Jiri, How does monetary policy affect income and wealth inequality? Evidence from quantitative easing in the euro area, ECB Working Paper No 2190.

1.4.6. BEYOND THE PANDEMIC CRISIS

Looking ahead, the impact of the pandemic is likely to continue to weigh on economic activity well into 2021. Weakness in demand and economic slack are depressing inflation. Much hope hinges on an effective vaccine to be timely available and distributed. The pace of the recovery has been determined by the course of the pandemic and proved to be unsteady and uncertain. Continued policy support safeguarding favourable financing conditions until the pandemic crisis can be judged to be over is needed to achieve the ECB's inflation aim.

The ECB will continue to deliver the financing conditions necessary to protect the economy from the impact of the pandemic. Complementing an ambitious and coordinated fiscal stance, the ECB's monetary policy measures will help the euro area economy to eventually recover and to bring inflation back to levels consistent with the ECB's price stability objective.

2. THE FISCAL RESPONSE: A STEP FORWARD TOWARDS DEBT MUTUALISATION?

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ECONOMIC AND MONETARY AFFAIRS**

2.1. INTRODUCTION

The absence of an EU fiscal pillar has afflicted the euro area since its foundation. The creation of the single currency, and the centralisation of monetary policy at the European Central Bank, has not been complemented by a corresponding budgetary tool for cycle management.

The EU budget has remained oblivious to any consideration of its effects on aggregate fiscal policy, and has continued its focus on the provision of European public goods: infrastructure, cohesion, education, research, etc. The current size of the EU budget makes any possibility of using it as an anti-cyclical element difficult.

In this respect, the Union has left sole responsibility for managing the cycle to national fiscal policies (apart from monetary policy). Since the Maastricht Treaty, there have been successive versions of the Stability and Growth Pact. These were reinforced during the sovereign debt crisis of 2010–12 with the new Treaty on Stability, Coordination and Governance. That Treaty's sole objective was to avoid free-riding behaviour by the Member States, and to go some way towards ensuring the use of automatic stabilisers at national level, for which governments must maintain healthy public accounts.

However, the Union has failed to take on board the necessity of an aggregate fiscal position that is in step with the position of the entire euro area's economy in the cycle. The overall effects of the various national fiscal policies, where each government tries to balance its budgets within the framework of European budgetary rules, bear no relation to the aggregate needs of the euro area.

In some ways there has been a failure to recognise the external effects of national fiscal policies on third countries within the monetary union itself. Management of the cycle

is consequently left solely to the European Central Bank, overburdening an institution that, for too long, has been managing the euro area on its own.

Nor has this disaggregated vision of monetary union led to the introduction of systems for monitoring the current accounts on the balance of payments, as would have been necessary in the absence of a common fiscal policy.

Monetary union was founded on a design that neither aimed at a fiscal union (necessary to give coherence to the euro area), nor created safeguards for ensuring stability if the objective was simply to advance a fixed exchange rate model. This vagueness was to have very negative effects in the financial and fiscal crisis of 2008–2010, leaving the EU with no clear path in managing that crisis.

The crisis triggered by the coronavirus pandemic has reopened the far-reaching debate on the nature of monetary union. For the first time, the Union has designed an instrument to finance the recovery with its ‘Next Generation EU’, which could be an embryo for a future euro area treasury. We are therefore on the threshold of a change that could open the door to establishing an EU fiscal pillar. We shall see.

2.2. AN INITIAL DIGRESSION ON THE METHOD OF EUROPEAN INTEGRATION

On 9 May 1950, the French foreign minister, Robert Schuman, issued his famous Declaration that began the long road towards European integration, to the current European Union. Schuman’s speech included a key phrase that has come to explain the European method of integration: ‘Europe will not be made all at once, or according to a single plan. It will be built through concrete achievements which first create a de facto solidarity.’

Although this maxim has underpinned the adoption of Community competence in recent decades, this method has also generated considerable problems. Doubtless there were no alternative options for constructing joint sovereignty, but progress in ‘concrete achievements’, which did not fully Europeanise sectoral policies, in turn produced unsustainable contradictions likely to worsen or generate crises in the future that should be resolved with renewed progress in integration. This has been the general trend, which the Europeanisation of economic policy has not escaped.

The Single European Act of 1986 laid the foundations for the single market and for the free movement of capital within the Union. It broke down many of the national barriers to consolidating a common trade area. However, this expansion in market size was hampered by exchange rate risk, derived from several national currencies co-existing the length and breadth of that single market. Exchange rates incorporated not only a cost to the depth of that market, but also significant uncertainty about collection and payment timescales for economic operators.

The belief was that the European Monetary System (EMS), which established an exchange rate fluctuation band, could create enough of a condition for making the growth of the internal market viable. However, full free movement of capital would remind us

of the inconsistencies of trying to design a single market while maintaining national currencies that are subject to different monetary policies. Coordination was not enough, and the EMS ran out of steam in the early 1990s.

The European response was to deepen economic union and not beat a retreat on the freedom of capital, nor on the ambition to consolidate a deeper internal market. And so, the Maastricht Treaty was signed in 1992. This set the course towards the single currency: the euro. However, without a Europeanisation of fiscal policy, this course posed serious inconsistencies and simply postponed the problem of overcoming specific national positions that prevented the establishment of a common budgetary pillar.

2.3. THE MAASTRICHT TREATY AND THE STABILITY AND GROWTH PACT

The Maastricht Treaty established a road map towards monetary unity on the continent, although some countries negotiated opt-outs and remained on the margins of this new mission. The road map set us on a path of convergence on interest rates and inflation but shied away from establishing a fiscal pillar. The Treaty nevertheless included deficit limits (three percent of GDP) and public debt (60 percent of GDP). At the time, a coordination of national budgetary policies was considered enough to protect the roll-out of the single currency. This was once again a step in the right direction, but a full commitment was avoided, opening up the possibility of future crises if that coordination did not function properly.

The Stability and Growth Pact (SGP) was drafted years later, once the path for entry into force established by Maastricht was reasonably well under way. The Pact was devised in 1997, maintaining the public deficit and debt limits, and one year later the rules to be applied to countries that abided by the Pact were agreed. The rules were designed to encourage virtuous behaviour. In 1999, the corrective rules were agreed, designed to be applied to Member States that failed to adhere to the benchmark limits.

The central problem that the SGP as a whole sought to avoid, with its rules and compliance incentives and disincentives, was the existence of free-riding behaviour within the monetary union. There was no consideration of the effect of national fiscal policies on the aggregate cyclical position of the monetary union as a whole.

The common monetary policy could make it difficult to align interest rates in individual countries with their fiscal position. A Member State might be tempted to take on higher levels of public debt as long as the single monetary policy minimised effects on the cost of that debt. Without a mechanism for coordination and oversight of budgetary policies, market equilibrium could therefore lead Member States to amass levels of debt that would at some stage become unsustainable. This would threaten not only the fiscal stability of a Member State, but also the integration of the monetary union.

Note that this concern did not extend to all of the 'external' debt of each country. That debt was still agreed in euros, but in the hands of European operators not located in the issuing country. It was only with public debt that there was seen to be a potential driver for free-riding behaviour. For this reason, neither the Stability and Growth Pact

nor the Maastricht Treaty offered a system for monitoring the current account of the balance of payments of each country. This was a supervisory framework that, by its very nature, should address all external imbalances: both those generated by deficits and those generated by surpluses.

The Stability and Growth Pact was therefore limited to avoiding high public debts and deficits that could build up in that framework of a single monetary policy. The effect of the various national fiscal policies on the euro area as a whole was not considered. Nor were potential problems in the balance of payments, which became secondary in the context of a common market, where there would no longer be current account deficits or surpluses that could create imbalances that would precipitate potential crises.

Fiscal policy debates centred on how coordinated national fiscal policies should be, with some voices in favour of a common fiscal policy, as advocated by Jacques Delors. However, in the discussions at the time, there was no concern about possible balance of payments crises, which were not seen as possible in a monetary union, even though the monetary union itself came into being in an incomplete form. The concrete result of those discussions were specific figures for public debt and deficit, a mechanism for monitoring and penalties for any deviations.

In successive years, the Member States focused on fulfilling monetary and fiscal requirements (inflation and interest rates), focusing more on deficit than on aggregate debt. By the end of the decade, all countries had fulfilled the formal requirements for the euro's entry into force, tempering oversight over public debt and granting an additional period for Greece, which eventually joined the euro area in 2001, one year before the new euro notes and coins came into circulation.

2.4. THE EURO'S FIRST DECADE WITHOUT A FISCAL PILLAR

The euro's entry into circulation preceded the first recession of the new century, after the dot-com bubble burst. Its effects were also felt in the financial markets. Portugal was the first country to go beyond a public deficit of three percent of GDP in 2001, followed by Germany and France the following year, Greece and the Netherlands in 2003, and Italy in 2004.

These first breaches of the Stability and Growth Pact triggered penalty mechanisms. However, the European Council, whose approach differed from the Commission, which abided by the principles of the Treaties, decided to suspend the fines and begin a review of the Pact's content. As a result, the Stability and Growth Pact underwent its first reform in 2005 with a more flexible approach, in a framework more dependent on structural than nominal balances.

First, the reform introduced the 'medium-term objective' as benchmark indices of public debt. Given the rule established to keep the deficit below three percent of GDP, the new Pact proposed setting a medium-term debt objective to aim towards through annual reductions of around 0.5 percentage points of GDP. Annual public deficit objectives were therefore adjusted towards this medium-term objective for public debt. This path

of convergence for public deficit, and the debt objective itself, should be quantified in structural terms, filtering out cyclical effects on budgetary positions.

In addition, and only for countries under the corrective limb of the Pact, i.e. those that exceed the public deficit limit of three percent of GDP, or 60 percent for debt, the new Pact defined more precisely, but also with more laxity, the ‘exceptional conditions’ that might explain this behaviour without the need to resort to penalties.

Any reduction in GDP, including an easing of growth in relation to the trend, could therefore be argued as a special condition for temporarily not applying the Pact. The time limits for bringing public accounts into line with the medium-term objectives could be extended.

The revision of the Pact would therefore enable the automatic stabilisers to function more flexibly, placing the focus on structural aggregates. It would also smooth the paths of convergence towards the medium-term objectives, more fully taking into account the specific circumstances of individual economies.

This reform of the Pact continues despite the absence of the consolidated effect of national fiscal policies on the cyclical position of the euro area as a whole. Moreover, although it incorporates the need to monitor Member States’ structural reforms, it does not internalise the risks of imbalances in the current account of the balance of payments. We continue with a euro area halfway between a monetary union and a simple pegged exchange rate agreement.

The first decade of the 21st century has therefore seen a more flexible and perhaps more holistic Stability and Growth Pact in its treatment of fiscal balances, with public debt standing out as a medium-term objective in relation to short-term deficit balances, together with the introduction of the ‘structural’ notion of economic cycles. More than a decade later, this concept is called into question alongside other technical refinements that proved weaker than suspected.

2.5. THE REVIEW OF FISCAL POLICY AFTER THE FINANCIAL AND SOVEREIGN DEBT CRISIS

The economy of the euro area recovered quickly from the relapse at the start of the century. This relapse was essentially concentrated in the Union’s core countries, as many of the peripheral countries continued to grow strongly thanks to the convergence in interest rates made possible by the euro, amplifying investment and borrowing – these factors would complicate matters after the financial crisis of 2007–09.

The demise of Lehman Brothers in autumn 2008, following the collapse of another financial institution before it, dramatically switched off global financial flows. Uncertainty about the correlation of risks and prices on securitisations, first of mortgages and then on a series of complex financial products, paralysed financial transactions pending balance sheet analyses, which turned out to be not as sound as assumed. The uncertainty led to a global crisis that received an immediate fiscal response.

In November of that year, the G20 met in Washington to agree on national budgetary response plans. As with the more recent crisis resulting from the coronavirus pandemic, European authorities were in step with international agreements and encouraged a fiscal response in line with the risks to economic activity. However, unlike the current European approach, it was left entirely to national budgets to determine the fiscal response.

For some time, expansionary budgetary (and monetary) policies helped to provisionally sustain activity in the EU Member States. However, current account imbalances that surfaced after the rupture in financial flows ultimately worsened the economic situation, which was also affected by fiscal policy that contradicted the measures needed to balance the current account.

At that time, expansionary fiscal policies proved counterproductive to ensuring the integrity of the euro area. Given the risk of potential ruptures in the exchange rate due to the single currency, fiscal policies had to become restrictive, despite their procyclical effect. This was because the extreme procyclicality of an expansionary fiscal policy could otherwise be much more profound and lead inexorably to the break-up of monetary union. Without a common fiscal policy for the euro area as a whole, national fiscal policies had to become restrictive. This paved the way for a very negative phase for the Union as a whole.

This situation revived the debate on the viability of the Stability and Growth Pact, whose benchmark figures no longer served any purpose. Similarly, the new context opened up a discussion on a deeper reform of economic supervisory mechanisms, whose scope should not be limited to fiscal aspects, but should also incorporate an analysis of the sustainability of external account imbalances – particularly in the absence of a common fiscal policy. The integrity and cohesion of monetary union became a central issue. This had been a question missing from previous budgetary discussions, and, what is more, it revealed widely differing visions of the future of the euro area.

The route to tackling the fiscal crisis, which threatened some countries' continued membership of the monetary union, was based on two axes. On the one hand, the content of the Treaties of the Union, which made any rescue of a Member State impossible, was reinterpreted. New mechanisms to support national treasuries were created. On the other hand, budgetary control mechanisms were strengthened, extending European monitoring to macroeconomic imbalances and particularly to the evolution of current account and international net asset positions. Both approaches specifically avoided establishing a centralised fiscal pillar for the euro area as a whole. Moreover, although channels of support to Member States were established, monetary union appeared to lean towards a fixed exchange rate model.

First, in early 2010, two support mechanisms for national treasuries subject to strict conditionality were set up to restore fiscal and external imbalances. The European Commission led the creation of the European Financial Stabilisation Mechanism (EFSM) with a financial capacity of up to 60 billion euros, backed by a European Union budget guarantee. This mechanism provided EU funding for the rescue programmes of Ireland, Portugal and Greece. This instrument could be seen as providing a model for the more recent roll-out of the SURE programme, with a borrowing capacity of 100 billion euros

to provide liquidity to national unemployment systems during the current pandemic. In any case, the EFSM used a Community budget guarantee to issue the debt, while SURE used national budget guarantees; the Next Generation EU programme, however, will have to use the Community budget.

The EFSM jointly assumed the risks of the programmes, insofar as any non-payment would affect the Community budget as a whole. For the first time, an instrument was created which, although it did not manage to transfer resources to Member States as ‘non-returnable’, did assume joint responsibility for any non-payment.

In addition, the Council set up the European Financial Stability Facility (EFSF) around the same time. The EFSF had a borrowing capacity of up to an additional 440 billion euros, which provided financing for the Irish and Portuguese bailouts. This facility once again issued debt backed by national budgets, rather than the Community budget.

Besides these two mechanisms, the International Monetary Fund (IMF) provided an additional 250 billion euros for cooperation with the European institutions in the bailout of several Member States. This gave shape to three channels of financial support totalling 750 billion euros. Besides amplifying financial support, the IMF’s participation introduced a bias, from an institutional point of view, to the monetary union, bringing its model closer to fixed exchange rate systems.

Finally, the EFSM and the EFSF began on the route towards establishing, in 2012, a new institution with a permanent vocation, the European Stability Mechanism (ESM). The ESM was created with an authorised capital of 700 billion euros. This gave it an extraordinary borrowing capacity for offering liquidity to States with fiscal sustainability problems. Its formation was based on an inter-governmental treaty signed by the Member States in monetary union. It therefore fell outside the Community framework, although it was established that it would need to be integrated into the Community acquis by 2019.

The ESM would issue all types of bonds, backed by its own capital, which consisted of Member States’ contributions, to provide liquidity to Member States after signing a Memorandum of Understanding on the strict conditionality of this type of operation. To some extent, the ESM was shaping up to be a European Monetary Fund, a multilateral, non-EU institution that issues a type of ‘eurobond’ to finance individual programmes in countries experiencing problems. If loans to Member States experiencing fiscal problems were returned in full, there was no mutualisation of the losses. However, the ESM meant the first mutualisation of fiscal risks between the Member States of the euro area, albeit not through the Community budget, but through their respective national budgets. This led some countries to demand greater security for their participation in the ESM through bilateral contracts, in addition to the Memorandum signed with the ESM itself.

During the negotiation of this Treaty, the possibility was considered of using this new instrument to directly recapitalise financial institutions, without the intermediation of the States where the institutions had their headquarters. However, this option was not acted on in subsequent years.

Second, and as a counterbalance to developing these liquidity instruments, the Union adopted new legislative measures to strengthen supervision of Member States' budgetary policies. If, on the one hand, mechanisms were enabled to circumvent the express prohibition in the Treaties on financial bailouts for Member States, control over fiscal balances was meanwhile tightened. Thus, in 2011 a package of reforms known as the 'Six Pack' was approved. Besides increasing budgetary supervision, a framework for monitoring macroeconomic imbalances was conceived for the first time, focusing on current account risks and the roll-out of structural reforms.

In the same vein, in 2013 the Union adopted a second set of measures through the 'Two Pack', and Member States signed a new budgetary treaty, complementary to the Stability and Growth Pact, known as the 'Treaty on Stability, Coordination and Governance'.

This package of measures gave shape to a new system of governance of budgetary issues across the Union, particularly in the euro area, which needs to be specifically explained.

Under the current supervision model, every autumn the Commission publishes its so-called Annual Growth Report, the Alert Mechanism Report and a Joint Employment Report. In these three documents, the Commission provides an outlook for the performance of the European economy, describing any imbalances in each Member State and the evolution of employment and other social indicators.

In turn, by 15 October Member States must send the European Commission a draft budget for the following financial year. The Commission assesses the draft and determines whether it provides a reasonable basis for convergence on deficit and debt with the targets set. Furthermore, the Commission may recommend that the Council block the processing of a draft budget if it concludes that the draft budget in question does not follow European recommendations, even where it could obtain a sufficient majority in the corresponding national parliament.

Note here that the EU institutions can block the adoption of a budget that could receive a national parliamentary majority, and they can do so without the approval of the European Parliament. To some extent, the Member States have transferred their fiscal sovereignty to the European Council as final arbitrator, without the participation of a deliberative body representing the citizens. The extent to which this supervisory model adheres to impeccable democratic traceability is a matter for debate.

Completing the European supervisory model is the individual report for each country, once again drawn up by the Commission, in which it analyses not only budgetary conditions but also management of economic policy as a whole, issuing 'country specific recommendations'. In addition, for countries identified as having some form of macroeconomic imbalance, the Commission draws up an additional in-depth report to analyse the situation and recommend corrective policies.

For their part, the Member States publish their national reform programmes and stability programmes in April, covering a three-year period. In these documents, governments attempt to frame their respective responses to budgetary or macroeconomic imbalances.

These reports are re-examined by the Commission, which assesses the extent to which these programmes comply with the specific recommendations and proposes their approval or non-approval by the Council. The latter adopts a final assessment in July.

This is the annual supervision mechanism as it stands. It is accompanied by a more automatic system of penalties. In this respect, the Commission may propose that a Member State that has not fulfilled its obligations provides a deposit of 0.2 per cent of GDP, ultimately increasing to 0.5 per cent if there is no corrective action. Through the new Stability, Coordination and Governance Treaty, these penalties would be automatic, unless a qualified majority were to vote against, thus reversing the burden of proof of the trigger for the penalties. Furthermore, the penalties could lead to blocking the receipt by the defaulting Member State of funds relating to the Union's cohesion policies. This potential cancellation of EU funds poses the greatest threat for any deviation from budgetary rules.

In structural terms, this latter Treaty forces all States to avoid incurring a structural deficit of more than 0.5 percent of GDP under any circumstances. This could rise to 1.0 percent if public debt was below 60 percent of GDP.

In the 2010–13 period, the Union therefore gave itself a much stronger framework for monitoring and implementing the Stability and Growth Pact, through the Two Pack and the Six Pack, together with the new Treaty on Governance. Meanwhile, the EU incorporated the European Stability Mechanism (ESM) into its toolbox as an instrument for offering Member States liquidity, subject to their agreeing to strict conditionality.

However, regardless of the more limited manoeuvrability in the design of budgetary policy, the monetary union evolved in those years towards a fixed exchange rate model, emulating the Bretton Woods agreements where the dollar-to-gold standard was set. At that time, fluctuation bands for market exchange rates, a balance of payments monitoring system and liquidity lines provided by the IMF to support these exchange rates were established, subject to the approval of conditionality programmes.

The new ESM would replicate the role of the International Monetary Fund, incorporating Commission responsibility for macro-supervision on current account imbalances. Furthermore, through fixed rates rather than fluctuation bands, it strengthened control over national budgetary policies in the case of monetary union.

The impossibility of agreeing on any form of joint fiscal instrument moves the euro area away from the institutional convergence needed for monetary union and creates a multilateral model that is also far removed from the Community method.

This digression from the Europeanist path was counterbalanced by the impetus given to the banking union from the summer of 2012 onwards, in parallel to the questioning of the nature of monetary union. The financial crisis, which directly affected national budgets, forcing a restrictive fiscal policy because of the risk of exchange rate rupture, led the European Council to launch the initiative to establish the banking union, so that future banking crises would not have such an impact on the treasuries of each country.

To that end, the Parliament and the Council agreed on a single rule book on banks, a single supervisory mechanism (SSM) within the European Central Bank, and a Single

Resolution Board, together with a fund financed by contributions from the banks themselves, to address future banking restructuring. Regardless of the functional agility of this joint supervision and resolution model, with authorities being responsible for cases of liquidation of smaller institutions, the project remains incomplete in the absence of some form of fiscal mutualisation.

On the one hand, the Single Resolution Fund should have a lender of last resort when faced with insurmountable financial shortfalls in the Fund. To that end, it was thought that the ESM could act as a fiscal backstop. That option should already be constitutionalised, just like the entire legal framework of the European Stability Mechanism (ESM). Recently, the Eurogroup has reached an agreement on this issue, pending ratification by the European Council.

On the other hand, the Commission's legislative proposal for the establishment of a European deposit insurance scheme is at a standstill in the Council and Parliament. Although such insurance is in principle private in nature, the potential for banking risks in third countries to seep into the national budgets of the other Member States has prevented any progress. For all these reasons, and before the current debate on the response to the crisis resulting from the pandemic, the Great Recession led to a certain change in the nature of the political project of the monetary union, by creating an institutional framework that specifically balked at pooling sovereign risks, moving instead towards a kind of fixed exchange rate system. This distanced monetary union from the Europeanist political project that underpinned the launch of the euro area.

The package of tools put in place helped to resolve that crisis, with the essential support of the ECB since the summer of 2012, although it entailed extensive economic and social costs that could have been minimised if there had been a different fiscal approach.

2.6. NEW FISCAL DEBATES DURING THE RECOVERY OF THE PAST FIVE YEARS

During the five-year economic recovery prior to the pandemic, the suitability of the budgetary surveillance framework returned to the centre of the debate. Some countries had less fiscal latitude for reviving activity. The new monitoring rules were put to the test in 2016–17 when some Member States such as Portugal, France or Spain failed to take on board the new framework of budget cutbacks. As was the case at the start of the century, the Commission adopted a more accommodating position, spurred on by a European Parliament, the majority of which was reluctant to see the provisions of the Treaties automatically applied, given that Member States themselves were also not very concerned with the country-specific recommendations.

In early 2015, before these potential problems with application, the Commission published a communication on implementing the Stability and Growth Pact that entailed renewed flexibility. Thus, the Commission anticipated that it would take greater account of structural fiscal balances and possible reforms as a mechanism for amplifying potential output, reducing relative fiscal balances. This slight relaxation was merely a detail in

a Stability and Growth Pact, which, together with the Treaty on Governance, called for further and more in-depth reform.

Furthermore, the need to strengthen the recovery guided the debate, once again, on constructing a Community fiscal tool. Without a large enough political majority, the European Commission revisited the experience of the European Financial Stabilisation Mechanism and created a new tool to offer both public and private liquidity through the European Investment Bank. This was backed by the Community budget through the programme commonly known as the “Juncker Plan”. This fund made it possible not to include loans contracted for by governments in the public deficit, provided this financing was aimed at funding the capital of public intervention instruments. The new fiscal rules allowed these contributions to be considered a ‘one-off’ and, therefore, to be left out of the structural calculations.

This experience was a significant success in reviving private investment, while Europe was advancing in a mode very similar to the Keynesian liquidity trap, in the context of secular stagnation. However, it did not succeed in completely reversing the approach to EU fiscal policy.

In addition, and in the absence of this European fiscal pillar, in 2017 the Commission again proposed a new regulation known as the European Investment Stabilisation Function (EISF). In this proposal, the Commission established a system for transferring funds to a Member State experiencing a recession to maintain the aggregate level of investment. This liquidity, in the form of a loan, would have to be repaid over long repayment periods, but the interest would be paid jointly through a fund set up with contributions from ECB profits, corresponding to each Member State.

Once again the Commission was putting forward an option that pursued automatic stabilisation at European level where only the debt servicing incurred was pooled. However, this proposal is currently at a standstill in Parliament and the Council.

Efforts in recent years to give shape to a Community fiscal pillar have therefore been confronted with a harsh political reality, with no majority in co-legislators to at least mitigate the imbalances of the euro area’s incomplete design. The shock of the coronavirus pandemic appears to be once again redefining the overall framework of this lengthy debate.

2.7. NEXT GENERATION EU: A ‘HAMILTONIAN’ MOMENT?

Europe is living through the severest peacetime economic depression for centuries. Moreover, without any certainty on how the pandemic will evolve, the development of treatments and, of course, the invention of a vaccine, the economic environment will continue to be very unstable. If social distancing and movement restrictions as measures of last resort to minimise the spread of the disease continue to be the first line of defence, the economic recovery will be very complex.

With this background scenario, and with an eye on developments in health research, economic policy is attempting to minimise the costs of this crisis, although there will be

no path to sustainable growth until the scenarios are made clearer by science. In this crisis, the institutions of the European Union, which are under a lot of strain, have responded quickly and sensibly.

After the first few weeks in March 2020, when each Member State initially made individual decisions on their lockdown and movement restriction measures – without any sort of cooperation at European level that would take into account the effects of these measures on the Schengen area – the European authorities created a climate of cooperation, first on purely health-related matters, through financial support, and then in economic matters. By April, the governments of the euro area had agreed on similar fiscal policies: the roll-out of guarantee and support programmes and national plans to socialise wage costs through different models. This response sought to contain the damage during the quarantine period, preventing the shutdown of the economy from destroying the economic fabric behind it.

These decisions were supplemented by the European Commission, which proposed not to apply the Stability and Growth Pact, i.e. to allow automatic stabilisers and the fiscal support of the national executives to be freely applied, irrespective of their effect on public deficits. The Commission also called for an additional ‘quarantine’ of state aid regulation, to facilitate public support for companies that might disappear during this downturn.

These policies, on the proposal of the Commission and the Member States, helped to prevent a substantial destruction of the economic fabric; however, they all left responsibility for financing them to the national budgets.

The finance ministers of the Member States also agreed to negotiate a special credit facility from the European Stability Mechanism (ESM), but again this support was only a credit facility, leaving responsibility for this debt to the countries of the Union.

In the same month, the European Central Bank moved to offer discreet support to national debt issuances, pressuring the Eurogroup to move forward with a common fiscal response that would not limit support to a coordinated expansionary fiscal policy. That attempt lasted only a few days, due to uncertainty arising in the markets, and ultimately forced the ECB to launch the pandemic emergency purchase programme, which ensured the demand necessary to issue the public debt anticipated for the entire year.

In April, the European Parliament, in a resolution at its plenary session in Brussels, joined the voices demanding a European recovery programme financed by Community borrowing. The Parliament was not asking for Eurobonds to be issued for which repayment liability would continue to lie with each Member State (if no country defaulted), where those with too much debt would benefit from a lower issuance cost; rather, the proposal concerned common debt whose repayment would be a collective responsibility.

During that month, there were additional proposals to increase mutual coverage, but always under the responsibility of each Member State. On the one hand, the European Commission proposed the SURE programme, to offer financial assistance to Member States that would cover part of their unemployment expenditure. This proposal was again inspired by previous Commission proposals to offer Member States financial

liquidity obtained on the financial markets by issuing Community debt guaranteed by the budgets of the Member States. This support was limited to a single liquidity facility, without assuming joint responsibility for the amortisation of these liabilities - again if no country defaulted.

The European Investment Bank also launched an additional plan to absorb the guarantees that Member States were arranging in their respective countries. Progress was also made in designing this exclusive ESM facility to cover direct or indirect costs arising from the consequences of the coronavirus. However, once again, these measures, although necessary in the short term, would further increase Member States' public debts, compromising their ability to contribute to the recovery in the second half of the year and in the next year. This reality increased pressure to devise a common response.

The European Parliament, again in a resolution adopted at its May plenary session, took its previous proposal further and called for a recovery plan of at least two trillion. The central pillar of this plan would be a special fund financed through common debt that would transfer these resources to the States, mainly through direct transfers rather than through new loans. This request went hand in hand with similar proposals from Member States such as Spain and France, and eventually led to a political majority calling on the Commission to draw up proposals along these lines. Weeks later, with some delay, the Commission presented its new Multiannual Financial Framework (MFF) proposal. It was not particularly ambitious but was in any case supplemented by the creation of a new fiscal instrument, Next Generation EU, which would raise 750 billion euros on the market and help finance the recovery. In late May there was finally a proposal on the table.

At that time, European countries were beginning to relax some of the restrictions imposed in early spring to slow the advance of the virus, and the first effects of this two- to three-month economic shutdown were observed. The recovery was reasonably rapid, but the evolution of the pandemic over the summer reminded us that the health crisis was not yet over.

In June, negotiations began within the European Council to give the go-ahead to this historic Union debt issuance, while the Parliament arranged separate regulations to soften the effects of the pandemic. The ball was then in the court of the heads of state or government of the Union's countries. Finally, at the very end of July, the European Council raised the white flag with an agreement that not only backed the requests of Parliament and of the Commission, but could also signify a major change in the Union's design. This is another question which we shall address later on.

The agreement approved the Next Generation EU programme, issuing common debt; however, it incorporated some details that were not to Parliament's liking. On the one hand, the MFF was finalised at 1.1 trillion euros, a figure below Parliament's ambitions, with an increase in 'national checks and balances' to accommodate the so-called 'frugal countries'. The MFF would therefore have fewer resources than those provided for in key policies for the Union: Erasmus+, Horizon 2020, Neighbourhood Policy, etc. Furthermore, resources from Next Generation EU debt issuance were reduced for strictly Community programmes, such as InvestEU, Solvency Support, the Just Transition Fund or foreign policy. Meanwhile, the percentage of these issuances were increased to

fund the Recovery and Resilience Facility (RRF), the new instrument for channelling part of these resources to Member States. There was therefore less funding for strictly Community-related expenditure and investment programmes.

In addition, the European Council agreed on a system of supervision and control of money to be transferred to the Member States through the RRF in which responsibility lay almost exclusively with the Member States themselves. This generated problems of democratic legitimacy in its implementation. Finally, the agreement aimed to create new resources of the Union's to repay this debt issuance, but without a clear timetable or a particularly firm commitment. This reduced the credibility of the whole package insofar as there is insufficient clarity on how the Community debt will be repaid.

At the end of July, following the Council's approval, Parliament adopted a new resolution that, while recognising its historic nature, underlined these negative aspects. Beyond these areas for improvement, which are neither few nor simple, the European Council's approval to allow common borrowing to activate a short-term investment plan, helping to bring about a territorially balanced recovery, represents a substantial change in the very nature of the Union.

At the time of writing, the EU's Parliament and Council are in the middle of legislative work to finalise all the details of this recovery package. First, both co-legislators agreed to improve the allocation of some investment programmes in the Multiannual Financial Framework, over which the Parliament has a right of veto. Second, the negotiations go on to design a Recovery and Resilience Facility implementation by improving its governance model. Concerning this, Parliament is working on a framework to develop the self-contained RRF, which depends less on the European Semester and responds exclusively to the needs of the current situation and the efforts required for a rapid recovery. Thirdly, Parliament and Council agreed a legally binding timetable for the entry into force of new own resources for jointly repaying the debt. It is on this last point that the nature of the historic debt issuance decision is at stake.

In any case, everything is now pending the announced veto of Hungary and Poland after the complementary agreement between the Council and Parliament to introduce financial conditionality linked to compliance with the rule of law by the Member States.

The euro area has lacked a fiscal pillar since its foundation. We saw the negative effects of this incomplete design during the years of growth that followed the entry into force of the euro. In the first five years of this century, what the euro area needed was a fiscal instrument to help contain the expansionary effects of monetary policy in some Member States, since compliance with the Stability and Growth Pact did not offer enough indicators in this regard. The same thing has occurred in recent years with the development of fiscal policy in countries such as Germany and the Netherlands. But it was during the 2007–10 crisis that its absence was felt, when a common expansionary response would have avoided the so-called 'expansionary austerity' that generated procyclical effects. On this occasion there has been enough political consensus to lay the groundwork for the Next Generation EU programme.

However, this new instrument, which recognises the euro area's structural design problems and the inadequacy of reforming it using a fixed exchange rate model, which

requires more budgetary supervision of Member States and monitoring imbalances in the current account of the balance of payments, has come into temporary existence. Political agreement has only been possible as an ad hoc option designed to respond to this current economic crisis, with no official intention of being permanent. We cannot therefore yet speak of a ‘Hamiltonian’ moment in the European Union. However, there are indications that it could help revise the temporary nature of this Community borrowing.

On the one hand, the European Council has proposed the approval of new European taxes to service the repayment of this debt. These new taxes range from a tax on single-use plastics, which comes into force in January 2021, digital taxes and the introduction of a CO₂ border adjustment on imports (which should be supported by a legislative proposal that either sets a tariff directly or revises how the EU’s Emissions Trading System works, to force exporters to the Union from third countries to buy these rights as well). There is also the prospect of introducing a tax on financial transactions and the conclusion of an agreement to consolidate corporate taxation at the European level.

All these taxes should make it possible to repay the debt from 2028 onwards, even though interest payments will be allocated to the ordinary budget of the European Union. These taxes are nevertheless permanent in nature and, although in their first years they will have to go directly towards repayment of the debt issued now, they represent a source of recurrent income which could be relied on as support for future issuances.

Moreover, the issuance of debt before introducing these taxes somewhat alters the nature of the European debate on taxation. Until now, the requirement for unanimity in the Council and the absence of a tangible opportunity cost for the national governments most reluctant to move towards common taxation has de facto blocked these initiatives. However, with the debt already issued, governments will have to decide whether they would prefer to make these new taxes viable or face repaying Community debt with their respective national budgets. To some extent, the burden of proof in the Council negotiations appears to have been reversed, and it remains to be seen whether the additional cost to national budgets, in the absence of agreement, is enough to unblock this debate.

Certainly, if there is no agreement on introducing new taxes, issuing the Next Generation EU package would have remained a joint issuance, where each country received financing depending on the damage this crisis caused to their economies, with each one repaying it according to its proportion of the overall EU GDP. There would be a degree of joint indebtedness, but the advantages of pooling this debt would be limited to having the same interest rate for all Member States and the relationship between the relative size of their economy and the recession (also relative) generated by the pandemic.

However, if the debt was repaid entirely through new taxes, we would be very close to that ‘Hamiltonian’ moment. To confirm that leap, we will have to wait until it is possible to assess the temporary or non-temporary nature of this issuance. There are therefore two further central questions to be added to the debate.

First, the likelihood of retaining the Next Generation EU package will critically depend on the efficient use of existing funds. The Recovery and Resilience Facility that will channel most of this debt issuance to Member States is a novel instrument whose

implementation depends on the level of ambition of national plans, but also on the supervisory capacity of European authorities. The overall assessment of the programme's ability not only to respond to the macroeconomic shock of the current crisis, but also to guide the micro reforms that could boost the potential growth of each country and of the Union as a whole, will be central to European public debate.

Second, the behaviour of the European economy as a whole, potential future crises and the ordinary course of events could make it advisable to prolong this type of issuance, or even to use its repayment as an anti-cyclical tool in the face of any economic boom. The happy years of the 1920s also had much to do with the end of the 'Spanish flu', which led to a marked unconcern with economic management after several years dominated by the pandemic. Perhaps a similar situation could be repeated, and issuing the Next Generation EU package could be an instrument of macroeconomic management that demands to be maintained over time.

Finally, the future of the Next Generation EU programme will be discussed in the forthcoming revision of the Stability and Growth Pact. After the experience of the last two decades and the fiscal data generated by the current crisis, in 2021 the Union will open a debate on the future of the budgetary rules. This should be concluded in the first half of 2022, in principle once the current suspension of the rules expires. Existing benchmarks such as the 60 percent of GDP limit for public debt have been overtaken by reality.

However, this debate must clear up several things. On the one hand, we will return to the regulation versus institutions debate. In my opinion, the experience of the Stability and Growth Pact, certainly in relation to how the European Central Bank functions, makes it clear that the design of institutions works substantially better than the decentralised application of rules of cooperation between Member States. It will doubtless always be possible to design better rules or more efficient systems for applying them, but it seems clear that the European economy will continue to be guided by cycles, and uncertainty about the future will not be eliminated. No rule of budgetary cooperation could anticipate how unknown future circumstances will unfold.

Other separate debates will follow, such as the revision of the prudential banking rules for government debt holders. The restructuring of Greek debt and attempts by some Member States to introduce a public insolvency framework in the constitutionalisation of the ESM make it clear that the debate on the absence of national debt risk in a monetary union is no minor issue. However, this question also leads to the need for a purely European risk-free asset. The issuance of the Next Generation EU debt is an EU risk-free asset that will coexist with national public debts for several decades, at least until 2058 (the current repayment period).

In my view, maintaining the Next Generation EU package or any other centralised fiscal instrument leaves the door open to reviewing the prudential nature of national public debts. Depending on how long that European fiscal pillar remains in place, and how robust it proves, progress can be made in updating the prudential treatment of national sovereign debt.

Finally, and tied to the debate between EU versus national risk-free assets, the new Pact could be of a very different nature. In one possible scenario, if the European fiscal pillar is robust enough to contribute to cycle management, the Pact could become an unnecessary tool in conjunction with removing risk-free consideration from national debt. However, to reach this point, the institutionalisation of fiscal policy at European level would need to achieve levels difficult to predict at this time.

I would therefore tend to favour a less ambitious compromise solution that makes the Next Generation EU programme viable. A solution that, through efficient management of existing funds, very slightly alters the prudential treatment of national public debt so as to make it more tied to the diversification of sovereign risks in bank balance sheets, while allowing monetary policy to shine through this Community debt. All this will require drafting a new Stability Pact whose degree of flexibility for national automatic stabilisers will depend on the strength of a European stabiliser managed from a democratic institution such as the European Commission, supervised by Parliament and the Council as representatives of the citizens and the Member States making up the Union.

2.8. CONCLUSIONS

In these short pages I have tried to look back at the evolution of the debate on the construction of a fiscal pillar since the signing of the Maastricht Treaty. I have tried to avoid simplistic explanations that always seek an original sin and sinners to rationalise all the problems of the present. The construction of Europe has been partial and ad hoc, resolving short-term issues that demanded a common response and waiting for better (or worse) times to finish outlining European strategies for problems still unresolved in the national arena. This is certainly not the path many of us would wish for rebuilding a shared sovereignty but, given the facts, it seems the only possible one.

The transfer of fiscal sovereignty goes to the heart of national democracies and, until now, it has not been possible to reshape a budgetary instrument that covers the entire euro area. Even with strict supervision, national budgetary rules and regulations do not allow for the consolidation of an aggregate fiscal position consistent with the euro area's fiscal position over the cycle.

Discussions have so far focused more on the degree of flexibility of these rules applicable to Member States when permitting the use of automatic stabilisers and discretionary measures.

The financial and sovereign debt crisis of 2008–12 did not begin an open debate on the design of a mutualised fiscal response. The euro area moved away from a monetary union paradigm and adopted instruments more in line with fixed exchange rate models. This response succeeded in overcoming that crisis, but with a very significant economic and social cost that could have been mitigated by reinforcing the mutualised nature that is the euro area's mission.

On the contrary, the current recession has allowed a political majority to emerge for the design of a mutualised fiscal instrument, the Next Generation EU package, whose

mission is not only to cooperate with monetary policy in responding to this crisis but also to light a path towards completing an efficient design of monetary union.

The package of taxes for repaying this debt and the successful management of these funds are necessary milestones along the way. This way forward will also involve a revision of the Stability and Growth Pact itself, which requires fewer rules and more institutions. Cooperation is not enough if we are to afford the monetary union an aggregate fiscal position, nor is it enough to achieve their fulfilment. This debate will be particularly relevant for the prudential treatment of national sovereign debt, which will require the strength of a purely European risk-free asset.

The ‘Hamiltonian’ leap in Europe will be made in stages. But we are already making it.

3. THE POLITICAL REACTION: HOW DID THE EUROPEAN INSTITUTIONS RESPOND TO THE CRISIS?

CRISTINA MANZANO

Arrogance. Arrogance defined the first Western reactions to the news about the spread of the newest breed of coronavirus, Covid-19, as it was to be known. It had happened before – MERS, SARS, Ebola – the virus would remain in farther, less developed regions. We did not need to worry... too much. Arrogance led to complacency and overconfidence, which in turn met with lack of preparation. Early warnings were ignored. The first cases from patients coming from China were considered an exception. At the end of January, the World Health Organization declared Covid-10 a public health emergency of international concern. National and European leaders slowly started to take some measures, while the virus was already quickly spreading. On 11 March, the WHO admitted that the coronavirus outbreak had reached the level of a pandemic.

A few days earlier, Italy had ordered the lockdown of the Lombardy region and 14 other Northern provinces, soon followed by the confinement of the whole country. Never before in living memory had more than 60 million people in an EU country been ordered to stay at home.

Suddenly, the general European mood started to change. Surprise, concern and panic spread all over Europe. After Italy it was the turn of Spain, France... most European countries, individually, took different measures to try and stop the virus. Sanitary and protective equipment, face-masks and sanitizing gel became the most demanded products. France announced it was taking control of their production, setting off a domino effect, which led Germany to declare a ban on exports of such equipment even to other EU Member States. The greatest success of the European project, the Single Market, was under threat. The Schengen Treaty, another major achievement of the EU, was cancelled (even if temporarily) when citizen's mobility across borders was also banned. A new health nationalism arose.

The ghost of national selfishness blew once more across the continent. European public opinion saw again, with dismay, that Europe was not ready to come to the rescue. The memory of the not-so-distant euro crisis revived anew. Back then, when the economic survival of several Member States had been at stake, it took several years before the European institutions reacted. This time it was not only the economy that was in danger; the pandemic threatened thousands of lives.

For a short while, the European Commission and its newly appointed president Ursula von der Leyen seemed to hide behind the technicality of health being a concern within the remit of each Member State. What the Commission can do, according to Article 168 of the Treaty on the Functioning of the European Union – the legal foundation and doctrine of the EU¹ – is coordinate, support, give advice and make recommendations to Member States on health issues. The Treaty also contemplates a solidarity clause in its Article 222.

The first actions from the Commission, with the support of the European Centre for Disease Prevention and Control (ECDC), were in fact to coordinate risk assessment and information and data gathering among Member States. As the crisis quickly unfolded, it was clear that much more was needed to tackle it.

For a set of institutions traditionally considered bureaucratic and boring, the chronicle of the fight against coronavirus lies between a mystery tale and a psychological drama; one of a race against time and national temptations. One epic drive of changing emotions and expectations, in which the dominant feeling was that of “now or never”: once again, the European project was on the verge of an existential crisis if not able to respond to the huge new challenge.

The chain of measures, discussions, and proposals since March 2020 led to the largest and most ambitious plan ever designed by the European Union, the Next Generation EU (NGEU) package, agreed by the European Council after a long and almost dramatic summit in July. The plan was linked to the next Multiannual Financial Framework (MFF), the European budget for 2021 to 2027.

At the time of submitting this paper, the European Parliament and the Council still need to approve the final version of the plan and budget. But the reality is that the EU has taken a giant’s leap towards integration due to the pandemic, faster and deeper than at any other moment in its more than sixty years of history.

A non-exhaustive summary of the main discussions and measures on the European response to coronavirus follows.

3.1 THE “WHATEVER IT TAKES” MOMENT

After initial hesitations, the Commission reacted quite quickly by announcing a cascade of measures aimed to tackle both the health and the economic crisis.

¹ <https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A12008E168>

From the healthcare perspective, in mid-March, in collaboration with the ECDC, the Commission set up a panel of scientists (seven experts from six EU Member states) to create guidelines and coordinate risk management. Led by Von der Leyen, a medical doctor herself, the panel also issues scientific recommendations.

In order to face the shortage of medical equipment, the Commission launched joint procurements for face-masks and other protective gear; with a sharp increase in the global race to buy and produce sanitary supplies, economies of scale became even more important. The Commission also drew up a plan to stockpile strategic medical equipment like ventilators, protective masks, and laboratory supplies, among others². The new European reserve – rescEU – is an initiative of the EU Civil Protection Mechanism, which, coordinated by the EU Emergency Response Coordination Centre, has delivered medical equipment and supplies to Europe and countries that have sought assistance around the world. This collaboration was also used to deploy teams of doctors and nurses from Romania and Norway to Italy.

A new discussion about what needs to be considered as strategic material has been initiated since then. “It is not normal that Europe doesn’t produce a single gram of paracetamol, and 80 percent of the antibiotics production of the world is concentrated in China,” stated the EU High Representative for Common and Security Policy, Josep Borrell, to the media³.

Reactions calling for “strategic autonomy” multiplied while the world witnessed a new cold war between the United States and China. Some European citizens were keener to recognize the value of the Chinese aid arriving to the most affected countries those days than to recognize the efforts done by the European institutions. A renewed battle for narrative is another collateral consequence of the pandemic.

In that first stage of the crisis, the Commission allocated €140 million to finance vaccine research and treatments. Some weeks later, it would head a (virtual) international donor conference where world leaders pledged €7.4 billion for developing a coronavirus vaccine and treatments, ensuring that they will be universally available and affordable⁴.

Seeking to control the expansion of the virus, EU countries reinstated border checks, not only violating the principles of the Single Market, but also causing long queues at internal borders and slowing down supply chains across the continent. In order to avoid shortages, the Commission called on member States to designate “green lanes” where

² https://ec.europa.eu/commission/presscorner/detail/en/ip_20_523
https://ec.europa.eu/info/live-work-travel-eu/health/coronavirus-response/crisis-management-and-solidarity_en

³ Masdeu, Jaume: “Josep Borrell: Europa ha reaccionado porque le ha visto las orejas al lobo”, *La Vanguardia*, 26-4-2020, <https://www.lavanguardia.com/internacional/20200426/48721547645/europa-ha-reaccionado-porque-le-ha-visto-las-orejas-al-lobo.html>

⁴ https://ec.europa.eu/international-partnerships/events/coronavirus-global-reponse-pledging-conference_en

border crossing, including checks and health screening, would not take more than 15 minutes⁵.

Lockdowns, quarantines and travel bans left more than 625,000 EU citizens stranded outside the borders of the EU, according to official figures. The joint work of the Consular Coordination Task Force, the EU Civil Protection Mechanism and the collaboration of institutions and Member States enabled the return of more than 580,000 EU citizens to their homes by mid-May⁶.

In the aviation sector, one of the most affected by the pandemic due to the almost complete halt of operations, the Commission put a moratorium on the so-called “use it or lose it” rule, that stipulates that airlines have to use at least 80% of their allotted slots if they do not want to lose them.

By then, it was more than clear that the economic effects of the coronavirus crisis would go much further and much deeper than ever. There is no record of such a sudden stop of both supply and demand amid the highest level of integration of global value chains. The need to reinforce health systems and to protect citizens and businesses from the consequences of the recession was perceived by both national governments and European institutions as a priority.

Thus, in addition to the healthcare and operational measures, the EU soon put together a package of economic measures to face the looming crisis. To start with, the Commission proposed, for the first time in its history, the activation of the general escape clause of the Stability and Growth Pact, allowing Member States to increase their budget deficits and therefore suspending limits on government borrowing. The rule requires that budget deficits do not exceed three percent of GDP and that public debt must remain below 60 percent of GDP.

Within the Coronavirus Response Investment Initiative, the Commission allocated €37 billion unallocated structural funds and investments, whereas the European Investment Bank offered a package of €25 billion to help maintain cash flow for small and medium businesses⁷. Later, the EIB would scale up its funding to €200 billion.

Another significant step was taken with the approval of a European instrument for temporary Support to mitigate Unemployment Risks in an Emergency, better known as SURE. Under this line of financial assistance, Member States can access up to €100 billion in loans to protect jobs and to finance temporary unemployment schemes, especially addressed to self-employees and SMEs⁸.

⁵ https://ec.europa.eu/commission/presscorner/detail/en/ip_20_510

⁶ <https://www.schengen-visa.com/news/eu-repatriates-more-than-580000-citizens/>;
<https://www.consilium.europa.eu/en/press/press-releases/2020/05/15/europe-brings-home-over-half-a-million-stranded-citizens-an-unprecedented-challenge/>

⁷ <https://www.eib.org/en/about/initiatives/covid-19-response/index.htm>

⁸ https://ec.europa.eu/info/business-economy-euro/economic-and-fiscal-policy-coordination/financial-assistance-eu/funding-mechanisms-and-facilities/sure_en

But all eyes were fixed on the European Central Bank. Great concern blew across the eurozone after the President, Christine Lagarde, declared early in March that it was not the Bank's role to "close the spread" in sovereign debt markets. Her remarks exasperated citizens, politicians and financial markets, and a sharp spike in Italy's bonds – at that time Italy was the most affected country – and severe drops in most European markets.

Right afterwards she corrected her own remarks: "I am fully committed to avoid any fragmentation in a difficult moment for the euro area. High spreads due to the coronavirus impair the transmission of monetary policy," Lagarde stated in an interview with CNBC⁹.

Many analysts attributed her mistake to inexperience in the job; however, it also showed the fragility of the institutional structure of the euro.

Unavoidably, in the air was the unforgettable Mario Draghi's "whatever it takes", the turning point in the euro crisis. The need to convey confidence to shaky markets in turbulent times; the strong will to save the euro at its worst moment was defined by a simple sentence by the then president of the institution.

Now, when Europe was facing another shock, such a strong determination was desperately needed and expected. Lagarde soon backtracked. On 12 March she announced measures to support bank lending and expanded its asset purchase programme by €120 billion.

Only a few days later (18 March), unexpectedly, the ECB announced a €750 billion Pandemic Emergency Purchase Programme (PEPP), "a new temporary asset purchase programme of private and public sector securities to counter the serious risks to the monetary policy transmission mechanism and the outlook for the euro area posed by the outbreak and escalating diffusion of the coronavirus, COVID-19"¹⁰.

The new stimulus package would come on top of the €120 billion recently approved. "Extraordinary times require extraordinary action," wrote Lagarde on Twitter.

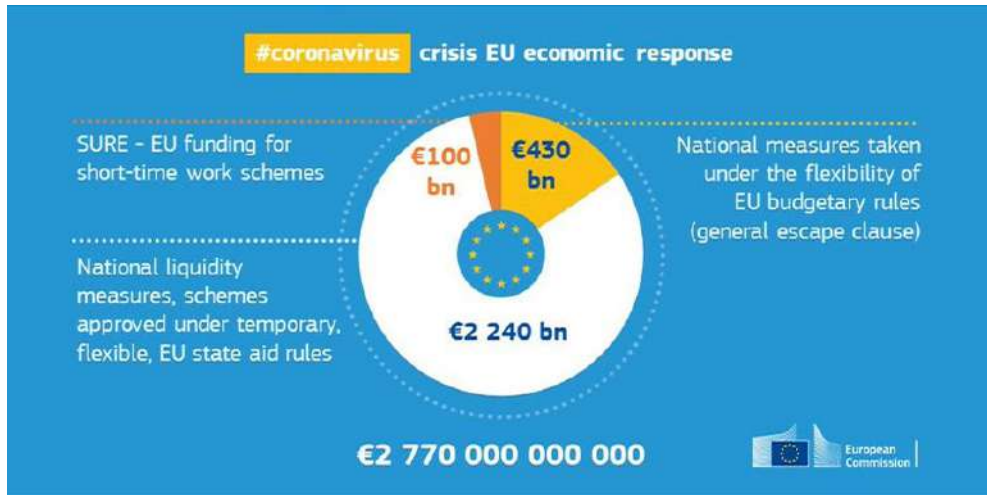
The ECB "will do everything necessary within its mandate," said the official communiqué. The institution "is fully prepared to increase the size of its asset purchase programmes and adjust their composition, by as much as necessary and for as long as needed. It will explore all options and all contingencies to support the economy through this shock."¹¹ Initially projected until the end of 2020, the package will be maintained until the COVID-19 crisis is over. "There are no limits to our commitment to the euro," Lagarde added.

⁹ Inman, Philip: "Christine Lagarde under fire for ECB coronavirus response", The Guardian, 12 March 2020, <https://www.theguardian.com/world/2020/mar/12/ecb-announce-plan-to-help-eurozone-banks-withstand-coronavirus>

¹⁰ https://www.ecb.europa.eu/press/pr/date/2020/html/ecb.pr200318_1~3949d6f266.en.html

¹¹ <https://www.ecb.europa.eu/press/blog/date/2020/html/ecb.blog200319~11f421e25e.en.html>

Step by step, meeting by meeting (or videoconference, the new forced modality), the different European institutions put together different packages to help the European economy hold out during these hard and uncertain times. By mid-April, according to the Commission, the EU economic response to COVID-19 reached almost €3 trillion. That figure was not direct aid, though, since it included national liquidity measures and schemes approved under temporary, flexible EU state aid rules and national measures taken thanks to the new flexibility introduced by the general escape clause.



Source: European Commission

Yet it was clear by then that that amount would not be enough to stop the drain caused by the pandemic. With an expected decline of 8% of GDP in the euro area for 2020¹², the urgency for a European recovery plan was more than evident. Meanwhile, deep differences about the ambition and the format of that plan emerged among Member States leaders; such differences of opinion were often linked to how much impact the health crisis was having on one country or the other.

Some analysts compared the European divide to the plan approved before the end of March by the US Federal Reserve, with \$2.5 billion addressed to people, businesses and states hit by the crisis. Despite the extreme polarization of American politics, Democrats and Republicans had been able to reach a compromise to help their fellow citizens¹³.

¹² https://ec.europa.eu/info/sites/info/files/economy-finance/ip132_en.pdf

¹³ Royo, Sebastián, “Al rescate: la respuesta de EEUU a la crisis del COVID-19”, Comentario Elcano 13/2020 - 30/3/2020, Real Instituto Elcano, http://www.realinstitutoelcano.org/wps/portal/rielcano_es/contenido?WCM_GLOBAL_CONTEXT=/elcano/elcano_es/zonas_es/comentario-royo-al-rescate-la-respuesta-de-eeuu-a-la-crisis-del-covid-19

Herszenhorn, David M and Sarah Wheaton, “How Europe failed the coronavirus test”, Politico, April 7, 2020, <https://www.politico.eu/article/coronavirus-europe-failed-the-test/>

Italy's and Spain's prime ministers, Giuseppe Conte and Pedro Sánchez, started to demand a joint debt instrument as the only possible way to finance the coronavirus plan, their countries being the hardest hit by the virus. Germany and the Netherlands led the opposition to the idea. South vs North; the profligate vs the frugal. Old stereotypes filled the headlines... again.

Reminiscences of the Eurozone debt crisis, and of the high economic toll Greece had to pay, reappeared. But this time the toll was not only economic. The lives and livelihood of hundreds of thousands of Europeans were at stake.

3.2. THE HAMILTONIAN MOMENT

Regardless of the efforts to face the crisis on its many fronts, the mood in Europe at the beginning of the spring was that of a perceived lack of solidarity, national selfishness, division, frustration, bias. According to an opinion poll quoted by *Politico*¹⁴, nearly half of Germans thought that Italy and Spain's situation regarding the coronavirus was due to poor governance.

On 25 March, the leaders of nine EU Member states – Greece, Portugal, Italy, Slovenia, Spain, Belgium, Ireland, France and Luxembourg – sent a letter to Charles Michel, the president of the European Council, urging a determined and strong response, including a common debt instrument.

“We need to work on a common debt instrument issued by a European institution to raise funds on the market on the same basis and to the benefit of all Member States, thus ensuring stable long term financing for the policies required to counter the damages caused by this pandemic.

The case for such a common instrument is strong, since we are all facing a symmetric external shock, for which no country bears responsibility, but whose negative consequences are endured by all. And we are collectively accountable for an effective and united European response. This common debt instrument should have sufficient size and long maturity to be fully efficient and avoid roll-over risks now as in the future (...). If we want tomorrow's Europe to live up to the aspirations of its past, we must act today, and prepare our common future. Let us open this debate now and move forward, without hesitation,” the letter ended.

In spite of the staunch opposition to any initiative that might sound like debt mutualization from countries like the Netherlands and Germany – a red line that most in those countries would in principle never dare to cross – the discussion was again on the table. And the wake-up call was coming from many different places.

¹⁴ Posaner, Joshua, “Half of Germans blame Italy, Spain pandemic woes on ‘poor governance’: poll”, *Politico*, April 8, 2020, <https://www.politico.eu/article/half-germans-blame-italy-spain-pandemic-poor-governance-poll-coronavirus/>

One of the most vocal in that regard was the French President, Emmanuel Macron, who in an interview with the *Financial Times*¹⁵ urged Europe to “think the unthinkable” to drive the continent out of the pandemic. Among his choices was solidarity in the form of financial aid funded by mutualized debt, which had been advanced some days earlier by Bruno Le Maire, his Finance Minister. In the context of a Eurogroup ministers meeting, Le Maire defended the creation of a common temporary EU fund – lasting five or ten years – with the sole mandate to help Southern countries to get out of the coronavirus crisis. The term “Coronabonds” started then to circulate.

“We are at a moment of truth, which is to decide whether the European Union is a political project or just a market project. I think it’s a political project (...) We need financial transfers and solidarity, if only so that Europe holds on,” Macron declared. The risk behind not doing it: raising populism.

The pressure, however, also started to arrive from Germany. In an unusual editorial article published in five languages, the prestigious German magazine *Der Spiegel*¹⁶ openly supported Eurobonds: “The German government’s rejection of Eurobonds is selfish, small-minded and cowardly. Existing mechanisms will not be enough to contain the crisis we are facing. We need to act now,” it stated. The new line of argument pointed not only to solidarity, but also to self-interest.

In a rare initiative, Spain took the lead with an ambitious proposal, a sort of “Marshall Plan” for the Union. The proposal, presented as a non-paper just before the European Summit of 23April, contemplated a recovery fund of around €1.5 trillion, financed through perpetual EU debt and allocated via grants, unlike the bulk of all the other measures taken until then, which were based on loans. The fund was to be linked to the EU budget¹⁷.

The amount proposed showed the scale of the challenge. It also aimed at bridging the opposing sides on the discussions: those who pushed for a joint budgetary response – Italy, France – and those who were more than reluctant to contemplate such a solution – Germany, the Netherlands. The Spanish plan even earned an expression of approval from the traditionally critical *Financial Times*: “If there is going to be a common European fiscal response to the crisis, this is the form it should take”¹⁸.

In the playground of forces among European powers, Spain seemed to be taking steps to use its weight and (re)gain influence. It was no more than an illusion; it is clear

¹⁵ Mallet, Victor, Khalaf, Roula, “FT Interview: Emmanuel Macron says it is time to think the unthinkable”, *Financial Times*, April 16, 2020, <https://www.ft.com/content/3ea8d790-7fd1-11ea-8fdb-7ec06edeef84>

¹⁶ Klusmann, Steffen, “Germany Must Abandon Its Rejection of Eurobonds”, *Der Spiegel*, 03.04.2020, <https://www.spiegel.de/international/europe/germany-must-abandon-its-rejection-of-eurobonds-a-e5f7c467-dcf6-48fd-b4e0-71e1b84e315e>

¹⁷ https://www.lamoncloa.gob.es/presidente/actividades/Paginas/2020/23042020_consejo-europeo.aspx?qfr=1

¹⁸ Sandbu, Martin, “The merits of Spain’s proposed recovery fund are irrefutable”, *Financial Times*, April 21 2020, <https://www.ft.com/content/69b90ec0-83d5-11ea-b872-8db45d5f6714>

where power lies in Europe. A few weeks later, Macron and Merkel announced their own plan. The Franco-German axis took the lead once again.

The significance of their plan lay not so much in the amount of money – €500 billion – as in the nature of the financial mechanisms behind it. The plan introduced three key innovations. One, that in order to finance the recovery fund, the EU would issue bonds directly in its own name and guaranteed by its own revenues, instead of using funds raised by national governments. Two, as an inevitable consequence, the creation of a fiscal federation. Three, the concept of EU borrowing in the markets instead of just using the EU budget.

The first point would allow Merkel to support European solidarity without compelling German taxpayers to finance aid to other EU countries, a historical taboo in Germany and a constitutional challenge.

The second would come out of the need to levy new taxes, presumably based on economic activities that transcend national boundaries, such as CO₂ emissions, or financial and digital transactions. Part of this was already in the spirit of some strategic policies presented by the new Commission, like the Green Deal or the Digital Europe plans.

The third offered big opportunities to EU funding, given the current circumstances, with near-zero interest rates for triple-A sovereign borrowers¹⁹.

For euro-federalists, in their eternal comparison with the birth and consolidation of the United States as a federation, that became their “Hamiltonian moment”.

Alexander Hamilton was the first Secretary of the Treasury of the United States. In 1790, he was able to strike a deal with his fellow “founders” – Thomas Jefferson and James Madison – to assume the individual war-time debts of the former colonies and convert them to joint obligations of the federal union (therefore, debt mutualization). The agreement was reached during a private dinner, which, by the way, is featured in the worldwide famous musical *Hamilton*. (A subtle suggestion here to EU communication experts about narrative-building techniques...) It is widely accepted that the deal helped the United States to become a genuine political federation.

That comparison is not and will not be strictly valid, given the sharp differences between a newly born nation and the voluntary union of centuries-old nations; and also given the huge differences between Member States when envisioning the future of the EU. However, the change of focus introduced by the Franco-German proposal needs to be considered a real turning point in the debates about the Union.

A clear demonstration of this change of tone and attitude was the reaction to the judgment of the German Constitutional Court (GCC) of 5 May. In its decision, the Karlsruhe Court ruled that the ECB had exceeded its powers with the stimulus package issued during the euro crisis since it failed to carry out a “proportionality assessment” of the policy’s impact with regard to its price stability mandate. It was a frontal challenge to

¹⁹ Kaletsky, Anatole, “Europe’s Hamiltonian Moment”, *Project Syndicate*, May 21, 2020, <https://www.project-syndicate.org/commentary/french-german-european-recovery-plan-proposal-by-anatole-kaletsky-2020-05>

European law – since the Court of Justice of the European Union had endorsed Draghi’s programme – from a national court. “Germany’s Constitutional Court goes Rogue,”²⁰ wrote a German professor of comparative law.

The judgment provoked an earthquake in European circles, precisely in the middle of the discussion about the scope and format of a Covid recovery plan. But after the initial shock, Brussels reminded all parties concerned of the primacy of EU law over national law in case of conflict, and was generally supported by governments and institutions. Also, all parties in any way involved – Merkel, Von der Leyen, the ECB – made an effort to calm down the mood. In August, after the deadline established by the GCC to address the issue, the Bundesbank stated that it would continue its asset purchase operations.

The myriad of plans, proposals, conversations and debates about how Europe should face the aftermath of the crisis and about the need for strong action to help combat the consequences of coronavirus were proof of the frenetic activity in the Union facing a possible recovery plan.

That is also reflected in the unusually large number of meetings – by videoconference – of the members of the European Council during those months. On 23 April, the Council tasked the Commission “to analyse the exact needs and to urgently come up with a proposal that is commensurate with the challenge we are facing”²¹.

A month later, on 27 May, Ursula Von der Leyen presented the Commission plan before the European Parliament: Next Generation EU. It was “Europe’s moment”²².

3.3. MERKEL’S MOMENT

Von der Leyen’s speech in front of a semi-empty/semi-full European Parliament, due to the health safety protocols, attracted an unusual consensus from both right and left of the political spectrum.

The President of the Commission acknowledged the magnitude of the challenge: “What started with a virus so small your eyes cannot see it, has become an economic crisis so big that you simply cannot miss it”.

Our unique model built over 70 years is being challenged like never before in our lifetime or in our Union’s history.

The common European goods we have built together are being damaged”²³.

The European response, therefore, should be able to tackle such a challenge.

²⁰ Pistor, Katharina, “Germany’s Constitutional Court Goes Rogue”, Project Syndicate, 8 May 2020, <https://www.project-syndicate.org/commentary/german-constitutional-court-ecb-ruling-may-threaten-euro-by-katharina-pistor-2020-05?barrier=accesspaylog>

²¹ <https://www.consilium.europa.eu/en/press/press-releases/2020/04/23/conclusions-by-president-charles-michel-following-the-video-conference-with-members-of-the-european-council-on-23-april-2020/>

²² https://ec.europa.eu/commission/presscorner/detail/en/ip_20_940

²³ https://ec.europa.eu/commission/presscorner/detail/en/SPEECH_20_941

Next Generation EU (NGEU), the newly born recovery plan, was far-reaching and original in its approach: €750 billion, to be distributed between grants (€500 billion) and loans (€250 billion). In addition to that, the plan was to be linked to the EU budget for 2021-2027, bringing up its financial capacity to €1.85 trillion. With the objective to emerge from the crisis stronger and readier for the challenges of the future, it also committed to not leave anyone behind, renewing the priorities the Commission had identified: green, digital, social and global.

It was the first time in history that the Commission offered support on a large scale in the form of grants instead of loans. Amid the doubts of Eurosceptics and Euro-pessimists, it sent – starting with the name Next Generation EU – a clear message to a younger generation – which is often apathetic towards the European project – but also to those badly hit by the crisis, especially the self-employed and small and medium enterprises.

According to the plan, the Commission would temporarily lift its own resources ceiling to 2% of EU Gross National Income, and launch the largest common debt emission in the EU history. The strong credit rating of the EU would allow it to borrow €750 billion on the financial markets on favourable terms, to be repaid over a long period throughout future EU budgets – not before 2028 and not after 2058. New taxes on carbon, digital, and so forth would raise additional funds.

In a quick overview, these are some of the highlights of the plan:

1. Supporting Member States with investments and reforms, with a new Recovery and Resilience Facility of €560 billion. This support would be linked to the supervisory mechanism of the European Semester, and offered to all Member states, but mostly to those most affected by the pandemic. In addition, €55 billion under a new REACT-EU initiative to reinforce current cohesion policy programmes, plus €40 billion for the Just Transition Fund, addressed to help Member States balance the transformation of their economies to reach climate neutrality, and €15 billion for a European Agricultural Fund for Rural Development.
2. Kick-starting the EU economy by incentivising private investments, with a new Solvency Support Instrument to mobilise private resources to support viable European companies in the sectors, regions and countries most affected, and prepare them for a cleaner, digital and resilient future. Its aim is to unlock up to €300 billion in solvency support. The plan also wants to upgrade InvestEU, Europe's flagship investment programme, and presents a new Strategic Investment Facility to generate investments of up to €150 billion in boosting the resilience of strategic sectors.
3. Addressing the lessons of the crisis, including a new Health Programme EU4Health (€9.4 billion), to strengthen health security and prepare for future health crises; the reinforcement of rescEU, the Union's Civil Protection Mechanism (€2 billion), and of the research programme Horizon Europe (€94.4 billion), among other instruments; and additional support for external action, including humanitarian aid.

The speech was well received, especially by Italy and Spain, two countries that had called for a determined and strong common response to the crisis. It was likely to raise more concerns among the so-called frugal four (the Netherlands, Denmark, Sweden and Austria), who were not willing to use grants but just loans.

The next step was for the European Council to discuss and approve the proposal. The first attempt ended in frustration, though. The Council meeting on 19 June showed the huge differences among countries about the amount of the recovery fund and the budget, about the distribution between grants and loans, and about the criteria and conditions to receive funds. It also showed, however, the willingness to try to find a common response to the crisis by all Member States. The Council was convened again for mid-July and its president, Charles Michel, offered to prepare a revision of the proposal and to have bilateral meetings with the Member States to negotiate the details of the agreement.

The urgency to show markets and European public opinion a concerted plan was also present in everybody's mind. As the pandemic evolved and its dramatic economic impact, after months of lockdown, became more and more evident, there was mounting pressure to plan a way out of the crisis.

In the meantime, on 1 July Germany took over the rotatory presidency of the EU. A historical coincidence had wanted Germany at the steering wheel of the Union at one of the most critical moments in its recent history.

The tasks for the following months were: to drive forward and approve the recovery plan and the next EU budget, and to end, as successfully as possible, the Brexit negotiations. A clear test for the well known German efficiency.

With a well coordinated machinery, Merkel and her team, especially her minister of Foreign Affairs Heiko Maas, presented their program throughout Europe. The words "solidarity", "stronger", "united" and "urgency" resounded during Merkel's speech to the European Parliament.

For the German Chancellor, it was a personal challenge. She had had some difficult months at home. After having announced that she would not be a candidate in the next general elections in 2021, her party was out of joint and in search of a leader. Several important CDU strongholds, the last one Hamburg, were lost in regional and local elections.

Her role during these existential times of EU crisis gave her back her position and aura as Europe's indisputable leader; the most valued, respected and admired European politician. At stake was her legacy.

The chronicle of the July European Council Summit is full of ups and downs; of tension and relief; of long sleepless hours in which the future of the European Union seemed often to be hanging in the balance.

Even if Charles Michel had done his homework, talked one by one to each Member State's leader and prepared a new version of the proposal, the differences were still huge when the 27 gathered in Brussels, in person for the first time in months, on 17 July. The meeting was expected to be long and difficult. It was the longest – together with the Nice summit – and surely one of the toughest. "A marathon", "grumpy", "the summit of

the terraces” – where leaders could meet without their masks on – were just some of the words the media used to describe it.

On the playing field: on one side, the leaders of the Southern countries – Macron, Costa, Sánchez, and Conte, among them – together with Merkel and Von der Leyen; on the other, the “frugals”, with Mark Rutte, prime minister of the Netherlands, as the main “villain” of the play; in between, the illiberals (mainly Orban), trying to force the limitation to the rule of law as a condition; and Charles Michel as main referee.

The major differences were still the size and distribution (grants/loans) of the recovery package and the Multiannual Financial Framework, the criteria to assign funds to each country and the conditionality behind, including the kind of reforms committed to by Member States. There were other more traditional but equally important issues, such as the Common Agricultural and Cohesion Policies and the rule of law.

At many points during the long four days with their nights of the summit, it seemed that there would be no agreement. A whiff of nationalism could be sensed after each negative headline. But the risks of not reaching a deal were too high and the best art of persuasion was put on the table. This is not the place to make a thorough account of the many proposals, amendments, changes and revisions needed to get there²⁴, but finally, at 5.30 am on 21 July, Michel posted on his Twitter: “Deal”.

The next morning, the EU leaders appeared exhausted, but satisfied, even euphoric. They had made true, once again, Jean Monnet’s sentence: “Europe will be forged in crises, and will be the sum of the solutions adopted for those crises.”

The deal included a historic €1.8 trillion package, including the recovery fund (NGEU) – €750 billion – to tackle the economic impact of coronavirus and the seven-year budget (MFF)²⁵ – €1.074 trillion.

The size of the recovery fund was maintained from the Commission’s original proposal, but it is to be divided in €390 billion in grants and €360 billion in loans. Bringing the amount of grants below €400 billion was one of the concessions the bigger countries had to make in order to keep the “frugals” in the negotiation. The whole amount will be borrowed by the EU on the markets and needs to be repaid by 2058.

Most of the recovery fund will be spent through the new Recovery and Resilience Facility (RRF), the bulk of which is tied to national recovery plans and, therefore, to economic reforms. Countries will get payouts based on their progress toward certain targets. The governance and conditionality linked to the national plans were two of the most disputed points of the negotiation. Finally, it was agreed that the Council needs to approve

²⁴ Two interesting accounts of the Summit in: Herszenhorn, David, and Eder, Florian, “Charles Michel, the budget deal and the art of the terrace tête-à-tête”, Politico, July 24, 2020, <https://www.politico.eu/article/charles-michel-the-mff-budget-deal-and-the-art-of-the-terrace-tete-a-tete/>; De Miguel, Bernardo, Cué, Carlos E., “90 horas de angustia para el mayor acuerdo de la UE desde el euro”, El País, 23 julio 2020, <https://elpais.com/economia/2020-07-23/90-horas-de-angustia-para-el-mayor-acuerdo-de-la-ue-desde-el-euro.html>

²⁵ <https://www.consilium.europa.eu/media/45109/210720-euco-final-conclusions-en.pdf>

those plans by a qualified majority vote on a proposal by the Commission, instead of by unanimity as requested by the “frugals”. In turn, the rebates on the annual gross national income-based contribution for these countries and Germany will be maintained.

To make sure that the money reaches the countries and sectors most affected by the crisis, 70% of the grants of the RRF will be committed between 2021 and 2022, and the rest in 2023.

To provide the EU with new resources, new EU taxes will be introduced (single-use plastic, digital, financial) as well as a carbon adjustment measure.

The EU leaders also had to accommodate the uncomfortable truth of the challenges to the rule of law posed by the so-called illiberal countries. The vague wording of the agreement allowed both parts to be relatively satisfied, but that will necessarily be a recurrent issue, since it threatens the very founding principles of the Union.

The major beneficiaries of the agreement are Italy, that will receive €209 billion, and Spain, with €140 billion.

The deal was done, but not completely. The agreement must be approved by the European Parliament and then the Member States must approve their Own Resources Decision. The Netherlands might even call a referendum.

All in all, those days in July mark the determination of the EU leaders and institutions to do everything in their hands to face the largest challenge in their living memory. The total recovery package – fund plus budget – together with the €540 billion of the triple safety net approved by the Eurogroup represents 17% of EU Gross National Income, compared to the 15.9% of the US response or the 4.2% of China²⁶.

Beyond money, let us see how the EU plans to become greener, more digital and stronger.

3.4. A GREENER EUROPE

One of the most ambitious objectives of Von der Leyen’s Commission is to make Europe become the first climate neutral continent. To achieve it, in January 2020 the Commission presented the European Green Deal, a plan to transform Europe’s economy towards sustainability, based on three major pillars: to cut net emissions of greenhouse gases by 2050; to decouple economic growth from resource use; and to facilitate a just transition, in which no person and no place is left behind.

The plan covers a good number of policy areas and targets, such as biodiversity, food, sustainable agriculture, clean energy, sustainable industry and mobility, infrastructures, pollution, and climate action. Its transformative agenda is built around these elements:

²⁶ De Miguel, Bernardo, “Charles Michel: “El Consejo Europeo no puede convertirse en una suma de coaliciones”, El País, 11 julio 2020, <https://elpais.com/economia/2020-07-11/charles-michel-el-consejo-europeo-no-puede-convertirse-en-una-suma-de-coaliciones.html>

1. to increase the EU's climate ambitions for 2030 and 2050;
2. to supply clean, affordable and secure energy;
3. to mobilise industry for a clean and circular economy;
4. to build and renovate in an energy- and resource-efficient way;
5. to accelerate the shift to sustainable and smart mobility;
6. from 'farm to fork': a fair, healthy and environmentally-friendly food system;
7. to preserve and restore ecosystems and biodiversity;
8. a zero pollution ambition for a toxic-free environment.

The unavoidable socioeconomic impact of this huge transformation was to be compensated by a €100 billion Just Transition Mechanism, which included a Just Transition Fund (€40 billion), a just transition scheme under InvestEU and a public sector loan facility.

European public opinion supported that kind of ambition. According to the Eurobarometer 2019²⁷, 93% of EU citizens see climate change as a serious problem and 79% see it as a very serious problem; 92% of respondents think it is important their national government sets ambitious targets to increase the amount of renewable energy used and 89% believe governments should provide support for improving energy efficiency by 2030; more than eight in ten in each Member State agree that greenhouse gas emissions should be reduced to a minimum while offsetting the remaining emissions, in order to make the EU economy climate-neutral by 2050.

As soon as the coronavirus started to spread, the narrow relationship between climate vulnerability and the loss of biodiversity, the bad quality of the air we breathe and deforestation became more obvious than ever.

The call to link any recovery plan – when the profound short- and long-term economic consequences of the pandemic also became obvious – to ensure a more sustainable and therefore healthier planet became louder.

“In the midst of a global health emergency and imminent economic recession, the importance of the European Green Deal has become even greater. It *must* be the framework for responding to the current crisis and the broader planetary emergency, of which it is a part”, wrote, in an open letter²⁸, Sandrine Dixon-Declève, co-president of the Club of Rome and Johan Rockström, director at the Postdam Institute for Climate Impact Research. “A new Marshall Plan”, they call it. “A plan that also addresses digital optimisation as a tool to enhance the long-term quality of life for all citizens not only when they are in a pandemic lockdown”.

²⁷ https://ec.europa.eu/clima/citizens/support_en

²⁸ <https://www.euractiv.com/section/energy-environment/opinion/emergence-from-emergency-the-case-for-a-holistic-economic-recovery-plan/>

Strong support for this line of action also came from the ministers for the Environment of 13 Member States²⁹; the EC showed their determination to go ahead with the Green Deal, despite warnings from some capitals (namely Warsaw) that, given the economic perspectives, they would not be able to fulfil their commitments, and despite the initial delay in presenting the “Farm to Fork” and biodiversity strategies.

The Council Agreement of July recognises climate transition as one of the top, if not the top, priority of the EU for the coming years.

It fixes a climate target of 30% to the total amount of expenditure from the Multiannual Financial Framework (MFF) and Next Generation EU (NGEU). It also establishes as a general principle that all EU expenditure should be consistent with Paris Agreement objectives³⁰. In total, around €550 billion of EU resources will be available for the green transition. In this regard, the Council also asked the EC to develop a methodology for monitoring and evaluating climate spending, and to report on it annually.

Another point of the Council agreement is to set a new EU 2030 emissions reduction target by the end of 2020, a clear signal to both states and markets on the European commitment to decarbonisation.

The most significant change from the initial proposal of the Green Deal affects the Just Transition Fund, which is more than halved from €40 billion to €17.5 billion. This will mean the need to apply other funding schemes, like the Structural and Cohesion Funds, to ensure that especially affected areas – like coal mining regions – get enough support in their economic and energy transitions.

Another interesting point of the agreement is the decision to devote 40% of the Common Agriculture Policy (CAP) spending to climate. The urgent need to modernize the CAP and to align it with the climate objectives will benefit from this push, which will also need a renewed effort of monitoring.

Finally, in this summary, the Council agreed to generate new resources to finance the climate transition, including a plastic tax to be introduced in 2021 and a revision of the carbon border mechanism and of the EU emissions trading scheme to extend it to the aviation and maritime sectors.

The Green ambition was clearly restated and renewed in the State of the EU Speech (SOTEU) by President Von der Leyen on 16 September. There she announced an increase of the 2030 target for emission reduction to at least 55%, together with a set of new initiatives to make the EU the world leader in circular economy.³¹

²⁹ Planelles, Manuel, Diez países europeos reclaman a Bruselas una salida “verde” de la crisis del coronavirus, *El País*, 9 abril 2020, <https://elpais.com/sociedad/2020-04-09/diez-paises-europeos-reclaman-a-bruselas-una-salida-verde-de-la-cri-sis-del-coronavirus.html>

³⁰ Claeys, Gregory and Tagliapietra, Simone, Is the EU Council agreement aligned with the Green Deal ambitions?, Blog Post, Bruegel, July 23, 2020, <https://www.bruegel.org/2020/07/is-the-eu-council-agreement-aligned-with-the-green-deal-ambitions/>

³¹ State of the Union Address by President von der Leyen at the European Parliament Plenary https://ec.europa.eu/commission/presscorner/detail/ov/SPEECH_20_1655

3.5. MORE DIGITAL EUROPE

Together with the Green Deal, a strong boost to digitalization has always been one of the main goals of the new European Commission. With a great difference between both ambitions: while Europe is a world leader in the fight against climate change, its shortcomings in the digital realm are more than evident, be it in the absence of a real digital single market or in the lack of technological champions able to compete globally. As an example, only 1 in 5 companies across the EU are highly digitalized³², and around 60% of large industries and more than 90% of SMEs lag behind in digital innovation.

The European Digital Strategy that the Commission presented in February 2020 included four main pillars: technology that works for people, a fair and competitive digital economy, an open, democratic and sustainable digital society, and Europe as a global digital player³³.

Then the pandemic helped to accelerate trends, habits and practices, like online teaching and learning, and working from home. It is only normal that the digital sphere occupies a relevant space in the EU recovery and budget plans.

The radical transformation of the economy, with renewed industrial and technological capacities, and strategic autonomy from other world powers are the two major goals of the European digital strategy. In fact, “strategic autonomy” has become one of the buzzwords of the EU jargon, and it is applied to several areas.

According to the plan agreed by the European Council in July, the new Multiannual Financial Framework allocates €6.8 billion to build and develop Europe’s digital capacities³⁴. That amount, however, is far, very far, from the €125 billion Von der Leyen calculates Europe needs to close the gap with the United States and China and reach strategic sovereignty. Nonetheless, it is expected that the amount allocated will be an important element to attract new investors.

Public-private partnerships will thus be essential to reach the amount of resources for initiatives required in that effort. Supercomputing, artificial intelligence, cybersecurity, blockchain, advanced digital skills and the creation of a network of Digital Innovation Hubs are some of the fields to be boosted by the Digital Europe Programme during the next seven years. It will complement other instruments, such as Horizon Europe for research and innovation, and the Connecting Europe Facility for digital infrastructure, in supporting the digital transformation of Europe.

³² https://ec.europa.eu/eurostat/statistics-explained/index.php/Statistics_on_small_and_medium-sized_enterprises#General_overview

³³ <https://ec.europa.eu/digital-single-market/en/content/european-digital-strategy>

³⁴ <https://ec.europa.eu/digital-single-market/en/europe-investing-digital-digital-europe-programme>

Data, technology – mainly AI – and infrastructure were the three domains that Ursula von der Leyen addressed in her first Speech of the State of the Union as President of the European Commission.

In data, considered the oil of the twenty-first century, the EU has a slight advantage in one specific aspect: following its capacity as a normative power, the EU has pioneered the protection of citizens' data privacy, thanks to the early General Data Protection Regulation (GDPR). However, if European citizens' data are to stay within the EU, developing a European cloud computing industry is mandatory. And not only citizens' data. Building a strong data economy will be a competitive “must-have” in the near future, as well as an important source for innovation and jobs. That is precisely the objective of the Gaia-X project: to develop a European cloud as an alternative to the current American and Asian systems.

Despite the general delay in digitalization in comparison with the United States and China, the prospective changes in the data field offer good chances for European industry. The global data volume is expected to increase 530% by 2025, up to 175 zettabytes from 33 zettabytes in 2018. Moreover, such an increase will come from objects and systems (consumer products, industrial components) and not so much from e-commerce or social platforms, like today. The automotive industry, industrial software and robotics, where Europe already has a competitive advantage, might lead this trend.

The European Data Strategy aims to set the framework for this coming data economy with quite ambitious targets: to reach, by 2025, a €829 billion value of the data economy, up from €301 billion in 2018, and 10.9 million data professionals, versus 5.7 million in 2018³⁵.

The pandemic has also shown the importance of having a good governance and management of the data economy, now lacking – especially in strategic sectors like health – as well as the long-awaited full disclosure of the digital single market. The Digital Services Act will offer businesses, including SMEs, legal clarity and equal conditions to compete in the single market, and it will protect consumers from unfair practices by the big platforms.

As for AI, the Commission wants to focus on developing European capacities as much as on setting clear rules and “putting people at the centre”, to avoid the tyranny of algorithms powered by unknown forces. That includes control over personal data and the protection of personal digital identities, now needed for so many actions in our personal and professional lives. To tackle this, the Commission plans to create a secure e-identity, which will also have a strong impact on the further improvement of bureaucracy and electronic public procurement.

In terms of infrastructure, Europe needs to improve its connectivity, with a strong focus on 5G and 6G networks. The 5G Action Plan, launched in 2016, aims to boost EU efforts for the deployment of 5G infrastructures and services across the Digital Single

³⁵ https://ec.europa.eu/info/strategy/priorities-2019-2024/europe-fit-digital-age/european-data-strategy_en

Market, ensuring commercial rollout of 5G in at least one major city in every Member State by the end of 2020 and uninterrupted 5G coverage in all urban areas and major terrestrial transport paths by 2025. According to the latest review (June 2020) of the 5G Observatory, “5G keeps progressing well in Europe, and the process has significantly accelerated during the past year”³⁶.

In her SOTEU, Von der Leyen linked the deployment of digital infrastructure to the need to revitalise rural areas, a renewed concern for European Institutions.

The other side of the infrastructure coin is cybersecurity. The EU Security Union Strategy (2020-2025) plans among other objectives to complete the review of the Network and Information Systems Directive (NIS) and the adoption of a new Cybersecurity Strategy, which will boost intra-EU cooperation, knowledge and capacity to keep European digital infrastructure safe. Two of the fields in which the safe exchange of confidential information is critical are foreign direct investment and EU defence programmes.

All in all, 20% of the NGEU plan will be invested on digital.

3.6. A STRONGER EUROPE

It is often said that the European Union is an economic giant and a political dwarf. Its huge potential in terms of population, GDP, scientific and cultural capacities, and so on, is not aligned with its role in the world. The EU does not play in the league of the big powers, mainly, because it never really wanted to.

In recent years, however, the debate about the need to become stronger has increased. The impact of the Brexit referendum and the arrival of Donald Trump to the White House put the concept of strategic autonomy on the table. The fact that the American president, for the first time in recent history, had a not-so-friendly attitude towards his European allies, and even towards NATO, triggered alarms about the future of Europe’s defence and security. Trapped in the middle of the new trade and technological war between the US and China, Europe – its leaders, but also its public opinion – do not want to choose.

All these trends have become more evident with the coronavirus crisis. The dependency on Chinese sanitary supplies and medicines enlarged the question of health sovereignty.

If there is a field where the EU has an outstanding performance, that is soft power. It is always good to remember that the Union is the world’s largest donor of humanitarian aid. Therefore, it comes as no surprise that, since the beginning of the pandemic, it has also made an effort to lead the global effort to fund and find a vaccine and to deliver emergency and humanitarian aid to its neighbours and other countries hit by the virus.

According to Rosa Balfour, director of Carnegie Europe: “Globally, Europe will portray itself as a promoter of multilateralism and cooperation, an alternative pole to the

³⁶ 5G Observatory Quarterly Report 8 Up to June 2020, http://5gobservatory.eu/wp-content/uploads/2020/07/90013-5G-Observatory-Quarterly-report-8_1507.pdf

United States and China, and a bridge builder among diverging powers. In areas as diverse as health, climate, trade, regulation, finance, diplomacy, governance, and international development, Europe can mobilize power, partners, and ideas. Together with international allies, it can invest in research and technology to harness the energy for innovation that the pandemic has anything but subsumed³⁷.

But soft power does not seem to be enough for the world to come. The new Commission had already expressed, from the beginning of its mandate, the need to work towards a “geopolitical Europe”. A clear reflection of that commitment is the section on Defence and Security that the MFF features, allocating, among others, the following amounts to:

- European Defence Fund (EDF): €7.014 billion – To strengthen the technological and industrial base of European defence.
- Military mobility: €1.5 billion – A contribution to the Connecting Europe Facility (CEF) to adapt European transport networks to military mobility needs.
- European Peace Facility (EPF): €5 billion – A new, off-budget instrument to finance actions in the field of security and defence³⁸.

A strong emphasis is put on migration and border management, with a security approach.

It remains to be seen whether the new investments, tools and instruments in the fields of security and defence are enough for the challenges coming from an unstable neighbourhood, or from a more assertive Russia and a more demanding Turkey.

The other new concept introduced by the Commission and ratified by the NGEU plan is resilience. It includes the future European will to occupy an outstanding role in the world arena thanks to its capacity to secure for its citizens high levels of well-being, to transform its production model towards sustainability, to defend the set of values and principles it is based on, and to make true the idea of “strategic autonomy”, in all areas.

The last four years have seen a boost in this sense, thanks to the confrontational mode showed by Donald Trump. Probably without wanting to, the American president has been a catalyst of European unity. However, there is the risk, as the Spanish professor José Ignacio Torreblanca pointed out recently, that a change in the White House may lead the EU to reconsider the urgency of achieving such a strategic autonomy³⁹.

That would be an error. In an increasingly fragmented and turbulent world, a power such as the European Union cannot be largely dependent on any other power: be it in security, in technology or in healthcare. Being autonomous does not mean becoming

³⁷ Balfour, Rosa, “Europe’s Global Test”, in *The Day After*, Carnegie Endowment for International Peace, <https://carnegieendowment.org/2020/09/09/europe-s-global-test-pub-82499>

³⁸ Dobber, Jeroen, “EU Budget 2021-2027: What’s in It for Europe’s Defence?”, Friedrich Naumann Foundation, 6 August 2020, <https://fnf-europe.org/2020/08/06/eu-budget-2021-2027-whats-in-it-for-europes-defence/>

³⁹ Torreblanca, José Ignacio, “Si gana Trump”, *El Mundo*, 11 octubre, 2020, <https://www.el-mundo.es/opinion/columnistas/2020/10/11/5f8190b721efa02c028b4640.html>

more confrontational; it means being able to exert its own voice in the international area, as well as being able adequately to defend its citizens and territory if needed.

3.7. CONCLUSIONS

At the time of submitting this paper (mid November 2020), an agreement has been just reached between the European Parliament and the Council on the recovery plan and the next EU budget. The agreement will reinforce specific programmes under the new MFF (2021-2027) by €15 billion.

The MFF, the recovery plan and the new agreement must now be formally adopted by the EP and each Member State, within their respective roles and procedures. The Own Resources Decision, which would enable the Commission to borrow to finance the NextGenerationEU programme, also needs to be ratified by all EU countries in line with their constitutional requirements.

The delay in the formal procedures will in turn delay the arrival of funds to the most affected countries beyond the beginning of 2021.

At this time, too, the pandemic is hitting European soil hard yet again, in an unstoppable second wave, worsening the economic and social prospects.

It is thus difficult to take stock of the final outcome of the response of the EU institutions to the coronavirus crisis. But the importance of what has been achieved so far cannot be diminished.

On the health front, new coordination mechanisms and new channels of sanitary supplies have been established. In her speech of the state of the Union, Von der Leyen defended the need for a stronger European Health Union and advanced new initiatives. There will still be room for improvement, though, but it will be difficult to advance much further or quicker considering that health will continue to be a national remit. In that sense, Ms von der Leyen also asked the Conference on the future of Europe – whenever and however it will start – to tackle the issue of remits and powers.

The European Commission together with the European Council have been able to present and approve the largest economic package of its history. More importantly still: the taboo of fiscal solidarity has been broken with a solution that fits both those in favour of debt sharing and those against. For some, the door is open to a future fiscal union; for others, it does not need to be so.

A cautious joy filled Von der Leyen's SOTEU in September. If working together EU Members could take the reins of the future and build "the world we want to live in: a Union of vitality in a world of fragility", as she titled it.

Von der Leyen's role deserves a specific mention, her leadership having been much questioned and criticized since she reached the Commission: hesitant, too deferential to national leaders, without control over her own team... However, there has also been a "Von der Leyen's moment" during this period, when she, and her team, were able to translate the Council's request to prepare a plan into an ambitious and feasible proposal. After decades of strong male leaderships, the Brussels bubble may have been surprised

by a new style, but the result so far cannot be considered bad. Only time will show whether such a change of style was genuine and leading to a new internal EU culture or a temporary wind.

Yet, years of self-flagellation and Euro-pessimism, and the ubiquitous presence of the virus, impede the slightest degree of general satisfaction. However, it would be blindness to deny the huge relevance of having been able to draw a common, united, and determined way out of the crisis.

It takes an external observer to describe the scope of the achievement, though. For the American scholar Andrew Moravcsik, “In the wake of COVID-19, many in the United States have asked themselves whether democratic countries can sustain farsighted, data-driven, expert-based policies. Would-be Trumps and Putins question whether such policies are even desirable, preferring to appeal to national greatness. The answer is in Europe: In the 21st century, such policies are not only sustainable but successful. Europe is the future”⁴⁰

With the plans on the table, the challenges will still be huge, but the risks of doing less were even bigger. Among these risks, the rise of populism bred in the economic crisis, social unrest, and further erosion of trust in political institutions and democracy.

The future, as always, looks uncertain; maybe more than ever. On paper, the EU is now better equipped to face it, and even to shape it. The end result, also as always, will depend on what its Member sStates want it to be.

⁴⁰ Moravcsik, Andrew, “Why Europe wins”, *Foreign Policy*, September 24, 2020, <https://foreign-policy.com/2020/09/24/euroskeptic-europe-covid-19-trump-russia-migration/>

PART II
ISSUES IN MONETARY POLICY

4. “LOW FOR LONGER”: THE CONSEQUENCES OF NEGATIVE INTEREST RATES

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Since the 1980s long-term interest rates have been falling steadily in the eurozone, as is the case in the leading advanced economies. The decline steepened after the financial crisis and in 2016 the 10-year German government bond yield turned negative for the first time. By mid-2020, yields on all government debt in eurozone countries (except for Greece) maturing in less than five years were negative, and the same was true for more than half of long-term debt.

This was also the trend in central bank interest rates in the leading advanced economies. In the case of the ECB, since it was created in 1999, official interest rates have been hitting increasingly lower cyclical minimums (2.5% in 1999, 2% in 2004 and 1% in 2009). Since 2012, all interest rate movements have been downward. In June 2014, the ECB took interest rates into negative territory when it cut the deposit facility rate to -0.10%. Although this measure, which was intended to undermine the deflationary expectations that existed at the time by driving economic growth toward its potential, may have been regarded as temporary when it was taken, the deposit facility has failed to turn positive again. In fact, it has gradually fallen, reaching -0.50% in September 2019.

Since March 2020, in response to the coronavirus crisis, the ECB has tried to relax its monetary policy by strengthening measures that entail an expansion of its balance sheet. As a result of this and the uncertainty about the control of the pandemic and its impact on the economy, the financial markets firmly expect negative interest rates to be the new normal for years to come.

The number of years this will last is important since it may lead to changes in the decision-making behaviour of the market players with regard to medium- and long-term savings and investments. It may modify strategic resource allocation decisions and change the business view of financial institutions on medium- and long-term investments. Effects

that have been secondary until now could become dominant, thus altering the monetary policy transmission channels. In short, the effectiveness of negative interest rates could come into question.

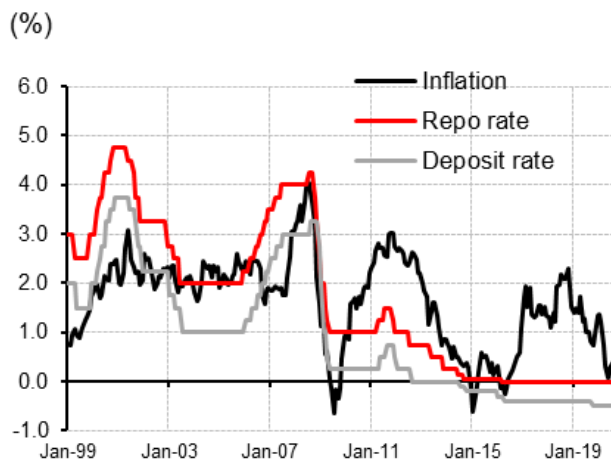
This article begins by explaining the concept of a “natural interest rate” and its role in monetary policy. It moves on to the specific factors behind the fall in nominal interest rates, and then analyses the ECB’s adaptation to this environment. The impact it has had on banks until now is dealt with in more detail below. The article ends by reflecting on how the financial environment is changing as the negative interest rate horizon lengthens.

Figure 1. Longterm interest rates



Source: OECD

Figure 2. ECB interest rates and inflation



Source: ECB

4.1. NATURAL INTEREST RATE AND MONETARY POLICY

The fall in both long-term interest rates and monetary policy interest rates raises the question of what role central banks have played in this process, particularly in the case of the ECB, in view of such a significant change in the tools it uses to implement its decisions. To this end, it is worth recalling how it has taken monetary policy decisions.

The ECB's monetary policy (like that of the Fed) is based on direct inflation targets. The theory behind it assumes that if, for example, market interest rates are above the equilibrium interest rate, the result will be a weakening of business and household expenditure and, consequently, a fall in inflation¹. This equilibrium interest rate, which is also known as the natural interest rate, is defined as the interest rate that enables economic activity to be carried out to its potential, while keeping inflation stable.

Since this concept defines the natural interest rate as being consistent with price stability and with a full employment economy, under a neutral monetary policy, the nominal interest rate, which is the economic variable that it may affect, gives rise to a real interest rate that is in line with the natural interest rate. However, if the economy is far from full employment and there is downward pressure on prices, the central bank will take the view that it has to implement an expansionary monetary policy and will set nominal interest rates at a level where real interest rates are below the natural interest rate.

The ECB has been faced with a declining inflation environment, especially after the financial crisis. Although average inflation during the first decade of this century was 2%, it dropped to 1.2% in the second decade. Moreover, the inflation expectations factored in by the financial markets have gradually ceased to be anchored to the ECB's target. The most popular benchmark indicator is derived from the 5-year, 5-year forward inflation swap, which remained above 2% until 2014. The indicator hovered around 1.5% until early 2019 but has decreased to 1% since.

Against this backdrop, the ECB has consistently resorted to the use of negative interest rates since June 2014. The central banks of Denmark, Japan, Sweden and Switzerland have also experimented with this tool. One of them, the Bank of Sweden, has now reversed them. Meanwhile, the Federal Reserve and the Bank of England have backed away from their use. In short, what underlies this is a lack of consensus on the effectiveness of this measure in stimulating aggregate demand and in aligning inflation with targets.

4.2. FACTORS BEHIND THE SECULAR DECLINE IN INTEREST RATES

The role played by central banks in the decline in interest rates is a subject of analysis and discussion.

The most widespread view is that the decrease in nominal interest rates is due to the fall in the natural interest rate as a result of an excess supply of savings compared

¹ This concept, which was introduced by Knut Wicksell in the 19th century, identifies a relationship between the marginal productivity of capital, market interest rates and price dynamics.

to demand for investment. This scenario posits an increase in the propensity to save combined with a drop in the desire to invest by economic agents, which may be linked to several phenomena.

The increase in the propensity to save is primarily explained by demographic trends, in particular higher life expectancy, which encourages people to save enough during their working lives for a potentially longer retirement². In principle, an ageing population may have an ambiguous effect on savings because it is also the case that when people retire their savings become negative as they consume the assets that they have built up over their working lives. Studies show that, to date, the first effect has prevailed and there is some consensus that it will continue to have this effect in the years ahead. However, some authors point out that the net effect could change direction over a longer period³.

Secondly, the increase in global savings has been linked to global trade imbalances. In particular, the accumulation of current account surpluses by emerging countries could be generating *ex ante* a global oversupply of funds with respect to investment demand⁴, leading to increased demand for reserve assets, which in turn causes their prices to rise and their yields to fall.

The decline in demand for funds is mainly attributed to the fall in expected return on investments as a result of the reduction in potential growth in economies⁵. The decline in investment has also been linked to the expansion of new technologies (IT and the Internet) that have encouraged the development of industries that are intensive in intangible capital and have lower tangible capital needs⁶.

Other assumptions have linked falling interest rates to the greater preference for safe and liquid assets (which puts downward pressure on the yield on investment grade public debt⁷), to increasing income inequality (since the propensity to save is higher in high-income segments of the population) and to cyclical factors such as private sector deleveraging in the post-financial crisis period.

In short, this view would conclude that central banks have lowered their interest rates in order to adapt them to an economic environment that requires lower interest rates as a result of the decline in the natural interest rate.

Another current of opinion holds that central banks and financial cycles have played a major role in falling real interest rates⁸. According to this line of thinking, monetary policy determines the cost of borrowing, which affects the financial cycle, which in turn

² Carvalho et al. (2016).

³ Goodhart and Pradhan (2017).

⁴ Bernanke (2005).

⁵ Gordon (2012).

⁶ Farhi and Gourio (2018).

⁷ Del Negro et al. (2018).

⁸ Boiro et al. (2017) defend the idea that the relationship between the fall in real interest rates and the determinants of savings and investment is not maintained when an empirical analysis is carried out for a time window starting before 1980. In contrast, they find evidence of the relationship between real interest rates and the monetary policy regime in countries that dominate international interest rate trends.

has a lasting impact on the economy and, therefore, affects real interest rates⁹. In a definition of the state of equilibrium that considers the existence of financial cycles, the natural interest rate would not be independent of monetary policy.

This approach represents an alternative view on how monetary policies work in the economy to that assumed by the main central banks (including the ECB) when designing their monetary policies. It questions the neutrality of long-term monetary policy and the use of the natural interest rate as a guide to monetary policy for two reasons. First, because its definition as an equilibrium interest rate ignores the implications it may have for prices of financial and real assets. And second, because the natural rate may not be independent of monetary policy itself, which would make it impossible for it to anchor monetary policy. In short, it calls for more attention to be paid to financial cycles, risks to asset prices and financial stability.

4.3. THE ECB'S ADAPTATION TO THE NEW ENVIRONMENT

Until mid-2007, the ECB's monetary policy was based on managing very short-term interest rates. To achieve the desired effect on the economy, its balance sheet needed to be just 13% of eurozone GDP. However, the effectiveness of traditional tools has gradually been exhausted.

The secular fall in interest rates gathered pace after the 2008 financial crisis. This was because the structural factors mentioned in the previous section combined with other cyclical factors, together with sharp asset price corrections and private sector deleveraging. Estimates of the natural interest rate in the eurozone show that they turned negative by 2010¹⁰. In a context of low economic growth and very low inflation, this triggered a change in the monetary policy response. In 2020, the ECB's deposit facility interest rate is at -0.50% and it has increased the size its balance sheet by five times, now representing 54% of eurozone GDP.

Although monetary policy management has more instruments and is more complex than before, it is not necessarily more effective. The ECB has to resort to a combination of mechanisms to affect the funding conditions of the economy. The tools at its disposal are: liquidity injections to banks linked to the granting of loans to the private sector (known as targeted long-term refinancing operations, or TLTROs), purchases of various types of financial assets (commercial paper, corporate bonds, securitisations and, above all, government debt under various programmes, which together are known as quantitative easing, or QE), negative interest rates and “forward guidance”, whereby the ECB notifies how it expects its monetary policy to evolve in the future.

In this process, the ECB has taken on an active role in reallocating financial resources in the eurozone on a regular basis, not only exceptionally as when it has been responsible for acting as a lender of last resort. When the ECB expanded liquidity injections to banks (TLTROs), it replaced the money markets in the role they played in redistributing

⁹ Boiro et al. (2019).

¹⁰ Schnabel (2020).

financial resources among banks. In rolling out QE, it became a benchmark operator in some secondary fixed income markets, in particular in the public debt markets, thereby reducing the weight of market makers. This would have consequences on the liquidity and depth of secondary markets. Lastly, since public debt accounts for a large proportion of QE (making up 78% of the ECB’s portfolio), it leads to an easing of its budgetary restriction (as financial costs drop). This has been criticised in some circles as it could lead to higher public spending.

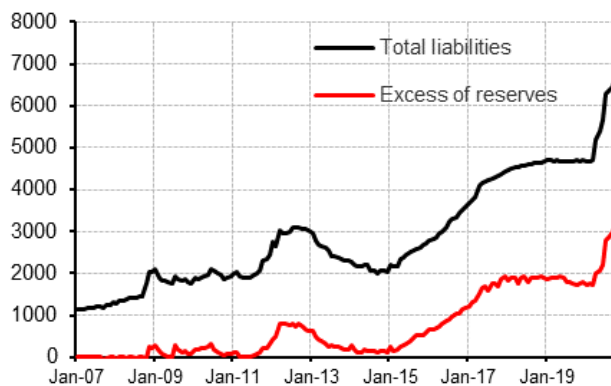
Moreover, negative interest rates and balance sheet expansion are tools that may have the opposite effect to that which gave rise to their initial use. Assessing the effectiveness of monetary policy has become a complex task because it requires an empirical exercise to analyse a broad set of interrelations and effects in different directions. Effectiveness involves estimating the net effect, which may change direction as the economic and financial environment changes or simply as a result of the passage of time. It will also be a dynamic task, where speed and the ability to anticipate will be crucial if undesirable effects are to be avoided. All of this will ultimately test the ECB’s capacity to respond.

The financial crisis was a challenge for monetary policy because conventional tools had been exhausted. The post-pandemic period will be another, no less difficult challenge because it will test the effectiveness of non-conventional tools. The variable shaping this new challenge is the duration for which monetary policy will face negative interest rates, in particular the impact it may have on banks, as they represent one of the main channels for transmitting monetary policy.

4.4. IMPACT ON THE BANKING SECTOR

The combination of negative interest rates, quantitative easing and forward guidance has impacted banks in a number of ways: by generating structural excess liquidity in the financial system, triggering a fall in interest rates and flattening the yield curve. Banks’ profitability and lending are affected in a number of ways, which may oppose one another.

Figure 3. ECB Balancesheet (€ bn)



Source: ECB

First, the ECB imposes a cost on financial institutions for holding their excess reserves, through interest paid to the ECB under the deposit facility. These excess reserves arise from the instruments used by the ECB to expand its balance sheet, and have become structural because they have reached such a volume that they cannot be eliminated by bank lending; given that the mandatory reserve ratio is 1% of eligible liabilities, credit would have to be multiplied twentyfold for current excess reserves to become mandatory reserves.

The ECB established two mitigating measures in 2019, introducing a system for remunerating excess reserves in two tranches (called a *two-tier system*) and improving the conditions of TLTROs for banks that met certain credit creation targets. Adjustments to these mitigating measures may be required from time to time, particularly if the negative interest rate period continues and quantitative measures are expanded. For example, the monetary measures taken in response to COVID-19 entailed an 80% increase in excess reserves between March and October 2020. Given the current design of the two-tier system¹¹, this will entail doubling the cost of excess reserves compared with what it would have been with the ECB’s balance sheet before the coronavirus.

The second effect is the impact on **net interest income**. Negative interest rates together with asset purchase programmes tend to compress net interest income because interest rates on loans fall more than does the cost of deposits.

Banks face difficulties in charging for deposits. In the eurozone, only a small portion of corporate deposits bear negative interest rates, although the percentage is growing¹². With household deposits this is even less common, either for political reasons or because of regulatory restrictions. Since households’ deposits account for most bank deposits (around three fourths), the interest on overall deposits in the euro area countries faces a zero lower bound (figure 4).

Moreover, asset purchase programmes place downward pressure on long-term interest rates. Since the banking business is based on the transformation of maturities, taking short-term deposits and making long-term loans, interest rates on new loans will gradually decrease to a greater extent than interest rates on new deposits.

If negative interest rates alter the relationship between the decrease in the deposit rate and the decrease in the lending rate, this measure may have a diminishing effect and there may come a point at which the credit transmission channel is disrupted. This

¹¹ Under the two-tier system a volume of excess reserves, calculated by multiplying required reserves sixfold, is exempted from paying the deposit facility rate. Between March and October 2020, surplus reserves increased by EUR 1.4 trillion, while reserves not subject to the deposit facility rate barely changed. As a result, the cost of excess reserves for the banking sector in October 2020 was estimated at about EUR 11 billion per year, compared with EUR 4.6 billion at the time the two-tier system was set up, in September 2019.

¹² Altavilla et al (2019).

occurred in Sweden, where the transmission to interest rates for loans slowed following the first two cuts in official interest rates¹³.

One way of offsetting the reduction in revenues from net interest income is by re-directing banking business towards fee- and commission-generating services, but these activities are unlikely to offset the loss of credit income, at least in the short term.

Figure 4

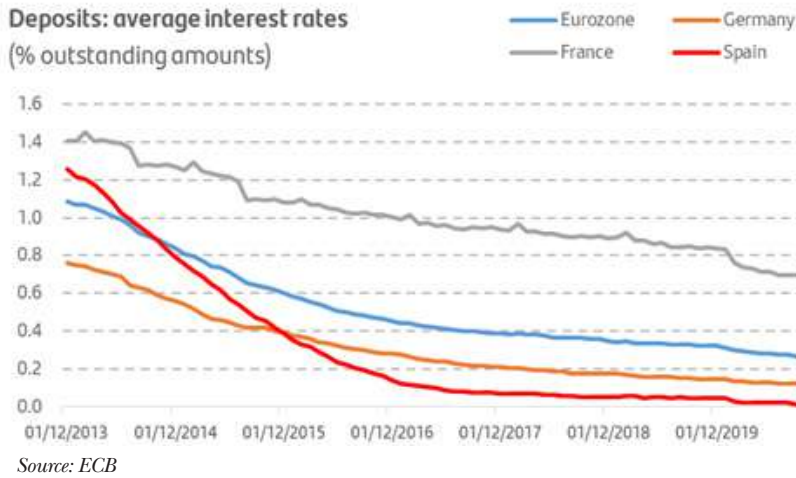
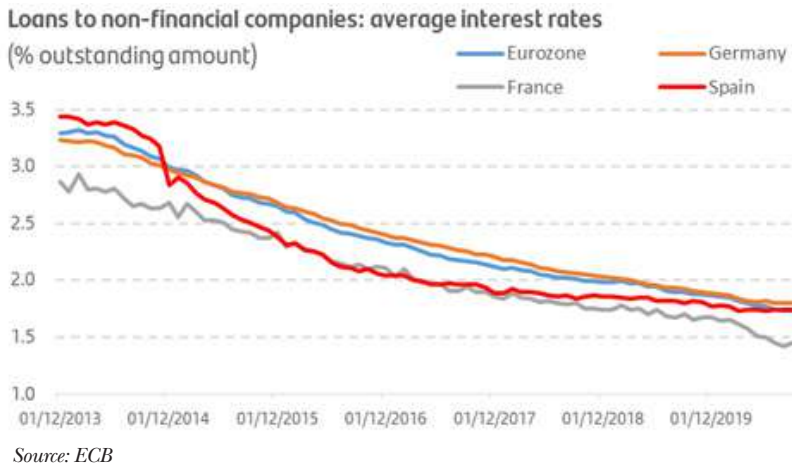


Figure 5



¹³ In Sweden, official interest rates fell to -0.10%, -0.25%, -0.35% and -0.50%. Eggertsson and Summers (2019) find that the transmission to interest rates on loans slowed starting at -0.25%.

There could also be a positive impact on banks' profitability if monetary easing measures succeed in rekindling economic growth, given that they will boost demand for credit, increasing the number and volume of transactions.

Third, QE can have a positive effect on **non-interest income** given that it raises bond prices in secondary markets, generating gains on banks' fixed-income portfolios.

Lastly, the potential effect on **provisions** resulting from an improved economic situation through better asset quality and a reduction in NPLs must be taken into account.

The ECB regularly queries banks on their perception of how they are affected by negative interest rates and QE through its Bank Lending Survey¹⁴. The banks note that these measures have favourable effects on their liquidity position, on market-financing conditions and on lending volume, but they are particularly critical of the measures' impact on profitability as a result of the pressure they exert on net interest income.

Empirical studies by the ECB find that until 2019 the compression of net interest income and the cost of excess reserves had a negative impact on banks, which may have been offset by the effect of the increase in credit volume, lower provisions and gains on fixed income portfolios¹⁵. However, the time horizon during which interest rates will remain negative is very significant.

The San Francisco Federal Reserve has studied the impact of the length of the period of negative interest rates for a broad sample of Japanese and European banks¹⁶. Because the reduction in net interest income accelerates over time, according to the Fed's estimates the effects on profitability turn negative for banks that have been operating longer in a negative interest rate environment. In addition, after five years, the impact is negative for the banking sector overall. Furthermore, because the emergence of a lower limit for the deposit interest rate reduces the profitability of lending, the study finds adverse effects on bank lending after the second year of negative official interest rates.

4.5. THE “LOW FOR LONGER” EFFECT

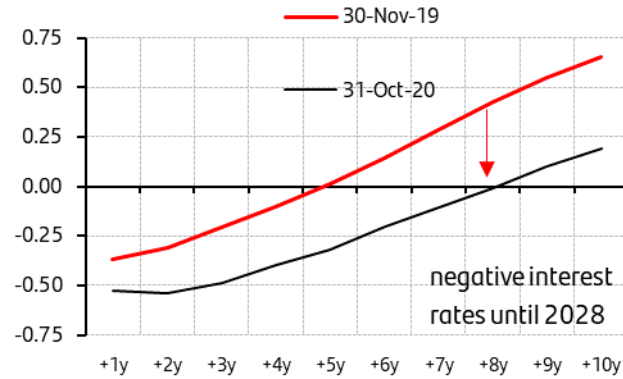
The issue of the effects of negative interest rates and quantitative expansion has become particularly important in the post-pandemic period. First, because the coronavirus has dramatically affected how long the market expects interest rates to remain negative – four years before COVID-19 versus eight years after it (figure 6). Second, because monetary policy will have to continue to buoy the economy, which means that it needs the credit channel to continue to function.

¹⁴ The euro area bank lending survey, Q3 2020.

¹⁵ Boucinha and Burlon (2020), Lopez, Rose, and Spiegel (2020) and Schnabel (2020).

¹⁶ Beauregard and Spiegel (2020).

Figure 6. Euribor 1 m forward



Source: Refinitiv

In an environment in which interest rates remain in negative territory for years, it will be increasingly difficult to offset lower earnings resulting from a decrease in net interest income with income from investment portfolios. Bond holdings will have been reduced through profit-taking, or securities will mature and will be replaced by others with lower yields (or a higher risk, which could have consequences for financial stability). This decline in earnings over the medium term erodes banks' ability to generate capital organically, which, all in all, will be detrimental for lending.

As a result of the decrease in net interest income, banks may consider different business models that place more importance on non-lending activities and generate fees and commissions. However, this could end up weakening the credit channel as a transmitter of monetary policy.

Banks may decide to increase their risk profile so as to increase returns (what is known as “bank risk-taking”), channelling lending to riskier activities or acquiring portfolios of high-risk securities. This change in attitude is not necessarily negative for the economy if it leads to the financing of profitable activities that boost economic growth. However, the consequences for financial stability would, in any event, have to be assessed.

Another possibility is that the economy will reach what has been called the “reversal rate”¹⁷, that is, the interest rate starting at which a monetary policy intended to be expansionary ends up being contractionary. This might happen if banks decided to raise interest rates on lending to compensate for the cost of deposits, because negative interest rates on deposits will end up offsetting the cost of hoarding cash or because banks have capital restrictions leading them to reduce lending in the event of a decline in interest rates. The reversal rate can change over time, and it might tend to increase if banks face problems in adapting to a long period of negative interest rates.

¹⁷ Brunnermeier and Koby (2019).

In such a situation, monetary policy would have to be redesigned. It might be necessary to increase long-term interest rates so as to raise the slope of the yield curve and favour the profitability of lending.

Lastly, the pandemic could reduce banks' tolerance in a situation with negative interest rates if in the following periods economic growth remains low and the natural rate of interest continues to decline¹⁸.

In sum, the possible limits on monetary policy and the challenges faced by banks when adapting to a prolonged period with negative interest rates highlight the importance that economic policy overall will have for boosting economic growth.

4.6. CONCLUSIONS

Monetary policy in the euro area has evolved towards the permanent use of negative interest rates and the expansion of the ECB's balance sheet with quantitative measures. An assessment of the economic impact of this is a complex matter because of opposing effects that arise in the financial sector.

A longer time horizon in which interest rates remain in negative territory is a new challenge for monetary policy in coming years, especially in the post-pandemic environment. The compression of net interest income could continue in response to the emergence of deposit interest rate floors when deposits approach zero. Capital gains on bond portfolios run out, the flat slope of the yield curve discourages lending (because profits come from long-term lending and short-term funding) and difficulties for generating organic capital may weaken capital and thereby reduce its ability to provide credit.

With a prolonged horizon of negative interest rates, banks could rethink their business in different ways: raising fees, increasing their risk exposure either through a more aggressive lending policy or through financial asset portfolios or even focusing on activities other than lending. Any of these options have monetary policy implications, either because they weaken the credit channel or because they may pose risks to financial stability.

In an extreme situation, the economy could reach the reversal rate, which would make it necessary to completely rethink the strategy of monetary policy.

This negative interest rate environment is unlikely to be overcome solely with monetary policy. Negative interest rates might activate the growth of aggregate demand and investment, boosting economic growth and eventually causing the equilibrium interest rate to rise. However, this scenario does not seem likely, especially in the post-pandemic period. What seems more likely is that monetary policy will need to be complemented by other types of policies in order to be able to emerge from negative interest rates.

¹⁸ This scenario is in line with the historical experience described by Jordà, Singh and Taylor (2020) in their analysis of the reaction of economies in post-pandemic periods since the fifteenth century.

Specifically, we are thinking of a fiscal policy that invests in activities with growth potential, structural reforms that improve competition, the functioning of markets and the business environment and a strengthening of the European Union.

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5. FUNDAMENTAL UNCERTAINTY AND CLIMATE: THE TWO ISSUES TO GUIDE THE ECB'S STRATEGY REVIEW

MARIA DEMERTZIS AND MARTA DOMÍNGUEZ-JIMÉNEZ¹

5.1. ABSTRACT

In the European Central Bank's strategy review, initiated by President Lagarde, two issues deserve explicit attention and require a substantial shift in monetary policy. First, the COVID-19 crisis has compounded the fundamental uncertainty that has come to characterise the European economy. Under such uncertainty, confidence in ECB actions will come from the range of contingency scenarios the bank considers and communicates, and from the adoption of policies suitable for a broad set of such scenarios. Second, the climate crisis has opened the door to green monetary policy. This could involve modification of requirements for asset purchase programmes and for collateral, so that low-carbon intensity securities are over-weighted in the ECB's balance sheet. A gradual approach is necessary to avoid undermining the price stability objective or causing evident market distortion.

5.2. INTRODUCTION

At the start of her tenure as President of the European Central Bank, Christine Lagarde initiated a strategy review of monetary policy after years of moderate turmoil. This process was put on hold because of COVID-19, as the ECB focused its resources on combating the downturn. However, in late September, President Lagarde made a speech in Frankfurt providing some preliminary considerations on this strategy review,

¹ Bruegel. We thank participants at the Bruegel seminar and Monetary Dialogue seminar at the European Parliament. Any remaining errors are our own.

thus returning focus (Lagarde 2020). We believe this is a major opportunity for the ECB to adapt monetary policy in order to tackle two important challenges.

The first is uncertainty. COVID-19 has caused a great increase in uncertainty, yet the ECB was already operating in a shifting and poorly understood new normal. Compounding the problem, traditional notions of uncertainty rely on the accurate measurement of risk, which at the moment is at best incomplete.

This manifests itself clearly in the effects of ECB policy, which has recently played a major role while using untested tools, with potential effects that are not fully understood and further contribute to uncertainty. These unconventional measures have led to the rapid expansion of an already large balance sheet and the protracted use of negative policy rates, raising questions about how this will affect the ECB's own health as well as that of the banking sector. The ECB has also provided much needed relief to sovereign issuers, creating space to combat the pandemic. However, the resulting suppression of sovereign spreads, in the face of growing debt levels, should raise concerns about medium-term debt sustainability. Could the ECB come under pressure to support these spreads and avoid market panic beyond the appropriate horizon?

These issues are compounded by a shortcoming in the ECB's toolkit. Monetary policy relies on estimates of unobserved variables, yet forecasting models have become less accurate under fundamental uncertainty.

Designed to revert to the mean, they do not function well when the fundamental equilibrium shifts (much less so if it is unknown). As linearised models, they can also only forecast accurately following small deviations from equilibrium (and COVID-19 has been a very substantial shock). A consequence of this has been an equilibrium real interest rate is estimated to be in negative territory by both models and the markets, which is unusual at best and leaves the ECB navigating in the dark.

In order to improve the conduct of monetary policy in these circumstances, we make three recommendations. First, traditional confidence intervals should be discarded. A range of possible outcomes should instead be provided, based on a set of underlying assumptions. These assumptions should be carefully communicated, with a focus on what the response should be to alternative scenarios and not on future predictions. Second, measures, whenever possible, should be ranked not based on whether they should achieve optimal outcomes in the baseline scenario, but acceptable outcomes under the widest range of scenarios. Third, redefining the price stability target to a set 2% and establishing fixed (and generous) tolerance bands around it would improve signalling to the market and formally determine tolerable levels of inflation.

The second uncertainty confronting the ECB is that the urgency of the climate crisis continues to grow. This has motivated President Lagarde to confirm she would like to explore the possibility of greening ECB green monetary policy. This would make the ECB the first major central bank to adopt such measures, under which the ECB would go further than merely including climate risk in financial stability considerations, aiding the transition to a low-carbon economy by disproportionately supporting funding for less carbon-intensive projects.

Two clear avenues for green monetary policy are available to central bankers.

The first concerns asset purchase programmes. The ECB has a large and rapidly expanding balance sheet, over half of which has been accrued through the direct acquisition of assets as part of a series of purchase programmes. These include the covered bonds purchase programme and corporate sector purchase programme. By adapting their eligibility criteria to include carbon footprint indicators, the ECB could skew future purchases to favour securities that have low-carbon content. This would have evident effects on the liquidity of these assets, providing support by raising their prices and reducing the cost of funding.

The second concerns collateral eligibility requirements. Unlike direct purchases, the majority of ECB collateral holdings (which serve to mitigate counterparty risk) concern private sector securities, including unsecured and covered bank bonds, corporate bonds and asset-backed securities. These forms of collateral receive a haircut based on perceived risk. Adapting eligibility requirements would allow for a more favourable (i.e. smaller) haircut for low-carbon-content bonds, which should result in a natural shift in collateral holdings towards greener assets as the reduced haircut makes them more attractive to banks.

Changing eligibility requirements for both asset purchase programmes and collateral holdings is therefore the way to advance this discussion. However, this must be done in accordance with ECB core principles (enshrined in the EU treaties), including the pursuit of secondary objectives “*without prejudice*” (Article 127 TFEU) to price stability and avoiding any evident market distortions (in keeping with market neutrality). The skew should therefore be gradual.

Furthermore, we believe such a focus on the green transition requires a clear political mandate. The European Parliament and the Council of the EU are the appropriate decision-makers for this, as representatives of EU citizens and member states respectively. This does not require a legally binding resolution, but it would require a clear ranking of ECB secondary objectives that prioritises support for a low-carbon transition above other secondary objectives.

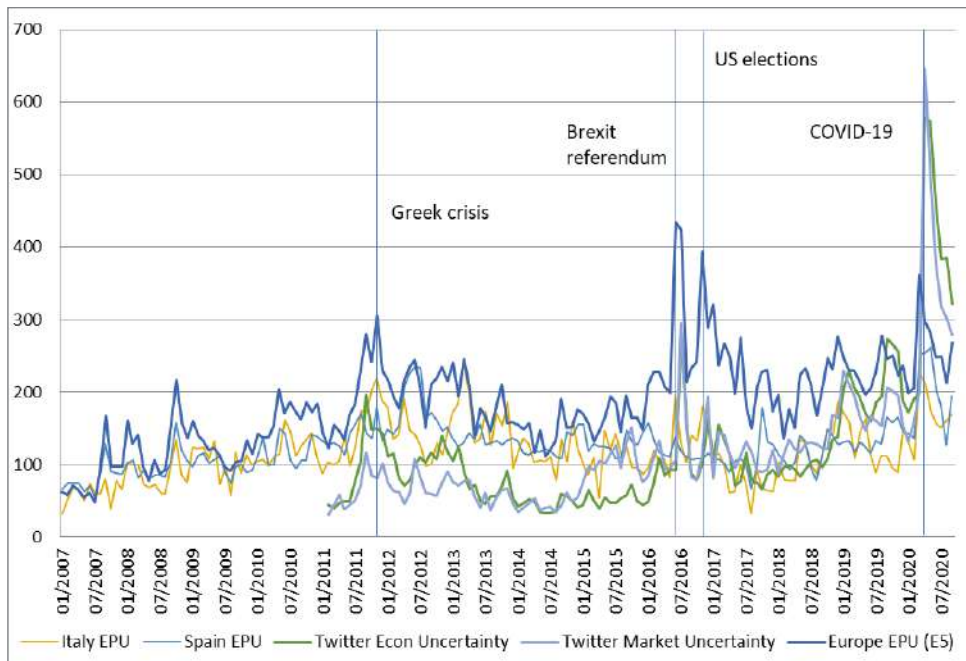
5.3. ADAPTING MONETARY POLICY TO A WORLD OF FUNDAMENTAL UNCERTAINTY

How should the ECB adapt its monetary policy to the context of fundamental uncertainty? The euro area is predicted to contract substantially in 2020, and in the midst of a second wave of COVID-19 it remains unclear how economic performance will evolve in 2021. Any notion of returning to normality hides the fact that the global economy faced major structural changes long before the outbreak. Policy design has become complicated, with the ECB navigating without a clear destination (Claeys *et al*, 2019). COVID-19 has compounded a high level of uncertainty: while intervention will be required, it will be guided by imprecise and rapidly shifting information.

This section discusses the two broad areas that can explain some of the underlying uncertainty. First is the ECB policy of preventing excessive financial fragmentation in times of crisis, which postpones but does not solve the problem of debt sustainability. This is not an argument against the choices made by the ECB, rather an argument that containing the debt should also be given significant consideration. Second is that policy relies on unobservable variables that have become increasingly difficult to estimate or even understand.

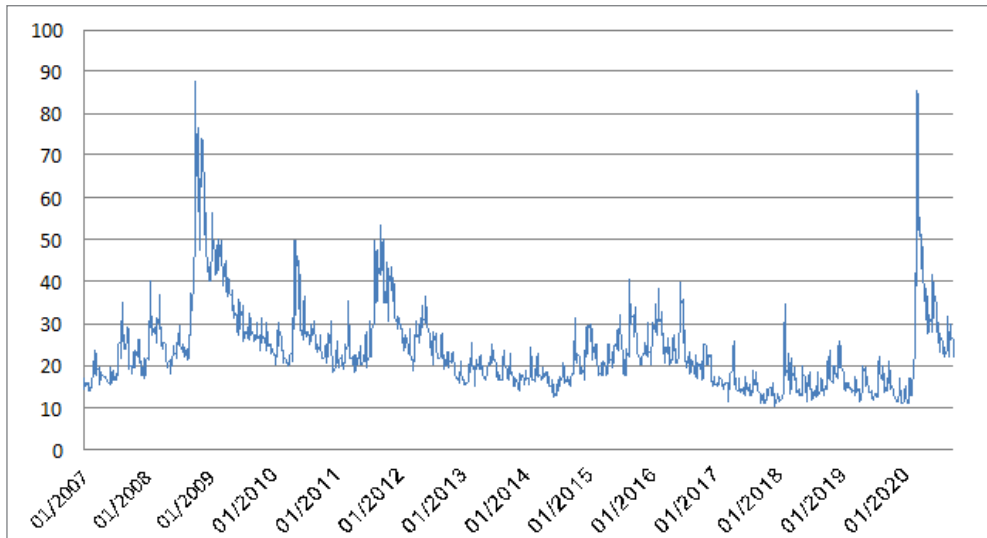
Before exploring these mechanisms, it is worth taking a look at how estimates of uncertainty have evolved. Figures 1 to 2 present two such measures: economic uncertainty as expressed in newspapers and on Twitter, and implied volatility of options. The peak at the outset of the pandemic is evident.

Figure 1: Economic Uncertainty as reflected in Newspapers and Twitter



Source: Bruegel. For Economic Policy Uncertainty (EPU)s: Baker et al (2016) for Italy and Ghirelli et al (2019) for Spain. St Louis Fed for Europe EPU Index (constructed from newspaper uncertainty in the five largest economies: France, Germany, Italy, Spain and UK). Notes: See Baker et al (2016) for details of EPU index construction. Values available at <http://www.policyuncertainty.com/>. For Twitter-based Economic Uncertainty (TEU) and Twitter-based Market Uncertainty (TMU), see Baker et al (2000). Values exhibited represent rolling monthly averages to avoid the excessive prevalence of isolated one-day events. Daily values available at <http://www.policyuncertainty.com/>. Twitter-based measures constructed from tweets only in English, thus best reflecting the situation in the English-speaking world.

Figure 2: Stock market volatility (VSTOXX index)



Source: Bloomberg. Notes: The VSTOXX Index, similarly to the VIXX Index in the US, measures euro-area stock market volatility through the implied volatility of EURO STOXX 50 Index options with rolling 30-day expiry. While implied volatility structurally trends above realised volatility, its evolution through time is the variable of interest.

While these measures provide a snapshot of the current circumstances, the implied assumption is that risk can be measured and thus policy can rely on these measures in seeking to achieve certain outcomes. Both the current pandemic and medium-term structural changes indicate uncertainty can no longer be measured accurately: our understanding of the underlying mechanics is at best partial.

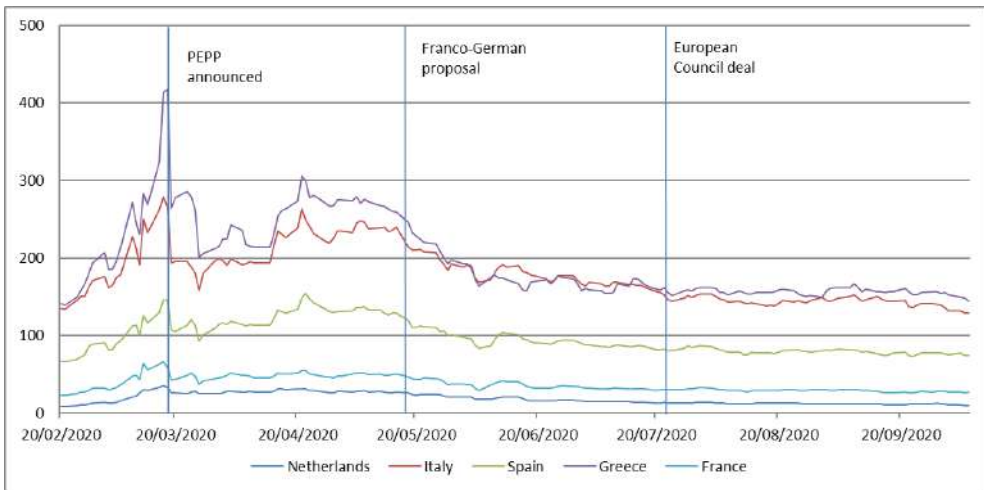
5.3.1 ECB POLICIES AND FINANCIAL FRAGMENTATION?

The ECB has been navigating in the dark for over a decade, its practice evolving as an incomplete monetary union faced a very substantial financial crisis and even the possibility of break-up. This situation partly repeated itself at the start of the pandemic, as the ECB was once again the first EU institution to react to the economic collapse quickly and substantially. However, many of the measures adopted may have uncertain side-effects.

After the first effects of the pandemic hit the euro area, the ECB began by reducing the targeted longer-term refinancing operations (TLTRO) refinancing rate to -75 bps, establishing an indirect 'subsidy' for banks borrowing under TLTRO (from borrowing at -75 bps and depositing at -50 bps). The ECB then loosened regulatory requirements and restarted quantitative easing (QE) with an initial €120 billion. More significantly, the

bank then introduced the pandemic emergency purchase programme (PEPP). For this programme, self-imposed issuer limits ceased to be binding, Greek debt became eligible and flexibility to deviate from the ECB’s capital key was introduced. The effect of this announcement on the markets can be seen in Figure 3: spreads were compressed and relief was provided to sovereign debt issuers, giving member states the policy space to respond to COVID-19 appropriately (Consiglio and Zenios, 2020).

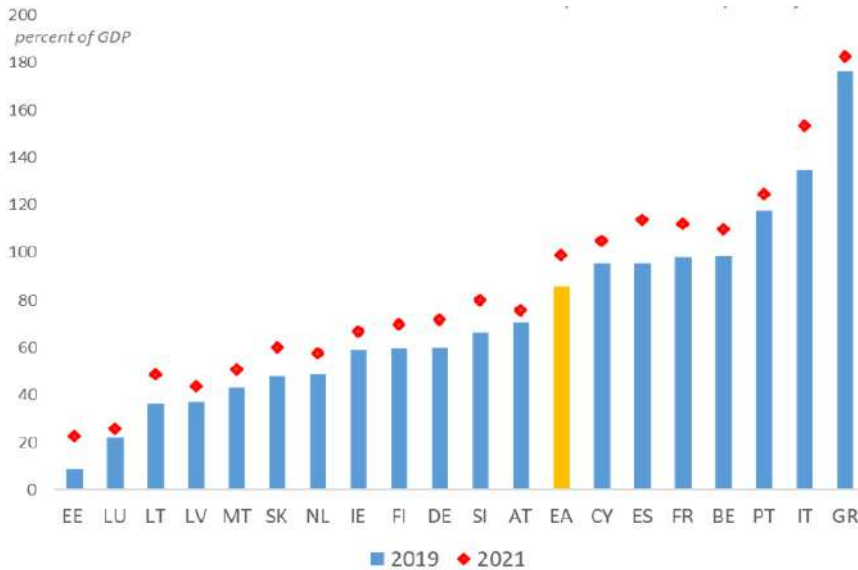
Figure 3: Sovereign spreads, 10Y, to DE (Feb-September 2020)



Source: Bloomberg. Note: the Franco-German proposal was the plan published by France and Germany in May 2020 for a recovery fund based on EU borrowing. It was succeeded by the European Commission’s proposal for what became Next Generation EU.

These measures and the resulting policy space were necessary to handle the emergency. They assuaged market fears of a sovereign debt crisis. However, these suppressed spreads do not necessarily reflect the real cost of debt. We should be mindful of how they evolved with the introduction of the euro – at the time, spreads between member states pretty much disappeared. The market expected *de-facto* risk sharing would follow a crisis, and thus priced Greek and Italian debt similarly to German debt. This was evidently damaging. This time, spreads have by no means disappeared, but they remain low despite rapidly growing levels of debt to GDP (Figure 4).

Figure 4: Public debt in the euro area in 2019 vs. projections 2021



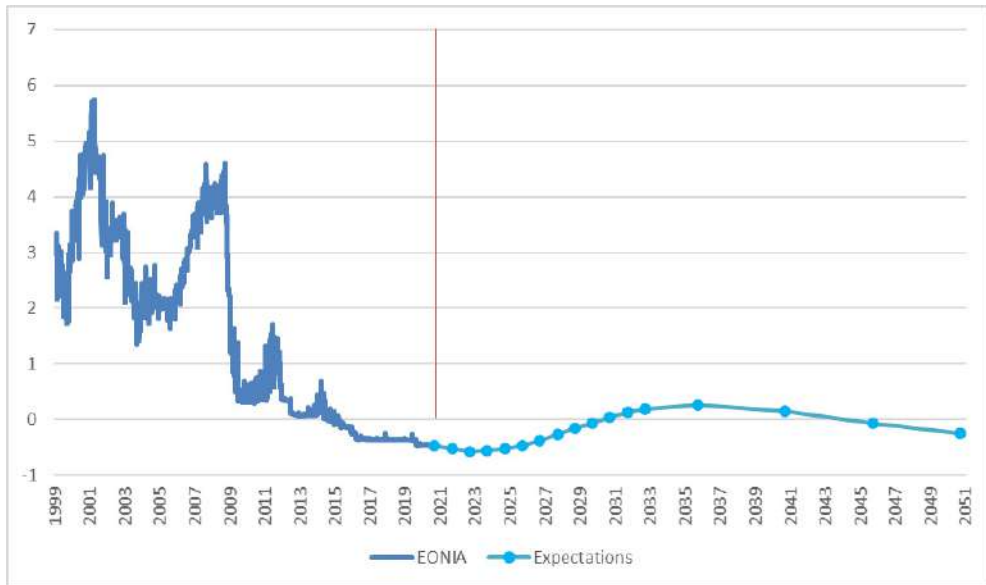
Source: European Commission, April 2020 forecast.

The wider effects of the way the PEPP has been constructed are also unclear. The self-imposed PSPP (public sector purchase programme) issuer limits of 33% had been reached in some jurisdictions around 2018 and it is unsurprising that their removal was required for an effective response (Claeys *et al*, 2018). However, this involves backtracking on their previous rationale. These limits were set so the ECB would not be able to block a restructuring (because a decision not to do so could be seen as monetary financing). The removal of these limits, together with more flexibility to deviate from the capital key, could lead to questions of independence.

Two challenges emerge from this. First, what do the ECB's unconventional measures entail for their own health and that of the financial sector? Second, what will the evolution of sovereign spreads be in the medium-term? Will they require continued ECB support and will this introduce a future threat to ECB independence?

Figure 5 shows that the markets anticipate nominal rates remaining low for a very long time. In fact, they expect rates to be negative for the best part of the decade and only then hover around zero. For as long as this turns out to be the case, the issue of debt sustainability will not in any way threaten the viability of euro, as debt repayments will remain low. This will not be the case if interest rates are required to increase in the future. If the euro area is subject to inflationary pressures (Goodhart, 2020; Goodhart and Pradhan, 2020) then the ECB might find that the monetary policy objective is in direct conflict with its desire to preserve financial stability. Although this is one of the potential outcomes in the universe of outcomes, such a possibility remains very unlikely in the immediate future.

Figure 5: Nominal rates in the euro area, up to 2050



Source: Bruegel based on Bloomberg.

5.3.2 FORECASTING HAS BECOME INCREASINGLY DIFFICULT...

This current underlying uncertainty is reinforced by the inability of our forecasting models to accurately predict key variables in this new normal, even as these are at the centre of determining monetary policy. Monetary policy depends on estimates of both observable and unobservable variables, estimates that have become less reliable as uncertainty grows.

Most developed-economy central banks (including the ECB) base decisions on monetary policy on the traditional Taylor rule:

$$i_t = \pi^* + r^* + \alpha_\pi(\pi_t - \pi^*) + \alpha_y(y_t - y^*)$$

- π^* is the inflation target
- r^* is the equilibrium interest rate
- $y_t - y^*$ is the output gap

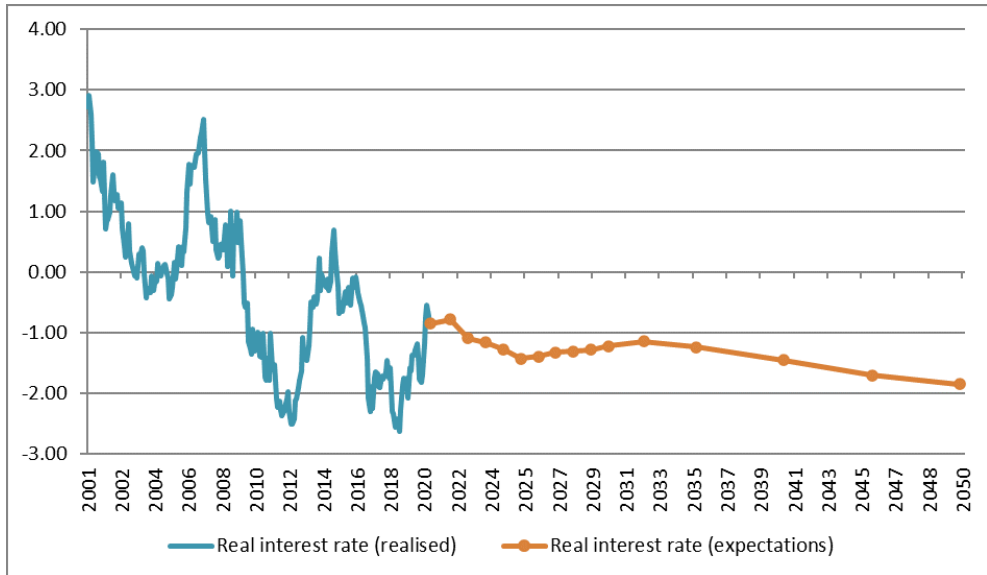
The policy rate is determined in order to close the output and inflation gaps, evident in a re-written Taylor rule:

$$i_t - r^* = \pi^* + \alpha_\pi(\pi_t - \pi^*) + \alpha_y(y_t - y^*)$$

In this context, the traditional tools employed in conducting monetary policy have two underlying features that do not work well under deep uncertainty.

We illustrate the point based, first, on how markets perceive the evolution of the real cost of capital. Figure 6 below uses the same methodology as Figure 5, this time to derive the future path of real interest rates as expected by the markets.

Figure 6: Real interest rate (realised and expectations)



Source: Bruegel based on Bloomberg. Notes: Real interest rates are calculated by subtracting inflation from nominal rates.

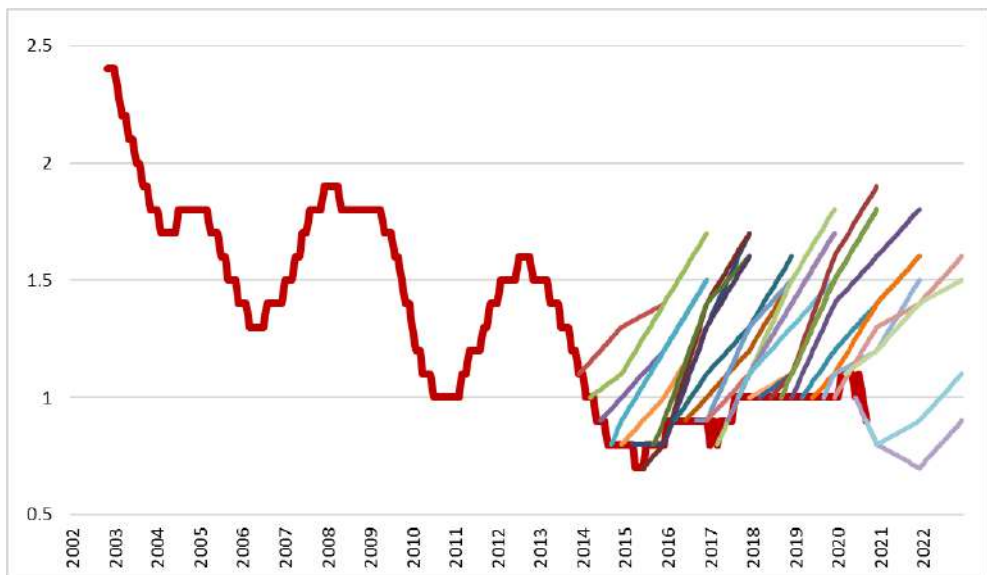
The numbers show that markets believe real rates will continue to remain negative for the next 30 years, their entire horizon. That is, at best, highly unusual. How can the real cost of capital be negative effectively, forever? The most reasonable explanation would appear to be that the underlying models used to estimate this real equilibrium interest rate are also poor, and the market is basing its expectations on a limited understanding of the new *status quo*. This issue existed before the pandemic, yet the current economic circumstances have introduced additional uncertainty around this equilibrium rate. There are fundamental changes going on, from digitisation to possibly deglobalisation, and our current understanding of where they will lead remains at best imperfect.

A second problem relates specifically to the current construction of forecasting models. These have been designed to revert to the mean, returning to their equilibrium. This makes them adept at describing and making predictions when the equilibrium is well-defined. After a deviation from equilibrium, policy should guide a return to this equilibrium and thus facilitate the reversion to the mean. In order to be traceable, these models are also linearised, which makes them very poor at forecasting after large

deviations from equilibrium, which undoubtedly includes the current shock. This together with a poor understanding of equilibrium makes these forecasting models increasingly inaccurate.

Figure 7 illustrates this issue. It shows the ECB staff’s macroeconomic projections for core inflation (moving 12-month average rate of change) every month over the next two years. Projections are shown each quarter since December 2013. This has been a period of uncharacteristically low inflation (comfortably below 2%) and thus the ECB’s model has predicted a persistent mean reversion throughout the seven years. The prediction has been systemically wrong and has not materialised (Darvas 2018). The natural inference from this is that our understanding of what determines inflation and the transmission of monetary policy has been incorrect. This has serious implications both for the effectiveness of monetary policy and even the credibility of the ECB. As our economy moves towards a new normal, these models are doomed to fail because of their constant return to the previous equilibrium.

Figure 7: Core Inflation, ECB staff macroeconomic projections for the euro area, average annual values

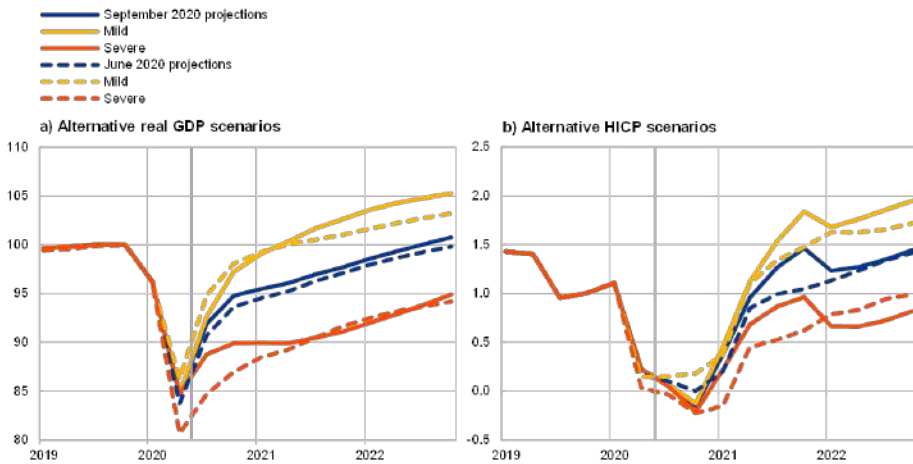


Source: Darvas (2018), based on ECB, whom we also thank for updating the series to include latest numbers. Note: The thick red line represents actual core inflation and each coloured line represents inflation forecasts for the subsequent two years at each point in time.

An additional source of forecasting difficulty is the introduction of confidence intervals. This relates to how forecasts are communicated, with these bands seemingly included to provide statistical confidence. However, these are econometric estimates based on past data, which under fundamental uncertainty cannot be used as a predictor of the future.

In its June and September staff macroeconomic projections, the ECB, faced with pandemic-induced unprecedented uncertainty, did not publish upper and lower ranges². Instead they discussed alternative scenarios for real GDP and inflation (shown in Figure 8). These are based on assumptions of the evolution of the pandemic and thus the strictness of containment measures. We welcome this development; backward-looking confidence intervals create a false sense of confidence. Discussing alternative scenarios instead provides information on the range of outcomes that the ECB would like to be prepared for.

Figure 8: ECB Staff macroeconomic projections and alternative scenarios for real GDP and HICP inflation in the euro area (September and June projections 2020)



Source: ECB staff macroeconomic projections for the euro area, September 2020, Box 3. Notes: The vertical line indicates the start of the projection horizon, index: Q4 2019 = 100 (left-hand chart) and year-on-year rate (right-hand chart).

We hope that this practice remains, as the COVID-19 shocks peter out in the next year and economic demand resumes. Fundamental uncertainty, in that fundamentals are changing, will remain in this transformative stage. As we build our understanding of what this new normal will be, we will always need to prepare for alternative scenarios, irrespective of how likely they may or may not be.

5.3.3 IMPLICATIONS FOR POLICYMAKING

Under fundamental uncertainty, policymakers face the key inherent issue of not being able to attribute degrees of confidence to their decisions and the expected outcomes of

² These computational ranges represented 57.5% confidence intervals (ECB, 2009) based on historical projection errors, considered inappropriate for the current circumstances.

these decisions. Confidence intervals involve an inherent trade-off between precision and predictability – depending on how much we’re willing to be concrete, at the risk of being wrong, we can draw narrower or wider bands. But under fundamental uncertainty, probabilistic estimates of these bands (and past forecast errors) must deal with multiple issues. How then can confidence be defined if not probabilistically?

We consider the ECB’s new approach, which computes alternative scenarios, a much better method in these circumstances. The ECB provides a baseline, a mild and a severe scenario, each based on concrete and clearly laid-out critical assumptions of how the pandemic will evolve, what the necessary containment measures will be and how economic agents will respond. Confidence then arises from the range of contingency scenarios examined. In this case, the ECB argues that inflation will be between 0.7% and 1.5% if their underlying assumptions fall in between these scenarios. Otherwise inflation cannot be expected to fall within this range.

This framework can provide policymakers with two ways of reaching decisions.

The ECB can first determine the inflation range it is willing to communicate. Once this has been established, the ECB can calculate the range of assumptions (in the current case relating to COVID-19 infections) under which inflation will fall within that range. If infections were to fall outside these numbers, the inflation range cannot be expected to hold. The opposite mechanism could also be employed: the ECB could determine the inflation consequences for a given range of infections. However, determining the appropriate range of infections is not part of the ECB’s traditional expertise, and thus makes less sense as a method.

The second benefit from this framework is that it allows the ECB to rank the appropriateness of different policies. If the ECB had to consider alternative policies, it should pick that policy which would achieve a given (and pre-established acceptable) inflation range for the most extreme scenarios (Ben-Haim and Demertzis, 2008, 2016).

This framework allows the ECB to provide inflation forecasts based on their best understanding of conditions, but to also clearly establish and communicate the consequences of incorrect assumptions. We hope the ECB will continue to communicate forecasts in this way and not revert back to ranges. They should also be careful to explain their policy choices as those that will result in acceptable outcomes under a wide range of contingent scenarios.

At the same time, there are two other ‘quick-win’ fixes the ECB could implement to better manage uncertainty by removing as much policy uncertainty as possible.

- First, it can change the price stability target to a set 2% (rather than below, but close to, 2%). Under the theory of focal points, clear objectives provide a better market signal (Demertzis and Viegi, 2008).
- At the same time, the introduction of tolerance bands should help determine what levels of inflation are tolerable. These should be wide; in times of uncertainty it is better to be predictable than precise (Demertzis and Viegi, 2010). Central bank communication should then focus not on what will happen but rather on what the reaction should be to alternative scenarios.

5.4. GREENING MONETARY POLICY

The second challenge that will take centre stage in the ECB's strategic review is the bank's possible role in mitigating the effects of the climate crisis. In July 2020, President Lagarde acknowledged the possibility of the ECB employing its various asset purchase programmes to combat climate change, expressing her strong wish to explore all available avenues (Financial Times, 2020).

This was the first time Lagarde addressed the possibility of green goals being pursued directly through the conduct of monetary policy. If this were to happen, it would make the ECB the first large central bank to integrate green criteria into its asset purchases beyond any financial risk considerations. Other than the various asset purchase programmes, a second avenue for green monetary policy would be the incorporation of green criteria into collateral eligibility requirements, with haircuts being adapted to reflect the carbon footprint of the asset. In many ways, this could be even more effective in achieving green objectives, given as a much larger share of collateral is made up of corporate bonds, while asset purchases have been largely focused on sovereign issuers.

When discussing the role of central banks in relation to climate change, much of the focus has been on their mandate to ensure financial stability. Climate risks present fundamental financial risks. Carney (2015) was one of the first prominent central bankers to address this. Financial risks arise from physical risk (natural events), liability risk (compensation claims for climate-related damage) and transition risk (from economic adjustment resulting from decarbonisation). Financial disclosures relating to climate-induced risks have been developed by the Financial Stability Board's Task Force on Climate-related Financial Disclosures (TCFD, 2017). Meanwhile, climate-related financial risks have been integrated into central bank analysis for some years now, though forecasting models remain poor and must develop to account for the probability of Green Swan events³ (Bolton *et al.*, 2020). Fundamentally, an adequate assessment of climate risk represents an appropriate response to central banks' financial stability mandate. Greening monetary policy takes this one step further, as it involves explicit support for a low-carbon economy, in line with ECB secondary objectives, as well as a diversification away from carbon-intensive assets.

The next section explores the two avenues for greening monetary policy, the implications for greener assets and how this would be integrated into the current legal framework.

5.4.1 HOW CAN THE ECB GREEN ITS MONETARY POLICY?

Before going into the mechanisms through which the ECB could pursue a greener monetary policy, it is worth considering whether it is allowed to. The ECB's primary

³ Green swan risks are potentially extremely financially climate disruptive events that could be behind the next systemic financial crisis, as per Bolton *et al.*, 2020

mandate is and has always been “*price stability*”, as per Article 127 of the Treaty on the Functioning of the European Union (TFEU). The article later states that “*without prejudice*” to this objective, the ECB can further support the general policies of the union as enshrined in Article 3 of the Treaty on European Union (TEU). This contains a broad set of goals that include “*sustainable development*”. Based on this, some scholars have called on the ECB to support the development of a low-carbon economy.

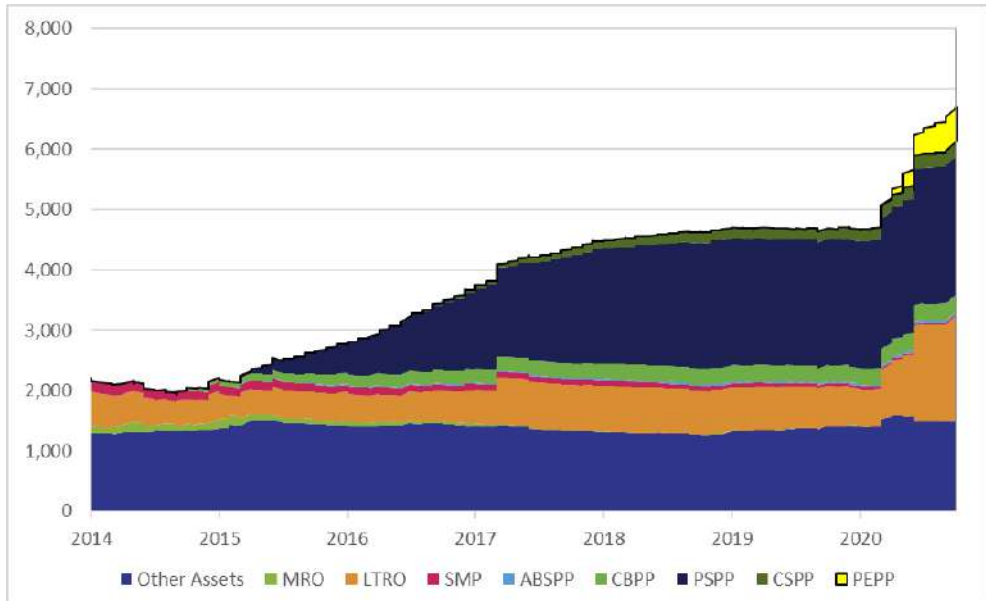
Second, ECB policy has long been governed by the notion of market neutrality, derived also from Article 127, which states that the ECB should be guided by the principle of “*an open market economy with free competition, favouring an efficient allocation of resources*”. In practice, this involves purchasing a proportional share of the available bond portfolio, be it corporate or sovereign bonds, in order to not lead to excessive distortion.

This principle remains relevant, and indeed any transition to a greener balance sheet should be very gradual. However, it should be noted that allocation is often non-neutral when it comes to carbon emissions, as the market exhibits a degree of bias towards companies that are carbon intensive. This is largely explained by the fact that carbon-intensive companies are often capital intensive too, and as such are over-represented in benchmark credit indices (Doda, 2016). In fact, in their analysis of ECB quantitative easing, Matikainen *et al* (2017) found a substantial skew towards high-carbon sectors, with 62% of corporate bond purchases being concentrated in manufacturing, electricity and gas production, which generate 59% of euro-area greenhouse-gas (GHG) emissions but only 18% of gross value added. Utilities, another high-emission sector, were also over-represented. Additionally, the exceptional COVID-19 pandemic and ensuing economic downturn have resulted in more flexibility from the ECB’s capital key for sovereign debt purchases under the PEPP. A similar degree of flexibility could be applied at the corporate level.

With this in mind, there is at least some scope for green monetary policy, though it should be executed in a way that does not compromise price stability or cause evident distortions. The ECB can support low-carbon securities by modifying the eligibility criteria for its various purchase programmes and for collateral (i.e. the required haircut). Adapting both in order to benefit low-carbon assets by integrating indicators of carbon emissions would provide substantial liquidity to these securities and reduce their cost of capital.

The ECB has engaged in a series of different purchase programmes that make up the bulk of the expansion of its balance sheet in the past decade. Figure 9 shows the ECB balance sheet since the introduction of these programmes. Public sector securities form the bulk of the securities purchased, but the ECB still holds close to €300 billion in securities under the covered-bond purchase programme (CBPP) and around €240 billion under the corporate-sector purchase programme (CSPP). Holdings under the latter are also growing noticeably.

Figure 9: ECB Balance sheet



Source: Bruegel based on Bloomberg.

A similar framework could be applied to ECB collateral eligibility, the current framework being outlined by Bindseil *et al* (2017). When banks borrow from the ECB, they must pledge collateral against counterparty risk. A haircut is applied to collateral based on the credit quality of the securities provided. Liquidity provision under the reduced TLRTO in the midst of the pandemic has substantially increased this practice (seen in Figure 9). By adapting its collateral framework, the ECB could ensure the requirements include additional criteria on carbon emissions, such that a less-substantial haircut is applied to covered or corporate bonds or asset-backed securities that perform better in terms of emissions indicators. As Schoenmaker (2019) pointed out, with synthetic products such as asset-backed securities, emissions indicators on the underlying beneficiary should be used, and corporate emissions data is available at ASSET4 ESG Scores in Datastream (Thomson Reuters) and the Carbon Disclosure Project (CDP), among others. For assets for which this is not the case, the bank supplying the collateral would provide an assessment.

Unlike central bank purchases, private sector securities form a large share of the assets supplied as collateral to the ECB. Concretely, in September 2020, €1.24 trillion in collateral held by the ECB (after valuation and haircuts) was made up of unsecured and covered bank bonds, corporate bonds and asset-backed securities, compared to only €490 billion in public sector securities (the remainder is made up of non-marketable

securities)⁴. In this case, a change in the eligibility criteria could thus be applicable to a larger share of securities.

5.4.2 MONETARY POLICY AS AN EFFECTIVE TOOL OF THE GREEN TRANSITION?

Once the mechanism is clear, the question focuses on the effectiveness of the proposed approach. After all, greening monetary policy is not without its detractors and requires a certain paradigm shift in the ECB's conduct of monetary policy to date (notwithstanding that ECB policy has already evolved substantially in the last decade). From a legal standpoint, it requires careful execution to remain in line with the EU treaties (or ECB principles). Assessing this remains complicated, as no major central bank has adopted the measures discussed above.

Schoenmaker (2019) constructed what he referred to as a central bank portfolio tilted towards low-carbon assets, dividing bonds into three categories based on their carbon emissions. In the portfolio, the share of holdings from the category containing low-carbon bonds was doubled (from 33% to 67% of bond holdings). Holdings of medium-carbon intensity bonds were reduced from 33% to 22% of the portfolio, and those of high-carbon intensity bonds were reduced from 33% to 11% of the portfolio. He estimated that this change (which would require a substantial transition period to avoid distortions) would already reduce the carbon footprint of the central bank portfolio by 55%. This very large decrease can be explained by the fact that very high carbon intensity sectors currently make up a disproportionate share of the overall footprint. Schoenmaker then went on to provide numerical examples of how fairly small increases in the haircut would reduce the collateral attractiveness of different types of high-carbon content bonds.

How would this affect the performance of these securities in the market? While in an efficient and liquid market the benefits of QE should pass through to all asset classes, as investors sell highly-demanded securities and purchase cheaper ones, in practice there is ample evidence that the price of eligible assets sees a disproportionate increase (Matikainen *et al*, 2017). This stems from market frictions and imperfect substitutability between securities (Haldane *et al*, 2016). Thus, central bank purchases benefit the specific asset purchased and those with similar profiles.

Similarly, securities eligible for collateral (with a lower haircut) should become more attractive and liquid as banks and other financial institutions benefit from their possible use with the ECB (Nyborg, 2017). This will mean a higher price and lower yield for these securities (Nagel, 2016).

These effects should combine to increase the liquidity and reduce the cost of capital for low-carbon intensive assets. Securities that are high-carbon intensive should see the opposite effect. This could lead to general cross-sectional rebalancing of portfolios.

⁴ <https://www.ecb.europa.eu/paym/coll/charts/html/index.en.html>.

Finally, there is the question of whether artificially favourable market conditions for green assets will accelerate the overall transition towards a low-carbon economy. A more detailed discussion is provided in Schoenmaker (2019) but, overall, the literature appears to be more ambivalent. For example, Heinkel *et al* (2001) examined how the loss of investment from exclusionary ethical investors could offset the cost of reforming their operations to become more climate neutral. They found that 20% of green investors would be required to induce some polluting firms to reform. More sobering, Lilliestam *et al* (2020) studied whether the punitive effects of carbon taxes have affected technology switching and, more importantly, if they have spurred technological development of low-carbon alternatives. They found no empirical evidence to support this. In the opposite vein, Braun (2018) found ECB actions result in a strong signalling effect to European financial markets (in a paper that looks at repo and securitisation markets). In this case, the implication is that this could result in a shift towards green investments throughout the financial system. Finally, Schoenmaker and Schramade (2019) found evidence of investors engaging with the companies in their portfolios to encourage a greening of their operations.

5.4.3 IMPLICATIONS FOR POLICYMAKING

Can the ECB actively pursue the greening of monetary policy and stay faithful to the EU treaties? The ECB's primary objective is enshrined in the treaty but there is no ranking provided for its secondary objectives (in Art. 3 TEU). We argue that there needs to be a clearer political mandate for the ECB in terms of supporting the transition towards a low-carbon economy using monetary policy tools. While the ECB is independent, it is not a political body and must have guidance on how to prioritise when its secondary objectives might be contradictory. After all, there are inherent trade-offs that are not technocratic but political in nature and must be resolved by an entity that has been democratically elected to represent citizens. Claeys and Domínguez-Jiménez (2020) argued that the European Parliament (representing European citizens) and the Council of the EU (representing the member states), both as the EU's co-legislators, should assume this role. This does not necessarily require a legally binding ranking. A clear establishment of priorities should provide the ECB with the political mandate to implement these preferences. The European Parliament, for example, could include this in its resolution on the ECB's annual report.

Naturally, other than a clearer political mandate from the European Parliament, green monetary policy must also be executed without prejudice to price stability and must avoid evident market distortions (to ensure market neutrality), as per the treaties. There should be an explicit ECB assessment, in line with its independent standing, on how green monetary policy could be executed while remaining faithful to these principle (i.e. how and to what extent can there be a shift in the ECB's asset holdings). Regarding collateral, internal assessment should also ensure financial stability is not impaired by the modified haircuts.

Once the political mandate is obtained and the internal assessment has been concluded, one could envisage ways of implementing it – for example via Schoenmaker’s tilt in both direct and collateral central bank holdings. This would stem from an adaptation of the purchase programme eligibility criteria, facilitating the partial overweighting of low-carbon private sector assets. It would also come from a change in the collateral framework to include carbon-emission criteria, ensuring low-carbon bonds receive a smaller haircut and so become more attractive to financial players. How extreme the tilt will be is up to the ECB and would rely on the abovementioned internal assessment. However, the objective should be to have the greatest possible effect on the markets for greener securities without compromising the ECB’s principles (and EU treaties).

With these principles in mind, we have explicitly not focused on green bonds during our analysis. The market for green bonds remains comparative small, at around 750 billion USD cumulative issuance at the end of 2019 (in a multitude of currencies), and highly restricted. Numerous issues arising from explicit targeting of asset prices by central banks have long been identified (see, for example, Mishkin, 2001), and ECB focus on such a small market could cause immediate distortion. Instead, a very gradual tilt towards less-carbon intensive assets (but by no means only green bonds) is encouraged, both to prevent distortion and to allow for the development of better indicators of the carbon intensity of securities and wider academic analysis of green monetary policy itself.

Additionally, while our analysis has focused on private sector securities, similar mechanisms could be applied to public sector securities. However, we believe this should be considered at a later stage. The current discussion around how to apply the green criteria to sovereign bonds is at time of writing ongoing. For example, many proposals have arisen on the question of a new sovereign framework for green bonds, determined not by the use of the specific funds for climate-neutral projects but broader national climate outcomes (Zachmann, 2020). At the same time, current legislation largely deals with corporate and financial sector disclosures, as do frameworks that facilitate the assessment of ESG factors by investors (such as the Task Force on Climate-related Financial Disclosures and the Sustainability Accounting Standards Board, PRI, 2019). Additionally, the support offered to sovereign debt markets by the ECB through the PEPP in the midst of these very extraordinary economic circumstances could be hampered by the introduction of a tilt in purchases towards low-emission economies. At best it would become very politically sensitive. Finally, much of the objective of green monetary policy is to raise the attractiveness of low-carbon projects given the favourable funding terms and encourage corporates to adopt cleaner technologies or banks to purchase securities with smaller footprints. At the sovereign level, energy and climate related decision-making and competences are typically entirely detached from the debt management office and other organs involved in issuance. The extent to which ECB monetary policy would influence environmental policy is thus less clear.

5.5. CONCLUSION

The ECB has restarted its strategy review. In our view, two clear challenges lie ahead and require nothing less than a paradigm shift in the way monetary policy is conducted. First, we live in a world of fundamental uncertainty, with COVID-19 compounding the effects of a shifting equilibrium. Second, the climate crisis is expected to have a substantial effect on human life and combating it requires every institution to play its role. The ECB must rise to the challenge, and adapt its monetary policy to the increasingly complicated circumstances.

Dealing with uncertainty will require a shift in both communication and the adoption of policy. Monetary policy options should be chosen based on their effectiveness in achieving acceptable outcomes in a wide range of contingent scenarios, not optimal outcomes if baseline predictions are realised. This should be communicated clearly, with forecasts presented contingent on assumptions and not surrounded by confidence intervals constructed from historical frequencies. The establishment of a set 2% target and adjacent tolerance bands would also be beneficial.

Meanwhile, given the enormity of the climate challenge ahead, everyone needs to play their part in the fight, and that includes central banks. While greening monetary policy is a largely untested idea, two clear mechanisms have emerged through which central banks can contribute to the transformation: eligibility requirements should be adapted for both asset purchases and collateral in order to favour a partial skew towards greener assets. This should be done gradually, in line with the treaties and following an updated political mandate for the ECB from the EU's co-legislators.

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6. THE INDEPENDENCE OF CENTRAL BANKS AND FISCAL DOMINANCE

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6.1. SUMMARY

Central Banks have become increasingly constrained in their ability to stimulate the economy. Facing an effective lower bound on nominal rates, they have been left with little conventional monetary policy space. Asset purchases were the natural step, particularly when it comes to government bonds. But buying government debt, today, is part of the ‘no-longer-unconventional’ policy tools at the lower bound. That alone is not monetisation. But whether it becomes so will depend on what happens in the future.

Will the ECB keep rates low for longer than needed because of high levels of public debt? Will it keep refinancing the large stock of debt it holds? We believe the institutional set-up in the region would stop that happening for now.

But pressure on the ECB to do more is likely to continue for some time, given the specificities of the region. Even before the Covid shock, there was the need for both monetary and fiscal policy working together but that was not necessarily the case. This need has been amplified by a disastrous 2020.

The Euro area is finally embracing the kind of cooperation required given the current circumstances. But that by itself is increasing the criticism of fiscal dominance and, at the same time, is also leading to calls for more exotic forms of stimulus that would threaten the independence of the central bank. The problem is that stronger forms of cooperation are likely to be needed if we really want to stop the threat of fiscal dominance in the future.

Either cooperation between fiscal and monetary policy is enhanced with a credibly irresponsible ECB and more ambitious fiscal response, or we risk fiscal dominance, and the independence of the ECB is likely to be challenged much more seriously in the future.

Without that response it will be just a matter of time before we hear louder voices on debt cancellation or pure monetisation of fiscal deficits. This is not for immediate consumption. But the joint policy response over the next two years will determine whether we move towards that scenario eventually.

6.2. THE INDEPENDENCE OF CENTRAL BANKS AND FISCAL DOMINANCE

Let's start with a simplistic and somewhat extreme description of the right policy response to the hibernation of economies in the spring. There was a massive loss of private sector income. The public sector has to help the private sector digest that shock and, at the same time, Central Banks need to help the public sector smooth that over time. Imagine the public sector transfers to the private sector the entire value of the income loss and the Central Bank buys the debt the public sector needs to issue to transfer those resources. Is this monetary financing? Are we under fiscal dominance? Is this a threat to Central Bank independence? We would argue that is not necessarily the case.

With a natural rate that has been falling consistently over many years as a consequence of progressive trends in structural factors, Central Banks have been increasingly constrained in their ability to stimulate the economy. Facing an effective lower bound on nominal rates, they have been left with little conventional monetary policy space. Asset purchases are the natural step, particularly when it comes to government bonds.

Indeed, buying government debt today is part of the 'no-longer-unconventional' policy tools at the lower bound. That alone is not monetisation. But whether it becomes so will depend on what happens in the future. Will the ECB keep rates low for longer than needed because of high levels of public debt? Will it keep refinancing the large stock of debt it holds? Will that debt eventually be cancelled? We believe the institutional set-up in the region would stop that from happening in the medium term.

But nothing can be taken as given. Even before the Covid shock there was the need for both monetary and fiscal policy working together but that was not necessarily the case. This need has been increased by a disastrous 2020. The Euro area is finally embracing the kind of cooperation required given current circumstances. This is certainly good news but that by itself is increasing the criticism of fiscal dominance. And the real problem is that stronger forms of cooperation are likely needed.

The ECB needs a clear commitment to be "credibly irresponsible". We also need a much more forceful fiscal response, even beyond what we have in the pipeline at the European level (Next Generation EU). The former will need to wait for the strategy review and it remains to be seen how strong and credible that commitment will be. The latter remains much more uncertain and is our main worry.

But, either cooperation between fiscal and monetary policy is enhanced today, and we have a "credibly irresponsible" ECB and the fiscal response becomes more ambitious, or we risk fiscal dominance and the independence of the ECB is likely to be challenged more seriously in the future.

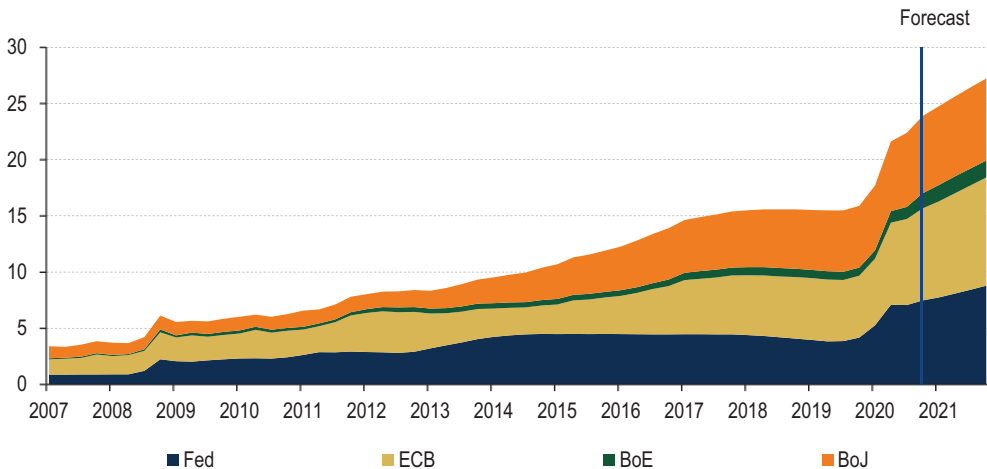
6.3. FROM CONVENTIONAL TO UNCONVENTIONAL

The world has gone through two historically large shocks in the past 12 years. In Europe, after the global financial crisis, we experienced a sovereign crisis and now a global pandemic. We have seen large, persistent deficits as a consequence, with a

corresponding increase in public debt. At the same time, Central Banks across the developed world have responded to those shocks on an unprecedented scale. With limited conventional policy space, they have embraced unconventional monetary policy. They have provided large-scale liquidity operations. Some have crossed the negative rates Rubicon, and all of the developed markets Central Banks have made large-scale asset purchases. Some of these tools had been used before, but never simultaneously or on the same scale as in the past decade.

Chart 1 shows the cumulative balance sheet of the four largest central banks. As of today they hold assets worth more than \$25trn. The majority of those assets are public debt. That number was below \$5trn at the beginning of the decade. Chart 2 shows the increase in public debt for those same countries. This intervention on an unprecedented scale together with the large increases in public debt have raised questions about the role of Central Banks and the risk (or even reality, for some) of fiscal dominance.

Chart 1: G4 Central Banks Balance Sheet



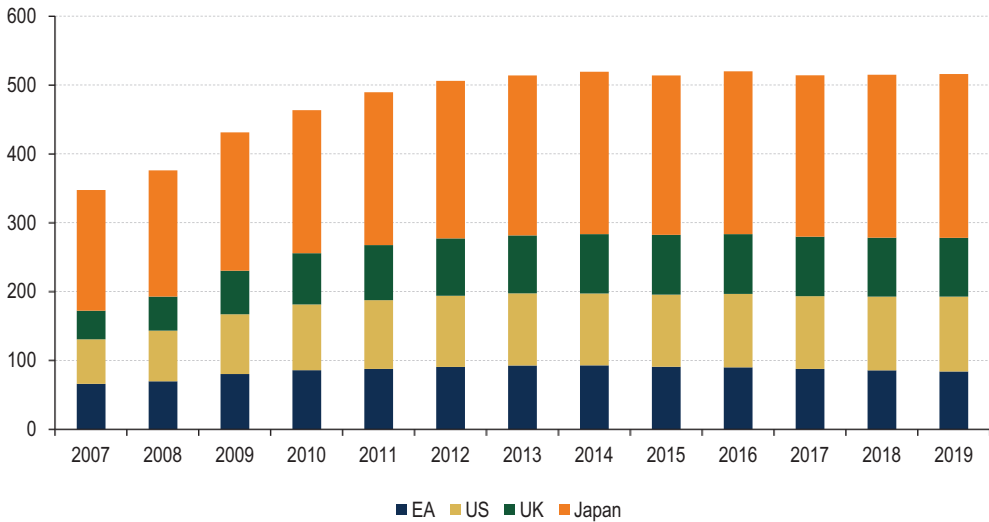
Source: BofA Global Research estimates, Bloomberg

Additionally, that balance sheet size is unlikely to be unwound any time soon and, if anything, it could grow even larger, at least for the next couple of years. Monetary policy will remain accommodative for a long time. The Fed has adopted average inflation target after years of inflation misses. Other Central banks, facing the same or an even bigger problem when it comes to long-term inflation, are discussing broader make-up strategies. Normalisation of monetary policy will not happen in the foreseeable future. But the obvious first question is: how did we end up here?

6.4. HOW DID WE END UP HERE?

Chart 3 gives us a large part of the answer. It shows the real natural interest rate, the rate that would be observed in a hypothetical equilibrium scenario. The nominal rate must closely track the evolution of the natural rate (adjusted for the inflation target) for inflation to be at target at all times. Real rates below the natural one lead to inflationary pressures. The opposite occurs when real rates are above the natural rate.

Chart 2: public debt (%of GDP)



Source: BofA Global Research, IMF

As it is clear in the chart the natural rate has been falling consistently over many years. This is the consequence of progressive trends in structural factors such as demographics, excess savings, inadequate fiscal support, and weak productivity growth, among others (Banco de España, 2019).¹ This has clearly constrained the ability of Central Banks to stimulate the economy. Facing an effective lower bound on nominal rates, they have been left with little conventional monetary policy space since there are limits on how negative (if at all) policy rates can go (the effective lower bound).

And this is likely to get even worse, given that some of those structural factors will further weigh on the natural rate, moving it even lower and restricting policy space even further. In fact, with an unchanged policy stance, monetary conditions would tighten

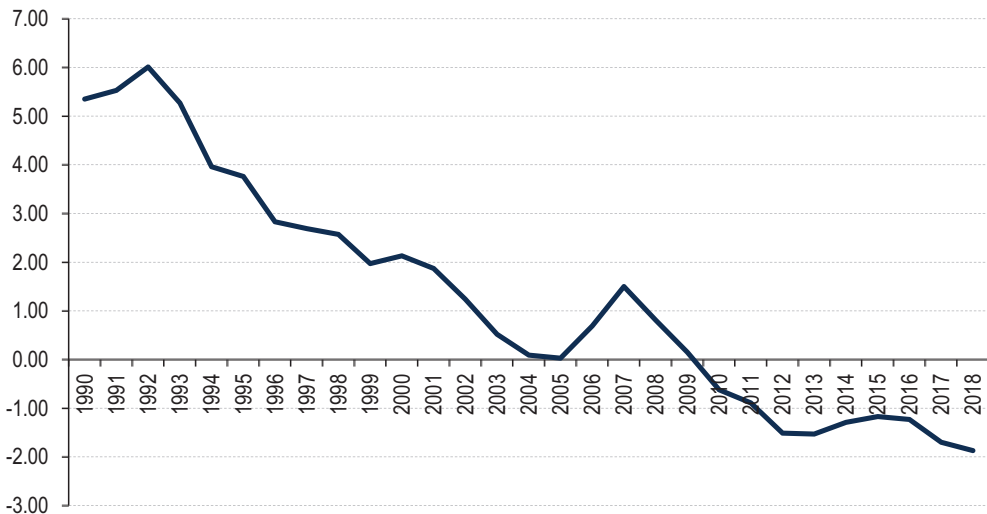
¹ Banco de España (2019). “Monetary policy design in the medium and long term”, Chapter 3, Annual Report 2018.

over time with the decline in the natural rate. Additionally, recent work has shown that the impact of the pandemic on the natural rate is likely to go in the same direction.²

This lack of traditional monetary policy space has pushed Central Banks towards unconventional tools, including asset purchases. As the former ECB executive board member Benoit Coeure stated, “At the extreme, one could argue that the true lower bound for monetary policy is reached only when the entire yield curve is flat at the effective lower bound”.³

This is how non-standard measures, in particular, asset purchases, need to be understood. And this is how non-standard measures have become, and will be, part of the conventional tool box for Central Banks going forward.

Chart 3: Natural interest rate for the Euro area



Source: Banco de España

6.5. A VERY SPECIAL SHOCK UNDER VERY SPECIAL CIRCUMSTANCES

The aforementioned need for unconventional monetary policy is further amplified by several other factors in the Euro area.

First, inflation has been well below target for many years and inflation expectations are far from perfectly anchored (Chart 4). The ECB will reflect on the kind of makeup

² Jorda, Oscar, Sanjay R. Singh, and Alan M. Taylor. 2020. “Longer-Run Economic Consequences of Pandemics,” Federal Reserve Bank of San Francisco Working Paper 2020-09.

³ Coeure, Benoit (2015). “How binding is the zero lower bound?”, speech at the conference organised by Imperial College Business School / Brevan Howard Centre for Financial Analysis, CEPR and the Swiss National Bank, London

strategies the Fed has adopted and, in any case, we face low rates for quite some time. We've moved from “low for longer” to “very low for very long.”

Second, at the lower bound fiscal policy is a much more effective tool when smoothing shocks, there are limits to what monetary policy can achieve. Increasing debt levels and unconventional monetary policy tools go hand in hand. And as ECB executive board member Isabel Schnabel recently said, there are, in this context, strong complementarities that reinforce each policy at the lower bound.⁴

Chart 4: Market based inflation expectations (5y5y)



Source: BofA Global Research, Bloomberg

Indeed, the expectation of low rates for longer should make fiscal policy more effective. Fiscal multipliers are likely to be larger than usual if fiscal policy is well targeted and rates stay low for very long. On the other hand, strong fiscal policy support today enhances the transmission of monetary policy. And, very importantly, to the extent that targeted fiscal policy can reverse that trend lower in the natural rate, at least partially; it can help also with the monetary space and stance of the future.

This is an important point and one could easily argue that those complementarities were not maximised, at least in the early years of the past decade and, in turn, the

⁴ Schnabel, Isabel (2020). “The shadow of fiscal dominance: Misconceptions, perceptions and perspectives”, speech at the conference organised by CER and EUROFI, Berlin.

suboptimal policy mix is part of the reason why the challenges we have so far discussed are particularly relevant in the region.

Indeed, one could also argue that the inappropriate fiscal stance (despite large deficits) in the Euro area over the past decade has contributed to the decline in the natural rate and, with that, has made monetary policy less effective. It can also be argued that the ECB, in an attempt to demonstrate independence and a lack of fiscal dominance, probably moved into unconventional monetary policies later than was desirable (see Reis, 2019, for a discussion on the ECB efforts to avoid fiscal dominance).⁵ As a consequence, we have had persistently lower nominal demand and inflation expectations deanchoring lower.

Fortunately these dynamics slowly faded away and, more recently, we have seen a more abrupt change. After the Pandemic hit the region we have finally both monetary and fiscal policy working in tandem. The Euro area is finally embracing the kind of cooperation required given current circumstances and that was already needed before this last shock. But that, by itself, is increasing the criticism of fiscal dominance.

Why is the need for coordination between fiscal and monetary even more necessary after the kind of shock that we have just been through? We have the public sector helping the private sector digest the shock and, at the same time, Central Banks need to help the public sector smooth that over time. That comes with large debt issuance to transfer resources to the private sector and, at the same time, large purchases of public debt by the Central Bank.

Without fiscal support to fill the gap on lost private income, monetary policy could deliver so much. And without a very patient Central Bank helping the private sector smooth the shock, the problem would only be transferred from the private to the public sector.

That, by itself, does not constitute fiscal dominance, nor does it represent the monetisation of budget deficits. Think of the simple example we started with in which the ECB would have promised to help digest all the funding needs generated by the Covid shock and refinance that debt for the next 20 years. Debt would still need to be paid eventually and repayment would be far enough off so as not to necessarily interfere with monetary policy on the way there.

Of course reality is not as clear cut and institutional and political restrictions have made the policy response more imperfect than what I have described. But the same line of reasoning applies. As Blanchard and Pisani-Ferry have argued, the worry cannot be about the ECB buying government bonds but about buying them for reasons other than price or macroeconomic stability objectives.⁶

Maintaining a smooth transmission of monetary policy is a valid reason, as it is the fact that disinflationary forces, in the context of a pre-Covid inflation path that was already

⁵ Reis, Ricardo (2019). “*The Second Decade of the Euro: Old Challenges in New Clothes*”, ECB Sintra Forum, Sintra.

⁶ Blanchard, Olivier, and Jean Pisani-Ferry (2020). “*Monetisation: Do not panic*”, VoxEU

extremely weak, justify more stimulus after the Covid shock. These are the two justifications the ECB is using for PEPP.

And indeed, if fiscal dominance was now a concern, inflation expectations would have risen significantly, while the opposite, at best, has been true (Chart 4).

6.6. WHAT MATTERS IS TOMORROW (1)

As argued above, buying government debt is part of the ‘no-longer-unconventional’ policy tools at the lower bound. That alone is not monetisation. But whether it becomes so will depend on what happens in the future. Will the ECB keep rates low for longer than needed because of high levels of public debt and not necessarily driven by price and macroeconomic stability? Will the ECB keep refinancing the large stock of debt it holds and will debt never get repaid?

We believe the institutional set-up in the region would stop that from happening in the medium term. True, rates are likely to stay low for longer than in other cycles. But if this happens, it would likely be driven by the Central Bank adopting the kind of make-up strategies the region needs to embrace to reanchor inflation expectations firmly at 2%.

And if we are lucky, and fiscal stimulus becomes more aggressive than currently and is already in the pipeline (next generation EU), inflation will rebound and the Central Bank will react more slowly than traditionally. Again, this would be driven by the Central Bank trying to achieve its target of price stability and not the need to monetise or reduce the real value of debt.

And yes, the ECB is likely to keep refinancing the stock of public debt for many years. But, going back to our initial example, even if the ECB were to do so during the next 20 years, as long as the debt was repaid eventually and this did not affect the normalisation of rates, we would not see fiscal dominance.

6.7. WHAT MATTERS IS TOMORROW (2)

So far we have discussed the policy reaction and tried to argue that fiscal dominance is not at play and so far the independence of the Central Bank is not at risk. But risks can certainly increase. Even today we are seeing calls for the ECB to “cancel” the debt it has bought from governments. We have also seen recurring discussions on the need for Central Banks to adopt modern monetary theory.

In a way, we face a very simple trade-off: unless cooperation between fiscal and monetary policy is enhanced today, we risk those calls becoming stronger over time. And we could even argue that those calls will increase even with that enhanced cooperation. But certainly the chances of bold moves are smaller if fiscal and monetary policy work better in tandem over the next few years.

Indeed, I have argued before that cooperation between the two forms of policy has certainly improved. But we need more. We need a much more forceful fiscal response. And the ECB needs a clear commitment to be “credibly irresponsible” and adopt a clear make-up strategy for the many years of missed inflation targets. The latter will need to wait for the strategy review and it remains to be seen how strong and credible that commitment will be. The former remains much more uncertain and is our main worry.

Yes, in our view, fiscal policy remains too timid in Europe. True, governments around the region have responded with large-scale liquidity and guarantee programmes. They have also implemented “hard cash” discretionary measures, the most important being short-time working schemes.

But when compared with other regions, the response is clearly much smaller (Table 1) when it comes to discretionary measures, i.e. “hard cash”. And even taking into account the NGEU, the total fiscal response in the region in the next few years would not be far from that of the US in just 2020. Yes, NGEU is sizeable, but not compared to the shock. And according to European Commission estimates, it will only be disbursed slowly (Chart 5). And that assumes countries make full use not only of grants, but also loans.

Table 1: Announced measures since the Covid shock hit

% of GDP	Additional spending and forgone revenue	Equity, loans, and guarantees
Finland	2.6	7.0
Spain	3.5	14.2
Belgium	4.0	12.1
Netherlands	4.6	4.3
Italy	4.9	33.0
France	5.2	15.7
Germany	8.3	30.8
United States	11.8	2.5

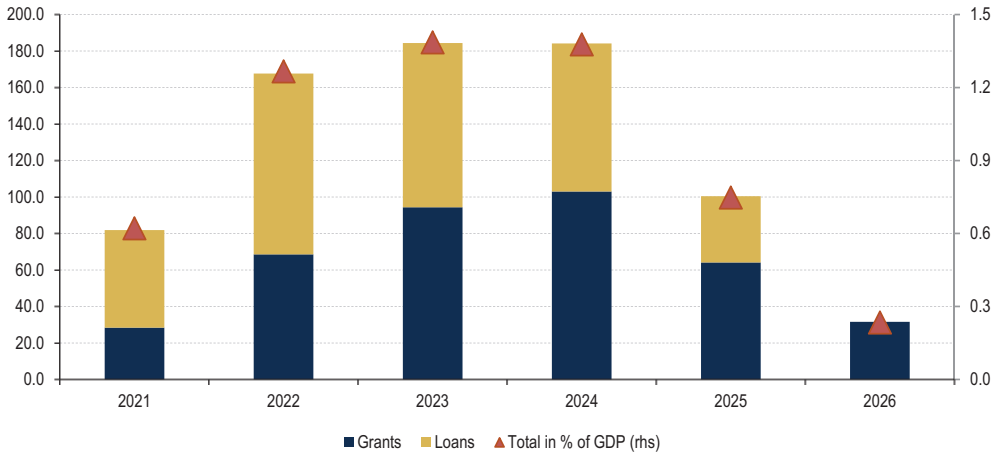
Source: IMF Fiscal Monitor, October 2020. Announced measures as of 11 September 2020

All that in a scenario where permanent losses created by the Covid shock are likely to be north of 6% by the end of 2021 (Chart 6). More is needed, and the needs go beyond compensating for the impact of the second Covid wave we are facing these days. Most importantly, more “hard cash” is needed. This is particularly the case given that during the first wave more debt was already forced into companies. This is unlikely to be successful the second time around given a bleak outlook and larger corporate debt levels.

Why the “timid” fiscal response so far in most of the region? Budget deficits are large already, and will remain so for some time. Governments need to worry not only about who will meet those funding needs this year and next, but also about who will refinance them in the future. The first part is addressed, partly, by the Pandemic Emergency Purchase Programme (PEPP) from the ECB. But despite the efforts at the European level

putting together the NGEU and the ESM Pandemic credit line, the second question remains unaddressed; hence, governments, particularly, but not only, in the periphery, have been shy with the fiscal response.

Chart 5: Tentative timeline of NGEU disbursements with peak effect in 2023/24



Source: BofA Global Research, European Commission

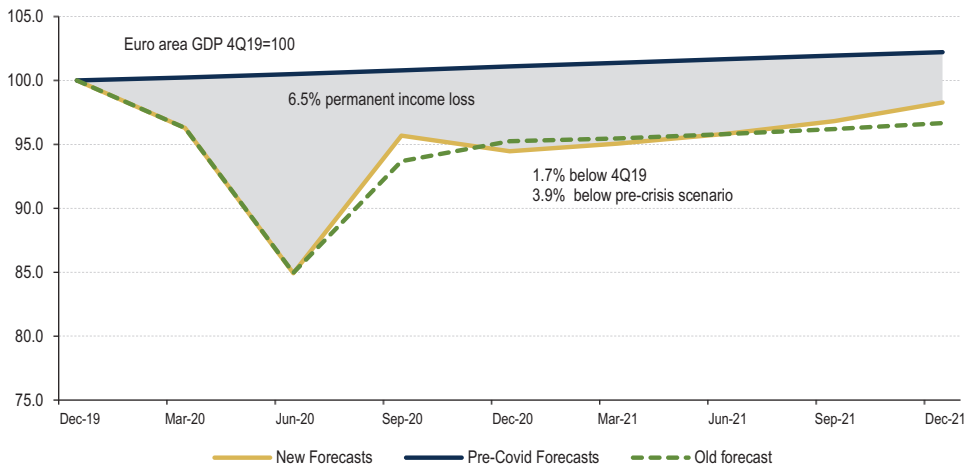
Let’s go back again to the initial example. If governments could be certain the ECB would refinance the fiscal response for quite some time that fiscal response would likely have been more aggressive today. This is again a simplistic example of enhanced fiscal and monetary policy cooperation that does not necessarily constitute fiscal dominance or threaten the independence of the Central Bank.

The reality is more nuanced. But the ECB has been actively asking for that enhanced cooperation even if it is not promising to refinance debt for 30 years. For instance, the ECB’s President Christina Lagarde argued recently that⁷

“The implication is that, in the current environment, both policies must remain expansionary for as long as necessary to achieve their respective goals. And, in disinflationary conditions when the economy is running short of its potential, the goals of each policy are naturally aligned.”

⁷ Lagarde, Christine (2020). “The monetary policy strategy review: some preliminary considerations”, speech at the “ECB and Its Watchers XXI” conference, Frankfurt.

Chart 6: Euro area GDP forecasts: very old, old, new



Source: BofA Global Research

And she did so again, even more explicitly at the ECB Forum on Central Banking:⁸

“First, while fiscal policy is active in supporting the economy, monetary policy has to minimise any “crowding-out” effects that might create negative spillovers for households and firms. Otherwise, increasing fiscal interventions could put upward pressure on market interest rates and crowd out private investors, with a detrimental effect on private demand.”

The main risk today is that the fiscal response remains insufficient and the ECB promise is not credible enough. We will need to wait for the latter. But absent a more forceful fiscal response, we risk larger permanent losses, subdued growth and inflation stuck well below 2%. All this even before we start thinking about the return of fiscal rules at the European level. Eventually, instability could build again, with toxic narratives coming back within, as well as between, countries (remember February?).

This is a scenario in which pressure for the ECB to do more will grow, while we will see increasing calls for MMT, debt cancellation, monetisation of fiscal deficits or helicopter money.

6.8. CAN WE GO RADICAL AND STILL KEEP INDEPENDENCE?

Summing up, the current outlook, together with significant structural challenges, call for enhanced cooperation between fiscal and monetary policy. Unconventional tools are the “new conventional”; they are here to stay. Large budget deficits too. Without that

⁸ Lagarde, Christine (2020). “Monetary policy in a pandemic emergency”, keynote speech at the ECB Forum on Central Banking, Frankfurt am Main.

enhanced cooperation pressure for the ECB to do more, even questioning its independence will grow.

We would argue that the pressure for more unorthodox policy is likely to build even without the toxic dynamics described above. In the end, Covid just adds to a very challenging situation that Europe was facing before the shock hit. And this goes beyond Europe.

Kapoor and Buiter (2020) have called for monetary financing to deal with the Covid shock.⁹ They argued in March that a one-off transfer worth 20-30% of GDP from Central Banks to governments could be the best macro policy to fight the crisis. Along the same lines, Jordi Gali (2020) and Eran Yashiv (2020) have argued in favour of helicopter money to deal with the Covid shock.^{10,11} Even well before Covid the discussion was alive, for instance, Woodford argued for a bond-financed fiscal transfer while Turner also defended the idea of helicopter money.^{12,13}

Certainly, conditions are challenging enough that these options are worth exploring. One can even argue that they could be implemented, while still trying to maintain central bank credibility and independence. Indeed, all of the proposals above discuss how to try to do so.

If we end up moving towards helicopter money or bond-financed fiscal transfers, it is important that the central bank:

1. clarifies that this is a one-off and temporary;
2. has credibility when saying this is a one off;
3. retains most of the control over how much to do and when to stop.

There are several ways to implement 1) to 3) that have been discussed in literature. One can open a small legal window for when this would be feasible. The monetised expenditures could clearly be pre-specified and purely devoted to a one-off shock (Covid). Would that be enough? We don't know, but given the challenging conditions we are facing, we would not be surprised if we end up running a natural experiment in the next few years.

⁹ Kapoor, Sony, and Willem Buiter (2020). "To fight the COVID pandemic, policymakers must move fast and break taboos", VoxEU.

¹⁰ Gali, Jordi (2020). "Helicopter money: The time is now", VoxEU.

¹¹ Yashiv, Eran (2020). "Breaking the taboo: The political economy of COVID-motivated helicopter drops", VoxEU

¹² Woodford, Michael (2012), "Methods of Policy Accommodation at the Interest-Rate Lower Bound", speech at Jackson Hole Symposium.

¹³ Turner, Adair (2013), "Debt, Money and Mephistopheles", speech at Cass Business School.

PART III
ISSUES IN FISCAL POLICY

7. THE EU BUDGET: THE NEW MFF AND THE RECOVERY INSTRUMENT: NEXT GENERATION EU

PILAR MÁRS RODRÍGUEZ¹

7.1. ABSTRACT

The COVID-19 pandemic has shaken the world and Europe to its core, testing health-care and welfare systems, society, economy, customs and living and working conditions. The scope of the crisis and the policy responses are unprecedented and the depth of the impact is still uncertain. The European Union (EU) and its Member States adopted emergency measures to preserve the health of citizens and prevent a collapse of the economy. This required a historic effort and an innovative approach, fostering convergence, resilience and transformation in the EU.

The Next Generation EU (NGEU) programme constitutes an important and well-timed step to support the recovery in Europe. The initiative entails a fiscal stimulus of 750 billion euros that could raise GDP by more than 4% in 2024 for some countries, according to EU estimates. NGEU will unlock the full potential of the European budget to kick-start the economy and boost Europe's sustainability, resilience and strategic autonomy. It builds on the Union's experience of harnessing market financing and expands it to achieve the scale of support that is urgently needed in the current circumstances.

A reinforced Multiannual Financial Framework (MFF) for 2021-2027, of 1074 billion euros, will guide the EU back from crisis to the path of long-term recovery, providing essential financing for immediate needs and for long-term investments in the green and digital transitions.

On 10 November 2020, the European Parliament and EU Member States in the Council reached an agreement on the next MFF and the NGEU, the largest package ever

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financed through the European budget. This is a great opportunity, not only to support the recovery but also to invest in the future of the European Union.

Keywords: Crisis; Digital; European Union; EU budget; Green; NGEU; Multiannual financial framework; Sustainability; Resilience.

7.2. INTRODUCTION

The COVID-19 pandemic has shaken the world and Europe to its core, testing health-care and welfare systems, society, economy, customs and living and working conditions. The scope of the crisis and the policy responses are unprecedented and the depth of the impact is still uncertain.

The European Union and its Member States adopted emergency measures to preserve the health of citizens and prevent a collapse of the economy. This required a historic effort and an innovative approach, fostering convergence, resilience and transformation in the EU.

At the request of the Heads of State or Government, the European Commission presented at the end of May a very wide-ranging package combining the future Multiannual Financial Framework 2021-2027 and a specific recovery effort under Next Generation EU. In July 2020, after long negotiations, the European Council agreed on this recovery plan for Europe and the MFF 2021-2027, leading the way out of the crisis and laying foundations for a modern and more sustainable Europe.

More than 50% of the long-term EU budget and Next Generation EU (750 billion euros), a total of 1.8 trillion euros, will support modern policies and set Europe on the path to a sustainable and resilient recovery. As the President of the European Commission said, “The agreement is a strong signal of trust and a historic moment for Europe.”

The EU recovery plan will require huge investment to repair the economic and social damage caused by the pandemic, kick-start European recovery and protect and create jobs. This challenge is a great opportunity, not only to support the recovery but also to invest in the future of the European Union.

NGEU will be channelled through European programmes to support the necessary measures to help Member States recover and emerge stronger from the crisis, boost private investment and foster sustainable and resilient growth.

Through the MFF 2021-2027, the European Commission will create instruments and strengthen key programmes using the NGEU to direct investment where it is most needed, reinforce the Single Market, intensify cooperation in areas such as health and crisis management and provide the EU with a long-term budget that will be the engine of the green and digital transitions and foster a more resilient economy.

On 10 November 2020, the European Parliament and Member States in the Council, with the support of the European Commission, reached an agreement on the next MFF and the Recovery Plan, the largest package (1.8 trillion euros) ever financed through the EU budget.

This document presents the main elements of the next Multiannual Financial Framework 2021-2027 and the Next Generation EU.

7.3. THE EU MULTIANNUAL FINANCIAL FRAMEWORK

7.3.1. BACKGROUND AND CONCEPTS

Since 1988, the European Union has had Multiannual Financial Frameworks in which the annual budget is embedded. This has provided great stability to the negotiation of the budget and put an end to the interinstitutional conflicts of previous stages.

The Lisbon Treaty provides that a Council Regulation will establish the Multiannual Financial Framework, conferring on it a normative status that it lacked previously, as it only responded to an Inter-institutional Agreement.

The Multiannual Financial Framework defines the budget cycle of the European Union for a period of seven years. It is up to the European Commission to present a proposal and the Council and the European Parliament to approve it in a co-decision process. The configuration of European policies and the margin of financial flexibility largely depend on the final agreement.

The objective of the MFF negotiations is to define, in general terms, the maximum limits of the amount of money that the EU can spend, the Spending Programmes that determine where the money should be spent (spending structure) and the Rules that establish how to finance the expenditures.

Spending limits

The MFF sets the maximum limits for EU spending, both globally and for each of the main policies or headings. Limits are set for “commitment credits” or theoretical fund allocations (by headings and years) and for “payment credits”, based on what is considered executable annually without distinguishing, in this case, by headings.

On the other hand, according to the Treaty on the Functioning of the European Union (TFEU), the MFF must guarantee that expenditures evolve within the limit of the EU’s Own Resources, including the percentage of own resources used to finance the payment credits on the EU’s Gross National Income (GNI).

The MFF is accompanied by a Decision on Own Resources and is complemented by the annual budget approved by the Council and by the Parliament. The spending ceilings of the Framework must be respected by the European Parliament, the Council and the European Commission, in the preparation, approval and execution of the framework. The budget must be balanced in terms of income and expenditures.

The size of the MFF has historically been limited, standing at around 1% of EU’s GNI. Their policies do not replace national ones, but rather enhance them with others that require a European dimension.

Expenditure structure and financing

The spending structure of the MFF and the size of each heading has been adapted to the priorities of the EU and to the circumstances of each moment.

Initially, the budget mainly financed agricultural spending, the Common Agricultural Policy (CAP) being one of the pillars of the 1957 Treaty of Rome, which brought about the creation of the European Economic Community (EEC). The share of the CAP in EU budget has been gradually reduced, from 75% in the 70s to a third currently. In parallel, other policies have emerged, such as the regional one, which represents another third of the budget. The rest of policies (R&D, foreign policy, infrastructure or education) have also increased their weight in the last two decades. Investment is focused on programmes managed at European level in areas such as research and innovation, transport and energy networks, youth mobility programmes and external action.

Almost the entire European budget is financed from the EU's Own Resources, which are classified into customs duties and levies (15% of the total), a resource based on Value Added Tax (VAT) (12%) and national contributions based on the weight of GNI of the country in the total (73%). The rest comes from other sources (fines, contributions from non-member states to certain programs, etc.).

7.3.2. NEW MULTIANNUAL FINANCIAL FRAMEWORK 2021-2027

A long and complex process of negotiations

The current 2014-2020 Multiannual Financial Framework expires on 31 December 2020 and since mid-2018 the new 2021-2027 framework is being negotiated. The environment in which the negotiations are taking place is particularly complex. On the one hand, there is a consensus on the need to respond to the main EU challenges (digital transition, climate, immigration and security, among others), to which are added the difficulty of the United Kingdom's exit from the EU and the need to face the challenge of European reconstruction after COVID-19, the biggest health and economic crisis in Union history.

The negotiations on the new Multiannual Financial Framework 2021-2027 have evolved from an initial proposal presented by the European Commission in May 2018, which amounted to 1,134,583 million euros (at 2018 prices), 1.11% of the EU-27 GNI. This introduced significant changes with respect to the current Framework:

- Changes in spending composition, increasing the weight of policies aimed at addressing new priorities of the Union (border control, defence, migration, security, development cooperation and research, etc) and reducing agricultural and cohesion policies. The structure was streamlined with seven new rubrics across 17 policy groups. The number of spending programmes was reduced, from 58 to 37.
- Special budgetary instruments were included to improve budget flexibility: the Flexibility Instrument (1,000 million euros per year), the Reserve for Emergency Aid (600 million euros), the EU Solidarity Fund (600 million euros), the European Globalization Adjustment Fund (200 million euros), the European Peace

Support Fund and the European Investment Stabilisation Function (loans of up to 30,000 million euros during the MFF period). The European Development Fund (EDF) is integrated into the MFF.

- The revenues side was modernised by introducing new categories of Own Resources based on the revenue of the EU emissions trading scheme, a contribution from Member States based on their plastic waste.

On 14 November 2018, the Parliament presented its detailed mandate, which included amendments to the Commission proposal relating to the MFF Regulation and a set of figures broken down by heading and programme. In particular, Parliament's report specified the following:

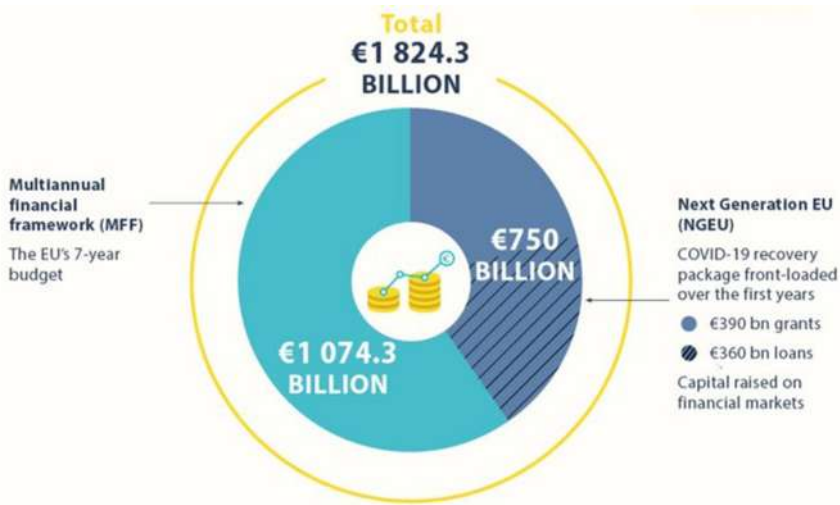
- The MFF ceiling for commitments should be increased, from 1% of EU-28 GNI to 1.3% of EU-27 GNI. This represented a maximum of 1,324,089 million euros (at 2018 prices), 16.7% higher than the one proposed by the European Commission.
- The allocations for the CAP and cohesion policy should remain unchanged in real terms. On the other hand, a number of priorities should be further strengthened, including programmes for the heading 'Single market, innovation and digital economy' (in particular, Horizon Europe), for 'Cohesion and values' (Erasmus+ and a new Child Guarantee) and for 'Natural resources and environment' (the Environment and Climate Action programme and a new Transition Fund).
- Funding for decentralised agencies involved in migration and border management should be higher, from around 3 billion euros to more than 12 billion. The contribution of the EU budget to the achievement of climate targets should be set at a minimum of 25% of MFF 2021-2027 spending, be integrated into all relevant policy areas and reach 30% as soon as possible. The mid-term review of the MFF should be mandatory and proposed no later than 1 July 2023.

In November 2019, the Finnish Presidency of the Council presented a proposal that included provisional figures for MFF 2021-2027 (1.087 trillion euros at 2018 prices in commitment credits). Nevertheless, this was severely criticized as Parliament considered it was well below expectations.

In May 2020, the European Parliament requested that the Commission present, before 15 June 2020, a proposal for an MFF contingency plan to provide a safety net and protect the beneficiaries of Union programmes.

Following the COVID-19 crisis and the huge economic consequences, at the end of May the European Commission presented a significant review of MFF 2021-2027. The proposal included a total amount of 1074.3 billion euros and an additional recovery instrument, the Next Generation EU programme, with 750 billion euros, 390 billion euros of grants and 360 million of loans (see Figure 1).

FIGURE 1. OVERALL BUDGET 2021-2027



Source: European Commission <https://www.consilium.europa.eu/en/infographics/recovery-plan-mff-2021-2027/>

Finally, on 10 November 2020, the European Parliament and EU Member States in the Council, with the support of the European Commission, reached an agreement on the largest package ever financed through the EU budget, of 1.8 trillion euros. The package will play an essential role in the recovery process of Europe. The strengthened multiannual framework will boost the recovery path after the crisis, providing funding for immediate needs and investments in the green and digital transitions for medium and long-term. The success of this recovery plan will depend not only on its size and ambition, but also on the speed of action and the ability to adjust the response to the evolution of the uncertain situation.

7.4. NEXT GENERATION EU (NGEU)

7.4.1. INITIAL RESPONSE TO COVID-19: SURE, ESM, EIB

The unprecedented crisis led to a prompt comprehensive European policy response, both monetary and fiscal. In April 2020, the European Union agreed an aid package of more than half a trillion euros to provide immediate support for Member States, whose economies had been severely hurt by the coronavirus outbreak. This response was added to the strong reaction of the European Central Bank (ECB), through liquidity (TLTRO), extension of QE and a new temporary QE programme (PEPP, in two phases: 700 billion euros and 650 billion euros).

European leaders discussed progress on the several dimensions of the response to the pandemic and agreed to coordinate as much as possible to ensure a gradual and orderly lifting of restrictions. They welcomed the *Joint Roadmap for Recovery* which set out import-

ant principles such as solidarity, cohesion and convergence, as well as four key areas for action: a fully functioning Single Market, an unprecedented investment effort, a global sphere of action and a functioning system of governance.

The European Council endorsed the agreements on three important safety nets for workers, businesses and sovereigns, amounting to a package worth 540 billion euros (see Table 1), and called for the package to be operational by 1 June 2020. It also agreed to establish a Recovery Fund and tasked the European Commission to present a proposal targeted towards the most damaged sectors and regions.

TABLE 1. INITIAL RESPONSE: 3-SAFETY NETS APPROVED AT EARLY STAGES OF COVID

ESM Credit Line Pandemic crisis support	EIB (EU level) Guarantees	SURE
FOR GOVERNMENTS Health care, cure and prevention	FOR FIRMS (Small companies)	FOR WORKERS (Short-time working schemes)
Credit line, 12 months, very low cost, maturity: 10 years	Loans to firms backed by a guarantee fund (€25 billion)	Loans to governments backed by guarantees (€25 billion)
€240 billion	€200 billion	€100 billion

Source: Own preparation based on European Commission data.

7.4.2. NEXT GENERATION EU: MAIN FEATURES

In July 2020, the European Council reached an agreement on Next Generation EU, together with the approval of the Multiannual Financial Framework 2021-2027. The overall quantity of NGEU (750 billion euros) and the relatively generous distribution to periphery and Eastern European countries remained unchanged from the European Commission proposal, although the proportion of grants was lowered from 66% to 52%.

NGEU constitutes an important and well-timed step to support the recovery in Europe. The fiscal stimulus of 5.4% could raise GDP by more than 4% in 2024 for some countries, according to European Commission estimates. Moreover, the fund is strongly redistributive. Only the grants component of the Recovery and Resilience Facility implies that rich countries will contribute with around 2% of their annual GDP. NGEU will be a great opportunity but also a big challenge: the capacity of absorbing such massive support and spend it on relevant projects will be tested.

TABLE 2. MAIN FEATURES OF NGEU

Main features of NGEU	
Size	€750 billion (5.4% EU GDP)
Composition	Grants (€390 billion) and loans (€360 billion)
Funding	Issuance in financial markets until 2026; repayment from 2028; possibly new taxes
To be spent fast	70% of grants (€273 billion) in 2021-22 and 30% in 2023
Allocation	In 2021-22 based on unemployment 2015-2019; from 2023 based on Pandemic effects on GDP
Conditionality	Country-specific recommendations
Rebates	From MFF 2021-2027 to reduce net contributions based on GNI
EU budget	€1074 billion
Rule of Law	It has been watered down but is likely to return in the future

Source: Own preparation.

Total amount, grants and loans

NGEU is the recovery fund for which the European Commission will borrow up to 750 billion euros on the capital markets on behalf of the EU. This Own Resources Decision is limited in time - until the end of 2026 - and scope – it will address the challenges of the crisis. The fund will consist of a very large Recovery and Resilience Facility (672.5 billion euros) and several smaller limbs. More than half of the total will be constituted by grants (390 billion euros) and the rest by loans (360 billion euros).

Strong redistribution

The Recovery and Resilience Facility (RRF), the main limb of the NGEU, will support public investments and reforms and will contribute to economic, social and territorial cohesion within the EU. It will help Member States address the economic and social impact of the pandemic whilst ensuring that their economies undertake the green and digital transitions, becoming more sustainable and resilient in the medium and long term.

The distribution of funds will take into account the uneven effects of COVID-19 across countries. The RRF will offer Member States 312.5 billion euros in grants (at 2018 prices), of which 70% would be committed in 2021 and 2022 and 30% by the end of 2023 (see Table 5).

The allocation key for 2021-2022 will consider for each country its population, the inverse of GDP per capita and the relative unemployment rate over the past 5 years. In the allocation key for 2023, the unemployment criterion will be replaced, in equal proportion, by real GDP growth in 2020 and over the period 2020-2021, initially based on the Commission Autumn 2020 forecasts and updated by 30 June 2022 with the latest published figures.

Moreover, 360 billion euros of additional loans for reforms and investments will be provided to Member States. As a rule, the maximum volume of such loans will not exceed 6.8% of the GNI of each country.

NGEU will be strongly redistributive. According to European Commission estimates, only the grants component of the Recovery and Resilience Fund (RRF) implies that rich countries will contribute with around 2% of their GDP. Including the loans component,

which admittedly is not a net transfer as they will have to be repaid in the long term, these countries will make a net contribution of around 4% of their annual GDP, while Spain will receive 6.5%. France will be also a net contributor. These estimates are assumed to be the same for all loan and guarantee components.

However, the regulation proposal explains that each instrument of the package will be allocated differently and there may even be no cross-country allocation key at all. According to Bruegel estimates based on European Commission and IMF data, some countries would obtain 15% of their GNI in grants and guarantees and others less than 1%. So, NGEU contains a strong redistributive elements that will mainly benefit the countries hardest hit by the crisis and with the lowest GNI per capita (see Table 3).

TABLE 3. CROSS-COUNTRY ALLOCATION OF THE NGEU AND THE 2020 ANNUAL BUDGET AMENDMENT: GROSS GRANT AND GUARANTEE PAYMENTS TO MEMBER STATES

	Grants			Guarantees		
	€ billion	% total	% 2021 GNI	€ billion	% total	% 2021 GNI
Total	433	100.0%		61.59	100.00%	
Italy	85.9	19.8%	5.2%	18.25	29.63%	1.10%
Spain	80.9	18.7%	7.0%	8.01	13.00%	0.69%
France	43.2	10.0%	1.8%	13.11	21.29%	0.56%
Poland	38.2	8.8%	8.1%	0.38	0.62%	0.08%
Germany	33.8	7.8%	1.0%	9.29	15.09%	0.27%
Greece	23.2	5.4%	13.5%	2.31	3.76%	1.35%
Romania	20.1	4.7%	9.6%	0.31	0.50%	0.15%
Portugal	16	3.7%	8.1%	0.98	1.59%	0.50%
Bulgaria	9.3	2.2%	16.0%	0.05	0.08%	0.08%
Czechia	8.9	2.1%	4.7%	0.24	0.39%	0.13%
Netherlands	8.8	2.0%	1.2%	1.6	2.60%	0.21%
Hungary	8.5	2.0%	6.7%	0.35	0.58%	0.28%
Slovakia	8.1	1.9%	9.0%	0.15	0.24%	0.17%
Belgium	7.6	1.7%	1.6%	1.9	3.09%	0.41%
Croatia	7.5	1.7%	15.4%	0.24	0.39%	0.49%
Sweden	5.5	1.3%	1.2%	0.9	1.46%	0.20%
Austria	4.8	1.1%	1.3%	1	1.63%	0.26%
Lithuania	3.9	0.9%	8.6%	0.06	0.10%	0.14%
Finland	3.9	0.9%	1.7%	0.79	1.28%	0.35%
Latvia	2.9	0.7%	9.9%	0.04	0.06%	0.13%
Denmark	2.8	0.6%	0.9%	0.35	0.58%	0.12%
Slovenia	2.7	0.6%	5.9%	0.12	0.19%	0.26%
Ireland	2.4	0.5%	0.9%	0.99	1.61%	0.39%
Estonia	1.9	0.4%	7.2%	0.01	0.01%	0.03%
Cyprus	1.5	0.3%	7.6%	0.1	0.16%	0.51%
Malta	0.4	0.1%	3.2%	0.01	0.02%	0.11%
Luxembourg	0.3	0.1%	0.7%	0.03	0.05%	0.08%

Source: Bruegel estimates based on European Commission data.

Rapid implementation

Launching the NGEU quickly will be crucial to turn the tide on the economic crisis. In July 2020 the European Commission invited Member States to come forward before the October European Council with proposals on how to accelerate and facilitate procedures in each country.

Conditionality

Conditionality and continued control will be unavoidable. Resources will be approved if they are aligned to the European Semester's guidelines (i.e. economic stability, innovation, digitisation and productivity, green deal and social fairness) and if the country reaches the targets previously committed. This is a powerful incentive for countries such as Spain that do not score high on reforms (outside a crisis period) and that can improve in the design or implementation of European projects.

European Commission will assess if funds follow the country-specific recommendations with more political control by the European Council (qualified majority).

Rebates and repayment

Richer countries will continue to receive rebates for the period 2021-2027 from the multi-year budget to reduce the net contributions based on GNI.

As proposed by the Commission, the borrowing by the EU will be repaid not later than 2058 and not before 2027 unless new own resources have been introduced.

Funding

NGEU will be funded through debt issuances, 70% up to 2022 and the rest in 2023. NGEU bonds will be rather liquid (the total amount outstanding would reach 750 billion euros by 2023, which compares with EIB 460 billion euros; ESM 100 billion, EFSF 200 billion, Germany 1.5 trillion, France 1.8 trillion, Italy 2 trillion and Spain 1 trillion). Moreover, the bonds would be well demanded, as they are expected to receive a high grade from rating agencies. Their main competitors would be core bonds.

The amounts of the Own Resources ceilings, the capacity to ask countries to contribute to the EU budget, will be temporarily increased by 0.6 percentage points, with the purpose to cover all liabilities of the EU resulting from its borrowing to address the consequences of the COVID-19, until all these liabilities have ceased to exist and at the latest until 2058. In any case, new Own Resources could be introduced or discussed after 2021, including a new one based on non-recycled plastic waste, to be introduced and applied as of 1 January 2021; proposals on a carbon border adjustment mechanism and on a digital levy in the first Semester of 2021 (at the latest by 1 January 2023); and other own resources, which may include a Financial Transaction Tax in the next MFF 2021-2027.

Evaluation

Europe reached an agreement to tackle the strong differences across countries and to maintain the size of the recovery fund that adds to the previous 3 safety nets already approved (SURE, ESM, EIB, together reaching 540 billion euros, or 4% of EU GDP) and EU countries’ fiscal stimulus of around 8% in 2020. This could help to prevent different fiscal responses across countries, bolster the functioning of the single market and support the economic recovery across the region, while strict control on the use of the funds will be positive in ensuring that investment and reforms increase potential growth and facilitate the transition to a green and digital economy. In addition, the increase in supranational debt to finance the NGEU will strengthen and complement the ECB’s stance (asset purchases programme), while reinforcing fiscal coordination. Although we are still far from it, it could be the seed for common fiscal stabilisers at the European level.

7.4.3. MAIN PILLARS AND INSTRUMENTS OF NEXT GENERATION EU

NGEU will be rolled out under three pillars: tools to support Member State efforts to recover, repair and emerge stronger from the crisis; measures to boost private investment and support ailing companies; and the reinforcement of key EU programmes to draw lessons from the crisis and make the single market stronger and more resilient (see Table 4).

TABLE 4. THREE PILLARS OF NGEU



Source: Own preparation based on European Commission information.

PILLAR 1: Supporting Member States to recover, repair and emerge stronger from the crisis

Public investment will play a crucial role to reach a balanced and sustainable recovery. In fact, more than 80% of the funding from Next Generation EU will be used to support public investment and structural reforms in Member States, concentrated where the crisis impact and resilience needs are highest.

The Recovery and Resilience Facility (RRF), together with cohesion policy and the Just Transition Mechanism, will be essential to achieve these important goals. In addition, the reinforced European Agricultural Fund for Rural Development will support rural areas to make the structural changes necessary under the European Green Deal.

❖ RECOVERY AND RESILIENCE FACILITY: THE CENTRAL PILLAR OF NGEU

The *Recovery and Resilience Facility*, embedded in the European Semester, will be a central pillar of NGEU. It will offer large-scale financial support for investments and reforms, including in the green and digital transitions, to make economies more resilient. It will be concentrated in the most affected areas of the EU, helping to balance divergences between Member States and to prepare the economies for the future.

In September 2020, the European Commission set out strategic guidance for the implementation of the Recovery and Resilience Fund in its 2021 Annual Sustainable Growth Strategy (ASGS) and on 11 November, the Facility was adopted by the European Parliament. The Facility will provide an unprecedented 672.5 billion euros in grants and loans to support EU countries for four years: grants worth a total of 312.5 billion euros (see Table 5) and loans a total of 360 billion euros.

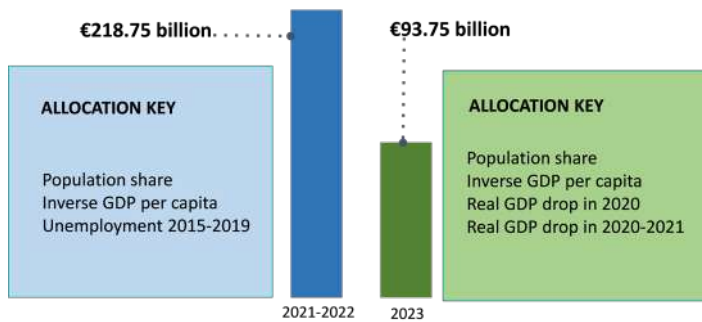
The new ASGS is fully aligned with the previous one, in which the European Commission launched a new growth strategy based on the European Green Deal and the competitive sustainability concept. The four dimensions of environmental sustainability, productivity, fairness and macroeconomic stability identified in the previous one remain the guiding principles underpinning national recovery and resilience plans and their reforms and investments. These dimensions lie at the heart of the European Semester and ensure that the new growth agenda helps to build foundations for a green, digital and sustainable recovery.

European Parliament agreed that the Recovery and Resilience Facility should only be available to Member states that respect the rule of law and the EU's fundamental values. National recovery and resilience plans should be consistent with six priorities – green transition, digital transformation, economic cohesion and competitiveness, social and territorial cohesion, institutional crisis-reaction and crisis preparedness – as well as with NGEU policies, which include the European Skills Agenda, the Youth Guarantee and the Child Guarantee. The Parliament also considers that each plan should contribute at least 40% of its budget to climate and biodiversity and at least 20% to digital actions. The plans should also have a lasting impact on European countries in both social and economic terms and provide comprehensive reform and a robust investment package.

EU funding should be visible and implemented transparently. The European Commission, responsible for the Recovery and Resilience Facility implementation, will submit to the Parliament twice a year a report on how the targets have been implemented as well as the amounts paid to each country. The recipients should ensure that spending under the Facility is visible by clearly labelling the projects as “European Union Recovery Initiative”.

An allocation key will fix a maximum amount for the grant of the Recovery and Resilience Facility per Member State. For 70% of the total grants, the allocation key will take into account the population, the inverse of GDP per capita and the average unemployment rate over the period 2015-2019, compared to the EU average. For the remaining 30%, the 2015-2019 unemployment rate will be replaced by the observed loss in real GDP in 2020 and the observed cumulative loss in 2020-2021. For loans, the maximum volume for each Member State will not exceed 6.8% of its GNI. However, an increase will be possible in exceptional circumstances subject to available resources.

TABLE 5. RECOVERY AND RESILIENCE FACILITY: GRANTS



Source: Own preparation based on European Commission information.

There has been some debate about the Recovery and Resilience Facility allocation criteria and structural objectives. The allocation criteria are based on indicators with a certain cyclical component while the Facility's objectives are structural (green and digital transformation, macro stabilisation and fiscal unity).

❖ **RECOVERY ASSISTANCE FOR COHESION AND THE TERRITORIES OF EUROPE (REACT-EU)**

Recovery Assistance for Cohesion and the Territories of Europe (REACT-EU) is an initiative to increase cohesion support and make economies more resilient and sustainable. It will help to bridge the gap between the initial response to the pandemic (Coronavirus Response Investment Initiatives) and longer-term recovery, contributing to a green, digital and resilient recovery.

Through REACT-EU, the European Commission will provide 55 billion euros of additional cohesion policy funding between 2020 and 2022 (almost 50 billion euros from Next Generation EU in 2021 and 2022 and 5 billion euros as early as 2020 by adapting the current financial framework).

REACT-EU will be based on the current cohesion rules, including the emergency flexibility introduced by the Coronavirus Response Investment Initiatives. Under these proposals, additional funding will be provided in 2020-2022 for the current cohesion

programmes as well as the Fund for European Aid to the Most Deprived, allowing funding for key crisis repair measures and support to the most deprived to continue without interruption.

The REACT-EU funding will be distributed among Member States taking into account the severity of the economic and social impacts of the crisis, including the level of youth unemployment and the relative prosperity of Member States. The European Commission proposed that 50% of REACT-EU additional resources for 2020 will be paid to Member States as pre-financing immediately, following the approval of the programme amendment concerned, and pre-financings in the following years will be paid with additional resources allocated to programmes. The generous EU-financing rate will contribute to a fast roll-out of this additional funding.

❖ COHESION POLICY

Cohesion policy will be crucial to ensure a balanced recovery in the longer term, avoiding divergences of growth between countries. For this purpose, the European Commission considers it essential to launch the new cohesion policy programmes at the beginning of 2021, in parallel with other funds available for the current programmes until the end of 2022.

The Commission is adjusting its proposals for the future cohesion policy to give even stronger support to recovery investments, for example in resilience of national health-care systems, in sectors such as tourism and culture, small and medium-sized enterprises, youth employment, education skills and child poverty.

Young people are likely to be particularly hard hit by the crisis. So, Member States with youth unemployment levels above the European average should allocate at least 15% of their European Social Fund Plus resources to help this group. The Commission also proposed that at least 5% of the Fund should be used to reduce child poverty.

To ensure sufficient support to most needed Member States and areas, the European Commission also suggests a review of national cohesion allocations in 2024, according to the latest available statistics. This review will lead to upward adjustments of only up to 10 billion euros for all Member States.

❖ REINFORCED JUST TRANSITION MECHANISM

The *Just Transition Mechanism* (JTM) will be a key tool to ensure that the transition towards a climate-neutral economy happens in a fair way. With this Mechanism it is expected to mobilise up to 150 billion euros through three pillars: a new Just Transition Fund, InvestEU and the European Investment Bank (EIB) public sector loan facility (see Table 6).

TABLE 6. JUST TRANSITION MECHANISM

Just Transition Mechanism, mobilizing up to €150 billion		
Just Transition Fund (up to €89-107 billion)	InvestEU (up to €30 billion)	EIB loan facility (up to €30 billion)
JTF €40 billion ERDF/ESF+ transfers Nacional co-financing	Investment generated by €1.8 billion	Investment generated by €1.5 billion EU budget and €10 billion EIB lending
Primarily grants	Crowds in private investments	Leverages public financing

Source: Own preparation based on European Commission information *JustTransitionMechanism*

The *Just Transition Fund* (JTF) will be equipped with 40 billion euros, an amount corresponding to fresh money made available to support European countries in their transition (10 billion euros should come from budget appropriations), while the remaining additional resources, covering the period 2021-2024, will constitute external assigned revenue stemming from the European Recovery Instrument.

To unlock funding from the JTF, Member States will have to match each euro received from this Fund for the share financed from the Union budget (10 billion euros) with 1.5 to 3 euros from their resources of the European Regional Development Fund (ERDF) and the European Social Fund Plus (ESF+). This spending from the EU budget will be supplemented by national co-financing according to cohesion policy. The total financing capacity of the JTF could reach between 89 billion euros and 107 billion euros.

The Fund will help to alleviate the socio-economic impacts of the climate transition in the most affected territories, by supporting the re-skilling of workers, helping small and medium enterprises to create new economic opportunities and investing in clean energy and circular economy.

The increase in *InvestEU* funds means that the second pillar of the Just Transition Mechanism will also be reinforced. Up to 1.8 billion euros will be focused on just transition goals. However, InvestEU will not only support investments in just transition territories, but also in other regions and in a wider range of projects (energy and transport infrastructure, including gas infrastructure and district heating; decarbonisation; economic diversification and social infrastructure). The final use of InvestEU will remain demand-driven and will depend on the project pipeline and the capacity of the regions concerned.

Finally, with a contribution from the EU budget of 1.5 billion euros, the *public sector loan facility* will enable the EIB to lend 10 billion euros, which is expected to mobilise

between 25 and 30 billion euros of public investments supporting a just transition over the period 2021-2027.

These loans would provide the public sector with resources to implement measures to facilitate the climate-neutral transition. Supported investments will range from energy and transport infrastructure, district heating networks, energy efficiency measures including renovation of buildings, as well as social infrastructure.

❖ RURAL AREAS: EUROPEAN AGRICULTURAL FUND FOR RURAL DEVELOPMENT

Rural areas will have a vital role to play in delivering the green transition and reaching the environmental targets. To that end, the budget for the *European Agricultural Fund for Rural Development* will be reinforced with 15 billion euros to support farmers and rural areas in making the structural changes necessary in line with the European Green Deal.

PILLAR 2: Kick-starting the economy and helping private investment

Urgent action is needed to kick-start the European economy and to create the conditions for a recovery led by private investment in key sectors and technologies – from 5G to artificial intelligence (AI) and from clean hydrogen to offshore renewable energy. This investment holds the key to Europe's future and will need at least 1.5 trillion euros in 2020-2021.

Different instruments will be used to reach these objectives. A new Solvency Support Instrument will provide urgent equity support for companies damaged by the crisis. This will also help companies in their green and digital transformation.

Moreover, InvestEU will be used to mobilise investment in sustainable infrastructure and digitisation, and a new Strategic Investment Facility will be created to invest in key value chains, which are very important for the future and strategic autonomy of Europe.

❖ SOLVENCY SUPPORT INSTRUMENT

The European Commission proposed a new *Solvency Support Instrument* to mobilise private resources and provide urgent support to viable companies from economic sectors that are suffering due to the crisis. This instrument will be temporary and will help to avoid massive capital shortfalls and possible defaults of viable firms.

It will mobilise private investment in troubled companies by providing partial guarantees against losses. The EU budget will provide a guarantee of about 75 billion euros to the European Investment Bank, which will ensure rapid delivery. The instrument will aim for an investment level of 300 billion euros in solvency support. The guarantee will be calibrated to ensure that investments are targeted at those companies that are in greatest need of capital, particularly in Member States less able to intervene through state aid and sectors with severe crisis effects.

In addition, the capital of the *European Investment Fund* will be increased in order to provide support to a wide range of small and medium-sized enterprises, including through implementation of the Solvency Support Instrument. This would further add

to building a comprehensive package for European recovery, also in conjunction with the measures agreed by the European Council in April. This capital increase of up to 1.5 billion euros will be financed both under the present and the next Multiannual Financial Framework.

❖ **ENHANCED INVESTEU: STRATEGIC INVESTMENT FACILITY**

A *Strategic Investment Facility* will be created as an additional window under InvestEU. This facility will support projects contributing to building strong and resilient value chains across the EU and enhancing the autonomy of the Union's single market, while maintaining its openness to competition and trade in line with its rules. This will enhance the resilience of the EU economy whilst providing the resources for important companies to prosper and grow.

With provisioning of 15 billion euros from Next Generation EU, the new facility would provide an EU budget guarantee of 31.5 billion euros and could generate investments of up to 150 billion euros to encourage European industrial leadership in strategic sectors and key value chains. The window will ensure that such investments exploit the potential of the Single Market, with the EU budget guarantee supporting companies and becoming a powerful instrument of recovery.

PILLAR 3: Lessons learnt from the crisis and addressing Europe's strategic challenges

❖ **PROGRAMMES TO BUILD RESILIENCE AND STRENGTHEN COOPERATION**

Next Generation EU will provide targeted reinforcement for key programmes that power growth and strengthen Europe's ability to survive and overcome future crises. These reinforcements are in addition to the European Commission's initial proposals for the future framework, recently approved by the Parliament.

A new programme to strengthen health security and cooperation

The crisis has shown that investments in healthcare systems must be reinforced in the future financial framework. To this end, the European Commission proposed an ambitious stand-alone *EU4Health* programme, amounting to 9.4 billion euros. The programme will help ensure that the EU is well prepared to react to future health crises.

The first component of the programme will address health security and crisis preparedness. It will support investments in health infrastructure, tools, structures, processes, and laboratory capacity, including tools for surveillance, forecasting, prevention and management of outbreaks. It will also support the establishment of a mechanism to develop, procure and manage health crisis relevant products such as medicines (vaccines) and treatments, their intermediates, active pharmaceutical ingredients and raw materials, and medical devices and medical equipment such as ventilators, protective clothing and equipment, diagnostic materials and tools. It will help create a new EU-wide risk communication framework covering all phases of a crisis.

The second component will support a longer-term vision of improving health outcomes via efficient and inclusive health systems across the Member States, through better disease prevention and surveillance, health promotion, access, diagnosis and treatment, and cross-border collaboration in health. The programme will support, among others, capacity building in countries, training programmes for staff and digital transformation of the health sector.

The programme will link up with relevant support provided under other European programmes and will establish new ways to implement joint actions. It will work with a reinforced rescEU, focused on direct crisis response capacities in emergency situations.

Reinforcing the EU response capacity to emergencies: rescEU

One of the lessons learnt from COVID-19 is that we must be able to react more quickly and flexibly in severe crises given the size of the potential disruption to the economy and society. To reinforce the EU's civil protection capacity to ensure a timely and effective response to large-scale emergencies, the Union's civil protection mechanism, rescEU, will be reinforced.

Its financial allocation will be 3.1 billion euros, financing investments in emergency response infrastructure (storage capacity, transport of medicines, doctors and patients) within the EU or bringing them in from outside the EU. The upgraded rescEU will give Europe the capacity and the logistical infrastructure needed to cater for different types of emergency, including those with a medical component, complementing the new EU-4Health programme.

Horizon Europe – investing in innovation and preparedness for the future

At the end of September 2020, the European Council finalized its position on the proposed regulation establishing Horizon Europe, the EU framework programme for research and innovation in 2021-2027 (Horizon Europe regulation) and on the proposed decision on the specific programme implementing Horizon Europe (specific programme decision).

The main outstanding issue of the *Horizon Europe regulation* concerns the internal break-down of Horizon Europe's budget, including funds to be made available under NGEU. The Council also agreed on provisions regulating international cooperation and the association of third countries as well as provisions ensuring synergies with other programmes.

Horizon Europe will amount to 94.4 billion euros to increase European support for health and climate-related research and innovation activities. This will also contribute to strengthened capacity to effectively and rapidly respond to emergencies and invest in science-driven solutions.

In the health sector, the reinforcement will be used to scale up research for challenges such as the pandemic, clinical trials, innovative protective measures, vaccines and treatments and diagnostics, and to translate these findings into public health policy measures.

Global response and solidarity with the rest of the world

The pandemic is a global challenge and the response must be global. Otherwise, every country and region in the world will remain vulnerable. The EU must continue demonstrating solidarity with its partners across the world in the fight against COVID-19.

The European Commission proposes to set the *Neighbourhood, Development and International Cooperation Instrument* at 87 billion euros, via a new External Action Guarantee, and the European Fund for Sustainable Development to support partners – in particular in the Western Balkans, the Neighbourhood and the rest of Africa – in cooperation with international financial institutions, such as the United Nations and the World Health Organization. A targeted adjustment to the current financial framework will allow 1 billion euros of additional support to be made available as early as 2020.

This support will provide liquidity to small and medium-sized enterprises, preserve investments in renewable energy projects and increase the capacity of funding in local currencies in other countries to reinforce health care systems and build manufacturing capacity for COVID-19 treatments and diagnostics. This will also help the most vulnerable countries and regions, addressing the severe social and economic effects of the crisis.

An increase of 5 billion euros will reinforce the *Humanitarian Aid Instrument*, reflecting growing humanitarian needs in the most vulnerable parts of the world. The impact of the pandemic and the economic fall-out, for example the loss of income due to collapsing oil and raw material prices and a drastic fall in remittances, are compounding existing needs, making it all the more important that the EU is prepared to demonstrate solidarity with the rest of the world.

Long-term financial framework for a more flexible and resilient EU

Strong measures to protect the European budget against fraud and irregularities are in place and the Commission will strengthen them further. The *European Anti-Fraud Office* (OLAF) and the *European Public Prosecutor's Office* (EPPO) will exercise their control and investigation powers.

In addition to the reinforcements financed under NGEU, other programmes will be covered to address challenges heightened by the pandemic and make the EU more resilient. These include:

- A total of 8.2 billion euros for the *Digital Europe Programme* to boost the Union's cyberdefences and support the digital transition.
- Investing in an up-to-date, high-performance transport infrastructure to facilitate cross-border connections, through an additional 1.5 billion euros for the *Connecting Europe Facility*.
- The *Single Market Programme* and programmes supporting cooperation in the fields of taxation and customs (3.7 billion euros, 239 million euros and 843 million euros, respectively), will create the conditions for a high-functioning single market.
- Investing in young people, through an additional 3.4 billion euros for *Erasmus Plus*, and in the cultural and creative sectors, increasing the *Creative Europe* to a level of 1.5 billion euros.

- Strengthening the resilience of the agri-food and fisheries sectors and providing the scope for crisis management, through an additional 4 billion euros for the *Common Agricultural Policy* and 500 million euros for the *European Maritime and Fisheries Fund*.
- Reinforcing the *Asylum and Migration Fund and Integrated Border Management Fund*, reaching a level of 22 billion euros, to step up cooperation on external border protection and migration.
- Increasing the *Internal Security Fund* to 2.2 billion euros and the *European Defence Fund* to 8 billion euros, with the end of ensuring strong support for European strategic autonomy and security.
- Supporting our partners in the Western Balkans by bringing the Union’s pre-accession assistance to a level of 12.9 billion euros.

With these targeted adjustments, the European Union will have a long-term financial framework better aligned with its priorities and tailored to reach a resilient recovery in the future.

7.4.4. NGEU AND NATIONAL PLANS

EU Member States have to prepare recovery and resilience plans that set out a coherent package of reforms and public investment projects to be implemented up to 2026 in order to be supported by the Recovery and Resilience Facility (RRF). These plans must be aligned to the priorities of the European Semester (i.e. economic stability, digitisation and productivity, green deal and social fairness) and should demonstrate how the investments and reforms would effectively address challenges identified in this context, particularly the country-specific recommendations adopted by the Council (see Table 7). The national plans should also include measures to address the challenges faced by the countries regarding the green and digital transitions.

TABLE 7. NATIONAL PLANS AND EUROPEAN SEMESTER

National plans should be aligned to the priorities of the European Semester			
Economic Stability	Digitalization and productivity	Green Deal	Social Fairness
Activation of the general escape clause : preserve jobs, help firms and support the recovery A supportive fiscal stance is currently warranted	Smooth functioning of the Single Market Innovation, investment in digitalization Education , skills and training Supportive investment environment and labor market	Projects to boost climate neutrality European Green Deal , National Energy and Climate Plans should guide investments	Preserving jobs Occupational health and safety Digital skills Inequalities and poverty; protecting vulnerable groups

Source: Own preparation based on European Commission information.

Member States can submit their recovery and resilience plans from the moment the Facility is legally in force (1 January 2021, according to Commission expectations) and before 30 April 2021. Given the comprehensive and forward-looking policy nature of the plans, there will be no need for the Commission to propose country-specific recommendations in 2021 for those countries that will have submitted it. Nevertheless, the European Commission will propose fiscal recommendations as envisaged under the Stability and Growth Pact.

Climate transition

Regarding the Green transition, NGEU is part of a broader policy package to drive the EU towards a net-zero emissions economy by 2050. It must be completed with carbon pricing policies that are both predictable and credible.

Member States should consider reforms and investments to maintain the climate transition as a priority. To follow the commitment of the European Council to achieve a climate mainstreaming target of 30% for both the multiannual financial framework and Next Generation EU, each national recovery and resilience plan will include a minimum of 37% of expenditure related to climate. Progress towards other environmental objectives is also important, in line with the European Green Deal.

The European Commission encouraged Member States to propose flagship investment and reform initiatives aimed at accelerating the development and use of renewables, improving the energy and resource efficiency of public and private buildings and accelerating the use of sustainable, accessible and smart transport. The reforms and investments included in the national plans will need to respect the ‘do no harm’ principle, meaning that they should not be to the detriment of climate and environmental objectives.

Member States will need to factor in the need to ensure a just and socially fair transition across green policy areas. In particular, national plans should be developed in full coherence with the proposed Territorial Just Transition Plans under the Just Transition Mechanism.

Digital transition

As part of the national plans, Member States should also ensure a high level of reforms and investments enabling the digital transition. The Commission proposed that each plan should include at least 20% of digital expenditure. This includes investing in 5G and Gigabit connectivity, developing digital skills through reforms of education systems and increasing the availability and efficiency of public services by using new digital tools.

7.4.5. NEXT GENERATION EU: IMPACT AND IMPLICATIONS

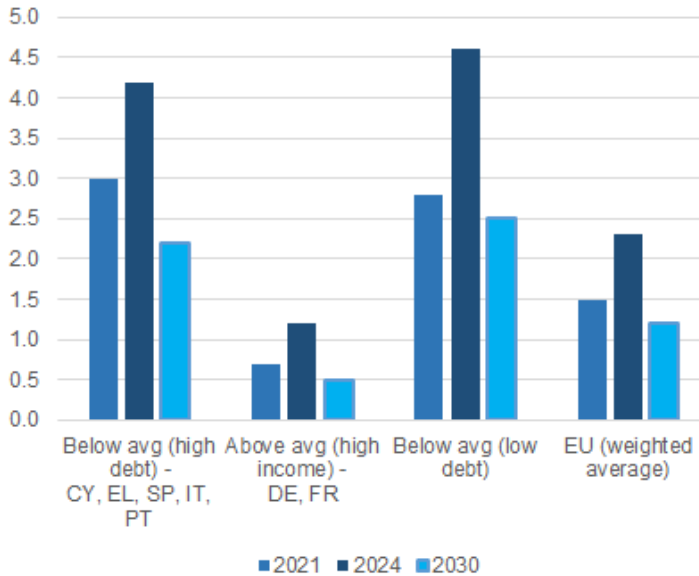
Impact on economic growth: ‘fiscal multiplier’

According to the European Commission’s estimates², the new fiscal stimulus (5.4% of EU GDP) could raise GDP by more than 4% in 2024 for some countries. Together, the fiscal support, including automatic stabilisers, could reach 16% of GDP in three years.

² https://ec.europa.eu/info/sites/info/files/economy-finance/assessment_of_economic_and_investment_needs.pdf

FIGURE 2. ESTIMATION OF NGEU IMPACT ON GDP

(Deviation from baseline, pp)



Source: European Commission https://ec.europa.eu/info/sites/info/files/economy-finance/assessment_of_economic_and_investment_needs.pdf

The estimated impact is significant in those countries with income per capita below the EU average and those with high debt (Greece, Spain, Portugal, Italy), but rich countries also gain. On average, the mobilised investment is estimated to increase real EU GDP levels by around 1.75% in 2021 and 2022, rising to 2.25% by 2024 (see Figure 2). Due also to the productivity-enhancing nature of the supported investments, economic output remains persistently above baseline levels in the medium and long term (around 1%). It should be noted that these figures are estimated by considering several assumptions about the amount of funds to be spent, the implementation schedule, the distribution between grants and loans and the type of project, among others.

The theoretical literature reveals that ‘fiscal multipliers’ are higher in economic recessions since, as the economy is far from its potential capacity, the fiscal impulse is less likely to crowd out private investment. In any case, there is high uncertainty over the ‘fiscal multiplier’ levels to be applied to each public expenditure category. Theoretical and empirical models suggest that public investment expenditure has a larger and more durable impact on activity than government consumption or transfers to households. Public investment not only increases demand in the short term, but also helps to expand capital stock and potential growth. In particular, for Spain the literature releases a wide range of levels for public investment fiscal multipliers, from 0.5 to 1.3³.

³ <https://www.bde.es/f/webbde/SES/Secciones/Publicaciones/PublicacionesSeriadas/DocumentosTrabajo/13/Fich/dt1309e.pdf>

Although factors associated with the current crisis (uncertainty, recession, EU coordination, etc) could point to higher multipliers, structural imbalances of each country (ageing, high public debt, etc) could indicate lower values. However, the magnitude of the fiscal multiplier will depend, to a large extent, on how the support will be invested and what structural reforms are implemented.

An opportunity for Europe to go ahead with integration and financial stability

NGEU is a great opportunity for Europe to go ahead with integration and financial stability. This is a way to walk towards a fiscal union which is forward-looking and not legacy-based. Together with the MFF 2021-2027, NGEU will ensure a coordinated European fiscal response to the economic fallout from the pandemic. While the 2008 European Economic Recovery Plan⁴ was only intended to coordinate national budgetary stimulus to be financed by each Member State, NGEU establishes a joint funding model to support government spending and reform the EU.

Even if the nature of the NGEU is temporary, it sets a precedent in different areas that could survive in the long term, unlike past attempts to evolve towards a fiscal union based on proposals of Eurobonds and/or mutualisation of legacy debt, which have met strong opposition from some countries. The fund will be financed through common bonds backed by all countries, a potential precedent of a safe European asset. This is the first time the EU issues debt to finance its own spending. The size of the fund implies that annual issuance will be equivalent to that of a large EU country, and could be used by the ECB for its QE purchases. This sort of eurobond could create a precedent for the future and increase the international role of the euro.

TABLE 8. NGEU: POTENTIAL IMPLICATIONS

The NGEU agreement is a major step forward, with potential implications for several issues	
Growth	Redistributional issues (net transfers favors most affected countries) Digital and Green, more sustainable growth
Integration and financial stability	Higher role of fiscal policy to complement monetary policy Safe asset for Europe Step to Fiscal Union Growing weigh of the euro as an international currency
Political	Enhanced role of the European Commission

Source: Own preparation based on European Commission information.

⁴ <https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52008DC0800&from=EN>

A powerful countercyclical fiscal instrument

NGEU is a powerful countercyclical fiscal instrument that could lead in the future to an EU-wide fiscal stance, a recurrent demand by institutions such as the European Central Bank (ECB) and the International Monetary Fund (IMF). The fiscal stimulus will complement the efforts of monetary policy to sustain the economy. Again, it creates a precedent for a more permanent fiscal policy instrument at the EU level in the future.

NGEU is a very positive step forward but still, concerns of debt sustainability remain, given the magnitude of the crisis. It should improve the fiscal stance in more vulnerable countries even with conservative assumptions on fiscal multipliers, but it leaves some of them, such as Spain and Italy, in a dangerous zone in the medium-term, with still very high debt levels.

Moreover, with the NGEU the risk of euro break-up should be reduced and the role of the euro as an international currency reinforced. Not only is the risk of recession mitigated by the fund, but also the commitment shown by the response with the European project has been reflected in the reinforcement of the euro exchange rate over the past weeks.

It will be crucial to ensure that the fiscal support provided through NGEU is not counteracted by the early withdrawal of fiscal support funded at national level. Given the depth of the pandemic, the general escape clause set out in the Stability and Growth Pact was activated in March 2020 with likely extension through 2021. This will allow Member States to take the measures needed to combat the COVID-19, deviating from the adjustment requirements under the pact while not endangering fiscal sustainability.

NGEU opens the door to the creation of Own Resources, new taxes for the reimbursement of the debt issued by the EU. Though these new taxes need to be debated, they would eventually become permanent. Behind the scenes is the debate on digital, green and financial taxes, and the controversy of unequal corporate income taxes across countries.

The reaction to the crisis will also have implications for the future design and implementation of the European governance framework. While expansionary fiscal policy is necessary to sustain the recovery, going forward it will be important for the fiscal rules to effectively support the reduction of high government debt in good economic times. Moreover, NGEU constitutes a new and innovative element of the European fiscal framework. This innovation could imply lessons for Economic and Monetary Union, which still lacks a permanent fiscal capacity at supranational level for macroeconomic stabilisation in deep crises. The review of the economic governance framework provides a good opportunity to incorporate these important considerations.

7.5. CONCLUSIONS

At this time of extraordinary hardship and uncertainty, the European Union needed more than ever to show that it was ready and willing to act decisively and chart a path to a better tomorrow. Agreement on an ambitious recovery plan with the EU budget at its heart will give the EU the best possible chance of success.

NGEU will unlock the full potential of the EU budget to kick-start the economy and boost Europe's sustainability, resilience and strategic autonomy. It builds on the Union's experience of harnessing market financing and expands it to achieve the scale of support that is urgently needed in today's circumstances.

A reinforced multiannual financial framework for 2021-2027 will guide the EU back from crisis to the path of long-term recovery, providing essential financing for immediate needs and for long-term investments in the green and digital transitions. The success of the recovery plan will depend not only on its scale and ambition, but also on the speed of action and the ability to adjust the response in the light of developments. Financial support is urgently needed in many parts of the Union to keep businesses afloat and support those in greatest need.

An early decision on the proposal to amend the current framework will allow additional funding to be made immediately available for REACT-EU, the Solvency Support Instrument and the European Fund for Sustainable Development, reflecting the urgency of these needs.

On 10 November 2020, the European Parliament and the European Commission reached an agreement on the NGEU and the next Multiannual Financial Framework, a package of 1.8 trillion euros, the largest ever financed through the EU budget. The success of this plan will be crucial for the recovery process and should help rebuild a greener, more digital and more resilient Europe.

- [1] 1.25 billion euros from reflows from financial instruments and 250 million euros from the budget.
- [2] COM (2020) 22, COM (2020) 23.
- [3] The borrowing costs for the grant component of NGEU will be paid out of the EU budget. It is estimated that these costs will amount to up to 17.4 billion euros during the 2021-2027 financial framework.

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8. WHY NEXT GENERATION EU MIGHT BE A POISONED GIFT (AND HOW TO AVOID IT)¹

ANTONIO ROLDÁN MONÉS

“It ought to be remembered that there is nothing more difficult to take in hand, more perilous to conduct, or more uncertain in its success, than to take the lead in the introduction of a new order of things. Because the innovator has for enemies all those who have done well under the old conditions, and lukewarm defenders in those who may do well under the new.”

Niccolò Machiavelli, 1505.

8.1. INTRODUCTION

“Spain should reform its labour-market regulation to foster transitions towards open-ended contracts, including by simplifying the system of hiring incentives...”. “Italy should modernize its justice system by reducing the length of civil trials at all instances...”. “Portugal should improve the skills level of the population to boost productivity...”

These are just a few examples taken from any random year from the European Commission’s country specific recommendations. Anyone who has been reading these documents over the years (or any other similar publication by a serious economic institution) must unavoidably have asked herself with frustration the following question: if it is so clear where the main binding constraints for growth in the economy are, how is it possible that after so many years, the Commission keeps on recommending the same laundry lists of reforms? What have all these countries done over the years? What is it that we are doing wrong?

¹ The author would like to thank Natalia Collado Van-Baumberghen for excellent research assistance.

Of course, there has been some progress. In fact, OECD data on structural reforms points to some structural progress in a number of areas in most countries, especially under the market pressure or bailout programs of the Eurozone crisis (Chang, Steinberg Torres, 2019). We all know that reforms do not happen overnight. Governments need to build coalitions, reconcile different interests and face their own conflicting incentives when they are in office and want to be reelected. But that misses the point.

Over the years the focus of governments and institutions in EMU has been on discussing *what needs to be done in the economy* but too little attention has been put into *how to make reforms actually happen*. With a specific focus on Southern Europe, the goal of this chapter is to explore what we know about the political economy of reforms in EMU to improve the chances of Next Generation EU (NGEU, from now on) becoming a true force for transformation.

European funds offer a unique opportunity for structural change for the EU and, in particular, for the largest southern European economies (Spain, Portugal, Italy, Greece; S4 from now on) after years of stagnant productivity. Because of its size and commitment schedule, NGEU should not be seen as a short-term countercyclical spending tool, but rather as a structural instrument “to chart a new economic development path” (Pisani-Ferry, 2020). Large investments are needed for that, but the impact on growth will be limited without reform.

On paper, it is precisely now (when money is available to compensate the potential losers of reforms) that it should be easiest for governments to implement reforms. However, the reality is that the political and economic incentives for reform for S4 governments could hardly be worse. In comparison to the last EMU crisis, citizens have grown tired of making sacrifices, governments are weaker, parliaments more fragmented, and populist forces at the extremes make it harder for governments to pass reforms. On the economics: low borrowing costs and the absence of other external constraints such as surveillance programs will make it easier, not harder, for governments to postpone otherwise necessary reform.

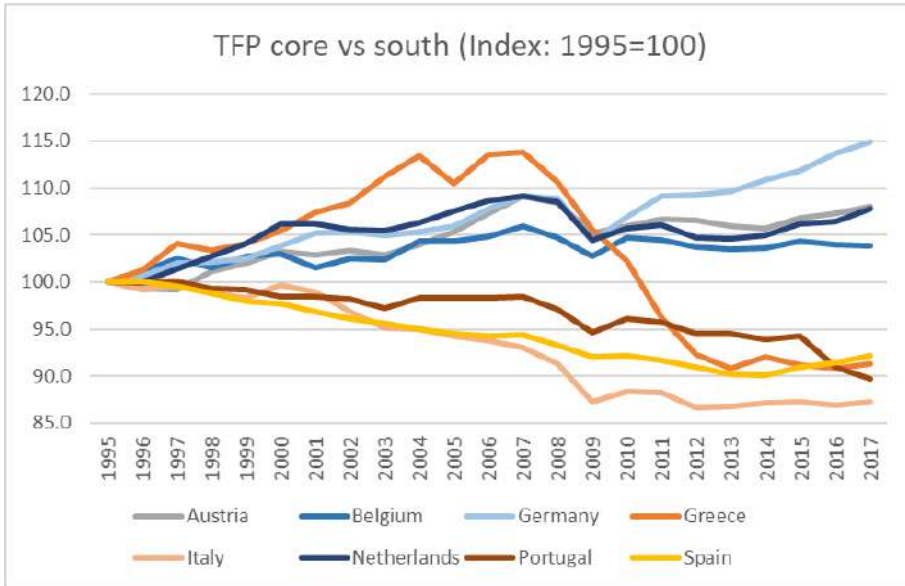
In the coming weeks and months, it will not be hard for the Commission and the European capitals to agree on a fifty-point reform plan coinciding with the established priorities of the European Semester and the green and digital transition objectives. The problem will start precisely *after* agreeing to that plan. Either we address that “*after*” - in other words, how to improve the governance of Next Generation EU to make it conducive to successful reform – or those reform plans will fail again, with perilous consequences for the future of EMU (see Wolff (2020)).

So far, the debate on reform conditionality versus non-conditionality has been misleading. No reasonable economist advocates a return to the harsh pro-cyclical fiscal austerity of the last crisis. Nobody is arguing that, after having been hit by a brutal crisis caused by a pandemic (a random event which is nobody’s fault), the people of Southern Europe should be exposed to any further social suffering.

But that does not mean we should just give up on reforms, close our eyes and hope that governments will use the massive windfall of money wisely when they have not done so in the past.

EMU was conceived, partly, as a mechanism that would help reduce the institutional and competitiveness gaps among European countries (Eichengreen, 1993). However, so far, progress has been too slow. In terms of productivity growth, the southern economies continue to lag far behind the core economies (see Figure 1). The Covid-19 crisis will just accentuate these diverging trends unless we change our approach.

Figure 1. Total Factor Productivity (Index: 1995=100)



Source: Prepared by the author on the basis of data retrieved from FRED

My proposal is to put in place a “Next Generation Reform Dialogue” to boost long-term growth in EMU. Member States and the Commission need to engage in an honest conversation, beyond the Country Specific Recommendations of the European Semester, which incorporates political economy considerations and prioritises a much smaller set of structural reforms. Rather than agreeing on large laundry lists of reforms that will never be implemented, the process should serve to select two or three truly binding constraints for growth in areas where reform is actually politically viable. The reference structure I propose to use as a guide for those dialogues is the Growth Diagnostics framework presented by Rodrik, Hausmann, & Velasco (2008).

Throwing large amounts of money at certain areas without reform will not work. In fact, more money could actually reinforce bad equilibriums. Think of Spain’s active labour market policies (ALMPs). Spain has the highest early dropout, unemployment, youth unemployment and temporary employment rates in EMU. Between the central and regional governments (or autonomous communities in Spain), Spain already spends more than 6 billion euros a year on ALMPs. However, according to the most

recent Spending Review by AIReF, Spain's independent fiscal authority, there is no evidence at all that this money is actually helping to improve employment opportunity for workers (AIReF, 2019).

As I discussed in the last section, the reason why the system does not work is that it is not in fact designed to boost employment, but rather to sustain a bad political economy equilibrium that benefits trade unions and autonomous communities, but not unemployed workers. Moreover, as a result of the pernicious institutional dynamics, ALMPs have been at the core of some of the wildest corruption scandals in Spain in recent years (see Martín-Arroyo (2020)). Throwing more money at the system will not help to expand opportunities but rather reinforce the existing bad equilibrium.

This is just one example but there are many more. If used well, the funds could help to improve health systems and reduce the social suffering caused by the pandemic. But also boost productivity and long-term growth. If used badly, however, they could represent a huge (maybe the last) opportunity for economic and institutional convergence in EMU.

It is not unrealistic to imagine a picture in five years' time in which pensioners in the Netherlands are being asked by their governments to cut their pensions, while the headlines of their newspapers are full of stories about ridiculous projects and corruption scandals involving EU funds in the South. Given the poisoned nature of politics everywhere, governments in the European core will struggle to justify to their domestic constituencies further support for integration. It will not take long for Eurosceptic forces to exploit this in their favour, posing a truly existential challenge for EMU.

The structure of this article is as follows. First, I explore the recent history of reforms in EMU and I analyse the asymmetric impact of the Covid-19 crisis on EU member states. Secondly, I review the evolution of conditionality in the NGEU framework and the literature on the political economy of reforms in EMU in order to identify key variables for reform. Then, I present some evidence on the political and economic factors that will reduce the chances of reforms in the coming years and I outline a framework proposal for a Next Generation Reform Dialogue to improve the chances of some reforms actually happening. Finally, I conclude with a case study of Spain to illustrate how this would work in practice and the main findings.

8.2. A SHORT HISTORY OF REFORMS IN EMU

When the Monetary Union was designed, the expectation was that it would help less advanced countries catch up with the European core. By abandoning the possibility of currency devaluation, the theory said, economies with weaker institutions would have no choice but to implement structural reform and modernise. This would naturally lead to a convergence towards best practices in all policy areas, from labour markets, to pension systems and taxes.

Southern European economies would benefit the most from the monetary straitjacket imposed by the irrevocable fixed exchange rate regime. Most of these economies were

barely escaping from semi-autarkic dictatorships, where clientelism and rent-seeking were common practice. For decades, these countries had suffered from fiscal imbalances, persistent financial instability, large unemployment levels and uncontrolled inflation. EMU would provide the indispensable anchor for these countries to abandon once and for all these bad practices and policies.

When the project to unite all the currencies into the Euro became a reality, the rhythm of reforms accelerated (1993-1999). Nobody wanted to be left behind and countries, particularly in the South, albeit at different rhythms, started adapting their economies to European standards. The financial crises in the 70s and 80s and, since the 90s, the EMU convergence criteria, led to deep transformations in these economies: liberalisation of large economic sectors, improvements in the welfare state and tax systems, a reduction in barriers to trade, and reforms in most areas. The Maastricht Treaty, signed in 1991, established ambitious deficit, debt and inflation objectives, and the need to stabilise nominal exchange rates within the Exchange Rate Mechanism left little space for countries to avoid reforms.

In 1999, eleven countries finally became full members of the EMU, abandoning their monetary policy autonomy. One immediate effect of the euro was that the perception of risk by investors immediately dropped and real-interest rates fell sharply in peripheral countries. By 2001, Greece was able to borrow at German-level interest rates. The large flow of credit that went into these economies generated large internal and external imbalances. In some cases, credit went to finance quickly rising public debt levels (like in Greece) and in other cases private debt and real estate booms (like in Spain). In all cases, including Ireland, external indebtedness increased abruptly (Sandbu, 2015).

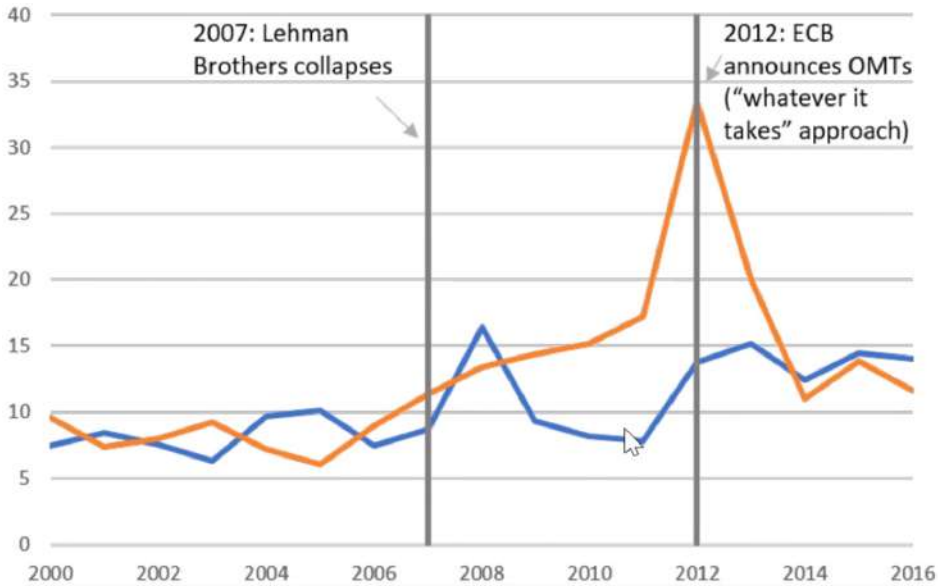
A second effect of finally entering the euro was that the rhythm of reforms slowed down. Unlike what the theory had predicted, the peripheral economies, fuelled by credit-driven economic growth, had fewer incentives to implement the necessary reforms to improve productivity and correct institutional and economic imbalances. Fernández-Villaverde et al (2013) have called this process “political credit cycle”, and argue that the flow of credit after the introduction of the euro led to a relaxation of constraints that reduced incentives for reform and led to the institutional deterioration that precipitated the Great Recession.

The boom years barely lasted a decade. When the crisis began a new period for reforms started in EMU. While in previous years reform activity had been slow, particularly in the South, the first years of the crisis led to a boost in reform activity. The sudden halt of credit, the spectacular rise in unemployment and the inescapable external constraints - in some cases with very stringent IMF and EU bailout programs - led to some major structural reforms in a number of southern European economies. Spain implemented ambitious reforms in its banking system and the labour market. Greece went through a traumatic reform process, involving deep transformations in its welfare state, pension system, and labour and product markets. Portugal also implemented ambitious reforms and structural fiscal savings (see, for instance, Manasse & Katsikas (2017)).

The reform process, while intense, did not last long. As soon as credit constraints started to subside, as a result of the easing of monetary conditions by the ECB, and

growth returned to most countries, the rhythm of reforms slowed down significantly again. A quick look at the available data on the evolution of labour market reforms in Europe matches this story quite well (see Figure 2).

Figure 2. Average number of labour market reforms undertaken by countries in Core and South of Europe



Source: Prepared by the author on the basis of data retrieved from LABREF. Notes: The graph shows the average number of labour market reforms undertaken per country per year, for different country groups. The numbers are derived by summing up the total number of all labour market reforms undertaken in each country of each group and dividing by the number of countries in the group. Core countries include Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands. South includes Cyprus, Greece, Italy, Portugal and Spain.

Figure 2 shows the average number of labour market reforms per country in the South of Europe (Cyprus, Greece, Italy, Portugal and Spain) and in what I denote the Core countries (Austria, Belgium, Finland, France, Germany, Luxembourg, Netherlands) between 2000 and 2016². The rhythm of reforms is almost flat until the start of

² The Labour Market Reforms Database (LABREF) compiled by the European Commission covers all labour market reforms and relevant collective agreements enacted and implemented in Europe from 2000 to 2016. Reforms and agreements are classified into nine different policy domains, covering labour taxation, unemployment benefits, other welfare-related benefits, active labour market policies, job protection legislation, disability and early retirement schemes, wage bargaining, working time organisation, immigration and mobility. Note that the LABREF database does not cover reform activity between 1990 to 1999, but this has been the most intense reform period in Continental and Southern countries in all policy areas (see Hancké & Rhodes (2005)).

the Great Recession in 2007, when reform activity increases across the board, and especially for those countries more severely affected by the financial and sovereign debt crisis (South).

The average number of reforms in Southern countries rises from around 11 in 2007 to 33 reforms in 2012, while Core countries introduced on average about 9 reforms in 2007, and 14 in 2012. After the announcement of the European Central Bank (ECB) to do “whatever it takes” to stabilise financial markets, reform activity drops sharply in the South, while it remains at a higher level than that prior to the crisis for Core countries. One possible explanation for that could be the return to growth and, generally lower external constraints, with bailout programs ending and the ECB intervening as a lender of last resort for these economies, relaxing significantly monetary conditions.

8.3. THE ASYMMETRIC IMPACT OF THE PANDEMIC

Because of the way it spreads and affects our way of life, the virus that has caused the Covid-19 pandemic seems designed to harm the southern European economies. The S4 economies (Spain, Italy, Portugal and Greece) are more dependent on “contact-intensive” sectors than their northern neighbours. According to Eurostat, while in Greece about 26% of the labour force works in tourism-related activities, in Germany the figure is less than 8%³. Spain, with about 80 million tourists a year⁴, is the second most visited country in the world (representing about 16% of its exports). The high dependence on the service sector translates into a high relative share of small SMEs and self-employed workers, who are financially more vulnerable than larger companies.

Cultural norms and demographics are also very different and not only because of the more intense social life in the south. According to the Population Reference Bureau (PRB), around 23 per cent of Italy’s population is aged over 65, the largest proportion in the EU. The percentage of young Italians (between 18 and 34) living with their parents is also among the highest in the EU: according to Eurostat for 2018 about two thirds of young Italians lived with their parents compared to an EU average of 48 per cent.

Italy and Spain were the two first European victims of the pandemic. During the first wave the number of daily deaths per one million people was above 17 in Spain or 14 in Italy, while it was 9 in the Netherlands or 3 in Germany. The second wave of the pandemic started in Spain almost two months earlier than in the rest of the EU. By September Spain had the highest excess mortality per one million people in the world, just before Ecuador and Peru. High incidence means lower mobility and stronger lockdown measures to control the virus, translating into a harder negative economic impact.

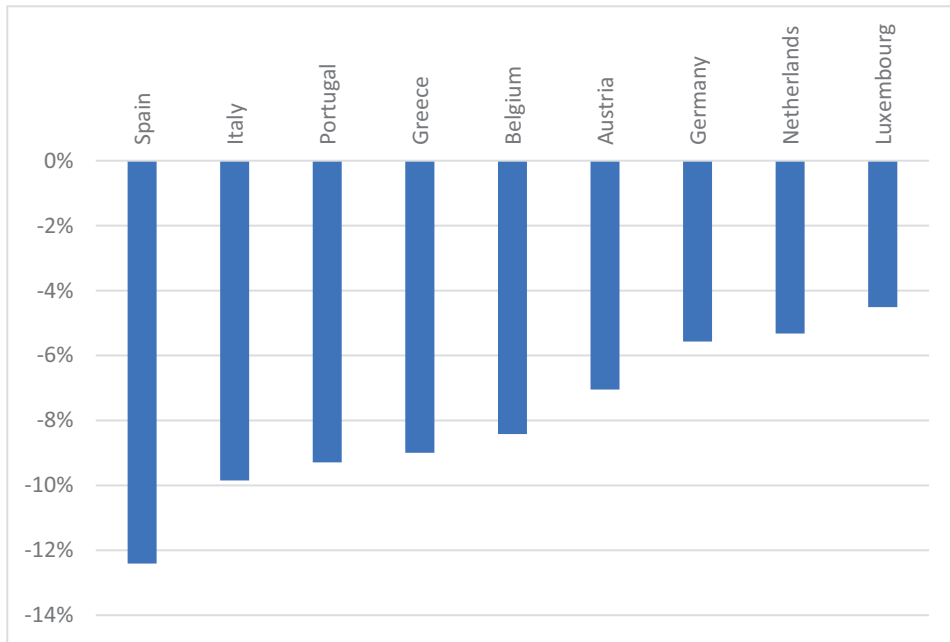
Besides the economic structure and cultural explanations, poor governance seems to have also been a key driving factor. Sapir (2020) finds that as much as 45% of differences

³ Data is for 2017 and does not include employment in the financial sector when computing the total labour force.

⁴ Data retrieved from INE, the National Statistics Institute of Spain.

in GDP losses between core and south could be explained by poor quality of government in the South in the first wave. As a result of the above, the economic contraction expected in 2020 for S4 countries will be much worse than in core countries, meaning years of economic convergence will be lost.

Figure 3. Forecasted GDP decline in 2020



Source: Prepared by the author on the basis of data retrieved from the November 2020 European Commission forecast

8.4. CONDITIONALITY UNDER THE RECOVERY PLAN

In July, the European Commission, the European Parliament and European Council agreed on a recovery plan to help repair the economic and social damage caused by the coronavirus pandemic and to “lay the foundations for a modern and more sustainable Europe”. The plan is articulated around two instruments, the Multiannual Financial Framework (MFF) 2021-2027 and the NGEU initiative. These plans respectively have €1,074.3 billion and €750 billion in funds, conforming the largest stimulus package ever financed through the EU budget.

The resources allocated to the MMF 2021-27 aim to reinforce some existing programmes, such as Invest EU, Erasmus+ or RescEU, or to create new ones, such as

EU4Health. The funds devoted to NGEU will be channelled through seven different programmes⁵ in the form of loans (€360 billion) and grants (€390 billion). The Recovery and Resilience Facility (RRF) programme represents the bulk of these resources, accounting for 90% of the NGEU funds (€672.5 billion), of which €360 billion are loans and €312.5 billion grants for the next four years.

In order to be eligible for financing under the RRF, the Commission, in its Proposal for a regulation of the RRF (European Commission, 2020), pointed out that Member States need to prepare national recovery and resilience plans setting out their reform and investment agenda for the years 2021-23. Originally, Article 16 laid down how the Commission would assess those plans linking the granting of RRF resources to their effective contribution to address the country-specific recommendations (CSRs) of the European Semester and, particularly, those relevant for the green and digital transition. Likewise, Article 9 links Facility payments to sound economic governance.

However, in September the European Parliament amended Article 16 of the proposal (European Parliament, 2020) deleting paragraph (a) which specified that the recovery and resilience plans should effectively address the challenges identified in the CSRs, thus eliminating economic conditionality. At the same time, the text was amended to add a suspension of payments to Member States that fail to abide by basic EU citizen rights and the rule of law.

On 11 February 2021, the Council of the EU adopted the final regulation of the RRF (Council of the European Union, 2021) and re-established certain economic conditionality. In line with Article 16 of the initial proposal, Article 19 (3b) states the Commission would assess whether the national recovery plans contribute to effectively address the challenges identified in the CSRs, or in other relevant documents officially adopted in the context of the European Semester. Also, Article 10 introduces the possibility of suspending the payments in case the member state has not taken effective action to correct its excessive deficit.

On paper, the framework in its final form gives the Commission effective power to condition reforms. However, in practice there is no reason to believe that this framework will be more effective in achieving reform implementation than other similar frameworks have been in the past. The politics might not help either: given the social suffering resulting from the pandemic and the presence of populist parties in most national parliaments, it remains to be seen whether the Commissions' threat of suspending payments will actually be credible.

⁵ Namely Recovery and Resilience Facility, ReactEU, Horizon Europe, InvestEU, Rural Development, Just Transition Fund and RescEU.

8.5. WHEN AND WHY DO COUNTRIES IMPLEMENT REFORMS?

Understanding why countries struggle so much to implement reforms, despite overwhelming evidence of these being good for society as a whole, has been the focus of study of a vast literature in economics and political science. In particular, in the literature on the political economy of reforms, two large sets of answers have emerged since the 90s to respond to that question.

Early research focused on power relations and the conflicts of interest among socio-economic groups in society (see, for instance Fernandez & Rodrik (1991)). Reforms (product-market, labour, institutional, etc.) might be good in the long-term as they boost productivity or growth in the economy, but the positive effects of these reforms take time to materialise and, in the process, they always create winners and losers.

Given the uncertainty about the distributional effects of reforms and the problem of credible commitment - to compensate the losers of those reforms, for example - interest-groups that benefit from the status-quo will oppose reforms so that they can continue extracting private rents. Alesina & Drazen (1991) in a classic work provide a model in which stabilisation is delayed because it is rational for different socioeconomic groups to try to shift the burden of stabilisation onto other groups, in a process that mimics a war of attrition game and leads to the accumulation of debt.

More recent research goes beyond the analysis of “winners” and “losers” of reform and introduces new elements such as beliefs, norms and preferences to try to understand why bad equilibriums are so persistent over time. People look at the world in a way that is strongly conditioned by pre-existing identity and partisan beliefs. These beliefs condition preferences for public goods which can be very resistant to change through technical evidence (see Khemani (2017)). When debates become more based on identity or ideology, reaching agreement on specific policy questions becomes increasingly hard (Miller, 2020).

In the empirical literature, Williamson (1994) and the OECD (2009) are the most ambitious works so far studying specific experiences of a number of different countries and reforms. More recently, for the case of the EMU crisis Campos et al (2018) and Chang et al (2019) also offer interesting accounts.

Some of their overlapping conclusions are that: (1) policy reforms are more likely to emerge in response to crisis; (2) reformers enjoy a “honeymoon period” of support before opposition builds up; (3) the strength and cohesiveness of the government is crucial; (4) strong leadership is important; (5) effective communication helps; and (6) a clear electoral mandate for reform helps too. The sequencing and intensity of reforms also matter as it is easier for instance to implement a reform on the margin or to engage in labour market reforms after product-market reform.

Beyond case studies, there is increasing consensus in econometric analysis (Campos et al (2018); Dias da Silva et al (2018); Duval et al (2016)) on at least four important factors driving reform: (1) macroeconomic conditions - the depth of recession and the

unemployment rate are positively correlated with reform implementation; (2) strong government - having a majority in the relevant legislature is associated with more reform activity; (3) external constraints - EMU countries tend to reform more when they have external political pressure (such as countries under EU programmes) and market pressure; and (4) weak initial structural conditions - a country which is far away from best practice in a concrete policy area also increases the probability of reforms.

The evidence is mixed regarding the importance of monetary policy conditions and financial market pressures in driving policy reform. In theory, low interest rates could be used in two different (opposing) directions: countries could use cheaper financing to compensate losers of reform, hence inducing more reform activity. Or, alternatively, they could use lower financing costs to postpone otherwise necessary reform.

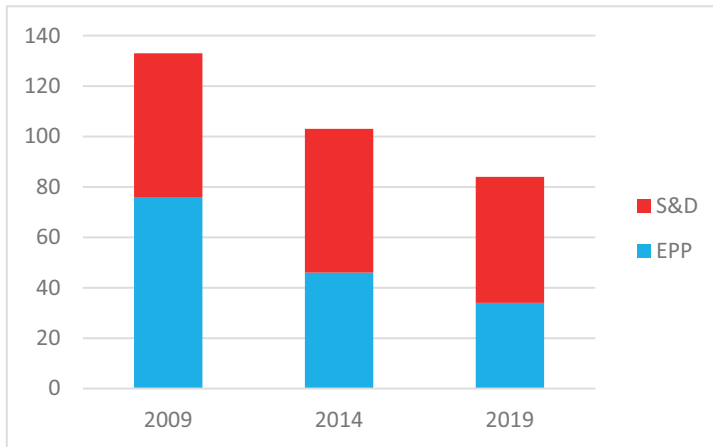
However, looking at the recent reform experience in EMU, the latter seems to be more plausible. Vamvakidis (2007), based on a large panel of developing and emerging economies, finds that external borrowing by the private sector leads to a delay in economic reform. The author argues that “External financing sometimes acts like a “pain reliever,” postponing the much-needed treatment of a sick economy by reform.”

8.6. A BAD OUTLOOK FOR REFORMS

Today most of the relevant variables that have driven reforms in the past seem to be pointing in the wrong direction. National parliaments are more fragmented, governments have weaker majorities and populist forces are threatening from the extremes. At the same time, governments face weaker external constraints. Monetary conditions have relaxed as the ECB has (rightly) pushed for unprecedented expansionary monetary policy. Interest rates are at historical lows and sovereign spreads in southern economies are compressed. This time there are no EU bailout programmes or external surveillance to push for reforms. Moreover, there is a strong crisis of political representation and less trust in political parties, and electorates are more volatile than ever. In what follows I revise evidence for southern EU economies to examine how conditions for reform have worsened in relation to the last crisis.

- 1. Mainstream parties are weak and face more competition. This will translate into less ambition to pursue costly reforms.** Traditional mainstream parties (proxied here with the European People’s Party and the Socialists & Democrats groups in the European Parliament) have lost ground since the financial crisis of 2008. Higher competition for the electorate on both sides of the political spectrum will mean governments will be more risk-averse and hence less willing to assume costly reforms.

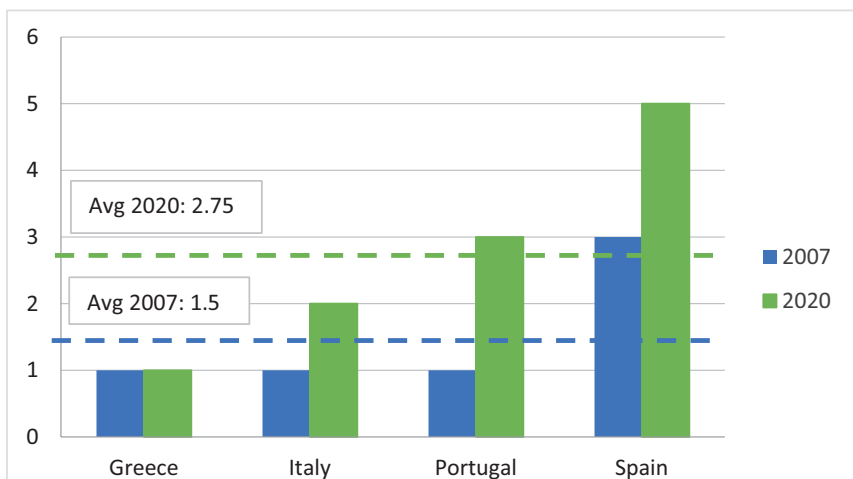
Figure 4. EPP and S&D seats from Greece, Italy, Portugal and Spain in European Parliament



Source: Prepared by the author on the basis of data retrieved from the European Parliament

2. Governments have weaker majorities. This will mean they have less political capital to pursue reforms. Another issue that will reduce the likelihood of reforms is the absence of absolute majorities. The graph below shows how the average minimum number of parties needed to obtain an absolute majority has increased over the last decade. Today, an average of almost three parties is needed to form a majority in S4 countries, while in 2007 about 1.5 parties would have been sufficient. More fragmented governments mean more parties have veto power on reforms.

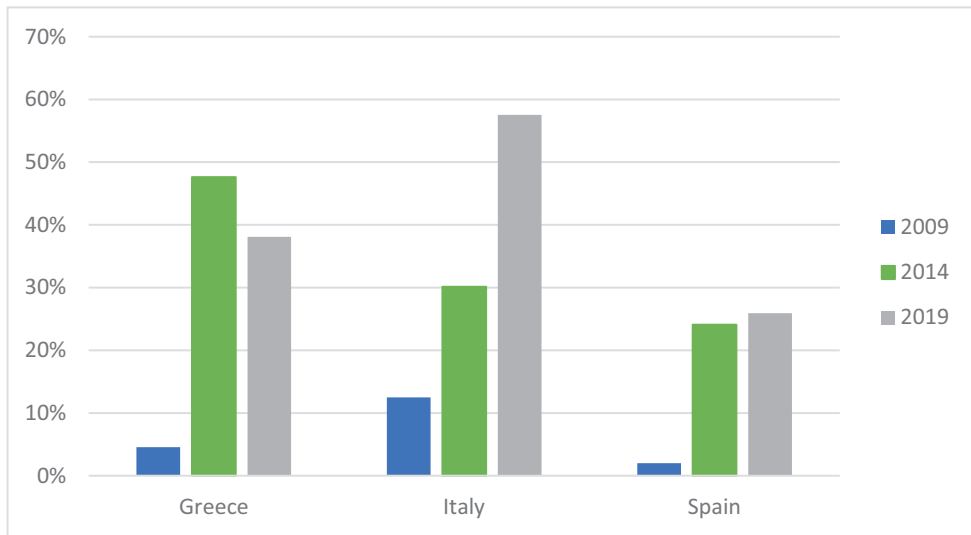
Figure 5. Minimum number of parliamentary groups to produce an absolute majority including the PM's party (2007 vs 2020)



Source: Prepared by the author on the basis of data retrieved from the National Parliaments

3. Rise of populism. When mainstream votes are lost, they do not go to other potentially reformist parties, but to anti-establishment forces at the extremes. This graph shows how the number of seats held by populist parties in the European Parliament have increased after the financial crisis. The competition with mainstream parties and the need to differentiate themselves challenges the implementation of growth enhancing-reforms⁶.

Figure 6. Seats obtained by populist parties in European elections (% over total country seats)

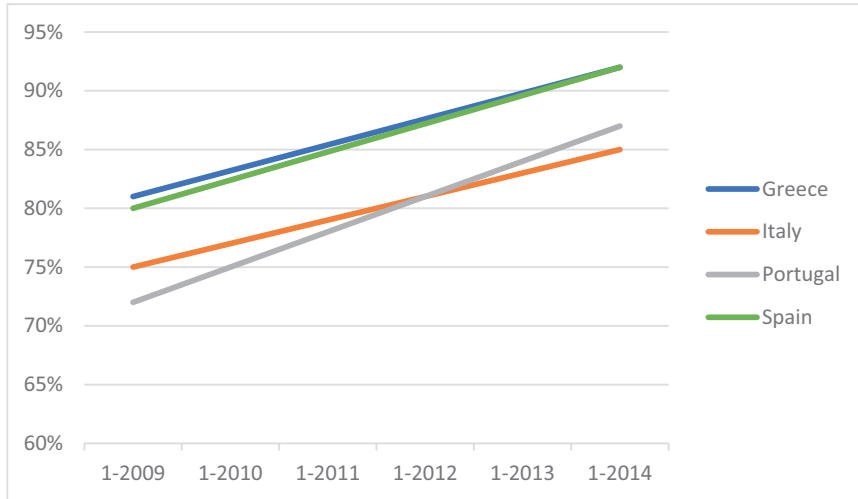


Source: Prepared by the author on the basis of data retrieved from the European Parliament

4. Lower trust in political parties. Political parties have less political capital than in the past, as citizens' trust weakened significantly after the last sovereign debt crisis. This will translate into a weaker capacity for parties to convince voters to pursue costly reforms.

⁶ Here I use the standard definition of populism by Cas Mudde (see Mudde (2004) and Mudde & Kaltwasser (2017))

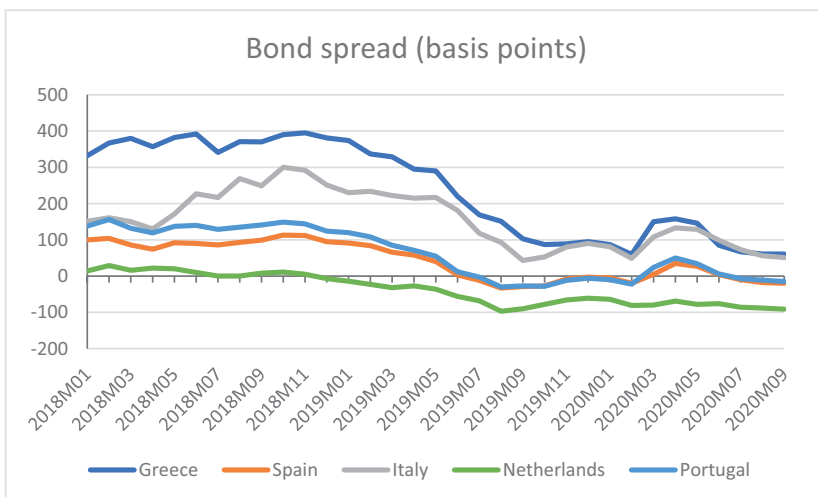
Figure 7. Evolution of the share of population with a lack of trust in political parties during the European Debt Crisis



Source: Prepared by the author on the basis of data retrieved from the Eurobarometer

- Lower borrowing costs. Cheaper financing will allow countries to postpone otherwise necessary reform.** Contrary to what happened during the financial crisis, the bond spread has been contained in the South by aggressive ECB bond-buying under the Pandemic Emergency Purchase Programme (PEPP).

Figure 8. Bond spread (basis points)



Source: Prepared by the author on the basis of data retrieved from Eurostat

8.7. BEYOND CONDITIONALITY: A NEXT-GENERATION REFORM DIALOGUE

Fifteen years ago, the Harvard professors Ricardo Hausmann, Dani Rodrik and Andrés Velasco wrote a widely cited paper called Growth Diagnostics (see Rodrik, Hausmann, & Velasco (2008)). After the experience of years of failed reforms under the Washington Consensus, the authors proposed a new strategy to derive policy priorities for governments “in a way that uses efficiently the scarce political capital of reformers”. Rather than trying to implement long lists of reforms which are “seldom helpful”, the authors proposed a framework to identify the most binding constraints for economic growth in a given country.

The first question governments should ask themselves, the authors argued, is what keeps growth low. Is it because of low returns to investment due to insufficient complementarity in factors of production such as human capital or infrastructure? Is it due to low appropriability of the returns, as a result of bad institutions (justice system, poor property rights) or high taxation? Once the most stringent constraints for growth are identified, countries should put all their political effort into reforming these areas first in order to get the biggest bang for their reform buck.

The European Commission over the years has focused on a specific reform strategy that can be classified as “Do as much reform as you can, as best you can,” using the jargon proposed by Hausmann et al. In other words: the laundry-list strategy. The idea is to go for any reform that is needed and seems enforceable through conditionality. The problem with this strategy is mainly political: the “spray-gun” approach dilutes the limited political capital governments have into too many fights. It does not take into account political economy considerations and, most importantly, it does not offer a sense of priority.

A more nuanced approach to reform priorities in EMU is needed. One of the most relevant recent contributions that looks to improve the governance of reforms carries the following suggestive title: “How to make sense of the structural reform lists for the euro area”. Henrik Enderlein and Ana auf den Brinke (2017) collect data on all key reform recommendations by the European Commission and the OECD (which in 2017 amounted to more than 200 recommendations for the 19 euro-area countries) and offer a framework for EMU governments to prioritise reforms on the basis of growth effects, contribution to euro-area stability and political feasibility.

They conclude that product market reforms should be the top priority as they have “the highest short-term gains, can be implemented in good and bad economic times, have the largest effects on potential growth and contribute significantly to the functioning of the euro area”. These reforms include key reforms in the service sector, such as deregulating closed professions and harmonising regulation.

As regards labour market-reforms (which are the most commonly recommended by the European Commission and the OECD) the authors suggest a change in focus: considering the potential political resistance, the short-term transitional costs and the timing of the reform. A way of getting around these short-comings would be to focus on what the authors call Next Generation reforms, which include, among others, harmonising protection legislation between insiders and outsiders and pushing for a strong demand-side

component to stabilise the economy (such as investment in ALMPs or education). The idea is simple: governments should incorporate the social costs of reforms in the equation from the beginning and prioritise those that provide the biggest return for growth.

In the context of Next Generation EU, economists and policy-makers have shown concern for the lack of a proper governance mechanism to guarantee productive use of the recovery funds (see Wolff (2020)). Jean-Pisani Ferry has argued that EU funds should go beyond their short-term Keynesian counter-cyclical effects. And such a path inevitably requires reform. The question is how to achieve such reform.

My proposal is to open up a Next Generation Reform Dialogue between the European Commission and each Member State. For each country, and beyond the Country Specific Recommendations, the EU Commission should engage in an honest conversation with Member States to establish a very small set of 2 or 3 reform priorities. The output of such conversation should be a “Future Growth Diagnostics” document, based on the Hausmann et al (2008) methodology. The priorities should be determined on the basis of two criteria: (1) the main binding constraints for growth, as well as the (2) social and political viability of those reforms. All reforms should be focused on tackling long-standing economic imbalances with a strong focus on next-generation reforms, as suggested by Enderlein & Auf dem Brinke (2017), and they should be accompanied by a generous demand-side component financed through the recovery fund. Ideally, the dialogue should involve not only national governments and the Commission, but also a group of selected academics, practitioners and relevant civil society representatives. The objective of the dialogue should answer the following question: if there were only three specific reforms you could do to improve opportunities for the next generation in country X, which ones would you choose? Once the two or three reform priorities are established, the Commission should design a conditional payment mechanism to ensure that these reforms are not only promised but also implemented.

Of course, identifying the most important binding constraints for growth is not a straightforward task. But it is not impossible either. In the following section I sketch out a simplified exercise for Spain.

8.8. CASE STUDY: “FUTURE GROWTH DIAGNOSTICS” FOR SPAIN

Comparatively, Spain does not have a poor infrastructure. It does not have particularly high taxes either. Access to finance is not a constraint for growth at this time. There is a lot to be done to improve regulatory harmonisation and market unity, and some specific professions remain shielded from competition. Spain also suffers from some institutional inefficiencies such as a slow justice system. Surely, reform in these areas would unleash growth potential. But most economists would agree that Spain’s key binding constraint is related to the labour market and weak levels of human capital.

The country has had deep labour-market imbalances for decades which hamper Spain’s growth and productivity. Spain has both the highest rate of structural unemployment and the highest temporality rate in the EU. Temporary employment (held mostly

by the young, women and immigrants) is used to provide a buffer for economic adjustment throughout the cycle: when the crisis comes, millions of temporary workers are sent home, and when the economy recovers those same workers are re-hired again on a temporary contract. Workers on well-protected permanent contracts are largely shielded from economic turbulence (Dolado, Felgueroso, & Jansen, 2010).

Spain's dual labour-market system is at the core of many of its social and economic troubles: thousands of brilliant young workers never get the chance to access a stable job; firms do not invest enough in human capital formation (Cabralés, Dolado & Mora, 2014); young people do not have sufficient means or job stability to have children (leading to the lowest fertility rate in Europe); and precariousness and child poverty are the norm for large segments of the population.

Anything that contributes to improve outsiders' access to jobs would help increase labour market participation mostly for women, the elderly, migrants and workers whose skills have become redundant due to structural transformations.

A first challenge starts at an early age. Spain has the highest early drop-out rate in schools. There is a high correlation between leaving school early and falling into long-term unemployment or the temporary employment trap. Correcting this should definitely be among Spain's top priorities for reform. There are a number of proposals to resolve this. Antonio Cabralés and I suggest two politically viable changes that could achieve that goal: the improvement of incentives for teachers during their careers and a strong investment in educational support in the classroom with programmes such as the successful PROA programme (Cabralés & Roldán, 2020).

A second problem is the existing EPL, which promotes duality. Reducing the protection wedge between temporary and permanent workers should be another top priority. Of course, this is easier said than done. Despite Spain's terrible unemployment figures, the system has remained largely unchanged over the years because it works as it is for both business representative/support organisations and trade unions. The former benefit from the extreme flexibility provided by unprotected temporary workers. The latter also benefit because their (legitimate) job is defending the interests of insiders, workers with permanent jobs who make up their membership and will re-elect them as trade union leaders (Dolado, Felgueroso, & Jansen, 2010). However, there might be a political equilibrium which both, trade unions and business organisations, could agree on and that would involve improving protection for temporary workers and a reduction of certain privileges of insider workers.

A third key challenge would be reforming the system of Active Labour Market Policies (ALMPs) which is partly broken, also as a consequence of the deep insider/outsider divide. Every year Spain spends about six billion euros on ALMPs, between the central and regional governments. But instead of providing real opportunity for the unemployed, the existing programmes have proven to have appalling outcomes, yet they are seldom reformed or evaluated. In particular, AIReF (2019) concluded that some programmes discourage participation in the labour market and that the design of the policy, based on an annual framework, challenges its implementation and management. To make it

worse, the system has not only proven to be inefficient, but it has also been at the core of some of the wildest corruption scandals in Spain in decades (Martín-Arroyo, 2020).

The problem is that the system was not really designed to help the unemployed or temporary workers get the jobs the market is demanding. Over the years, trade unions have become the main providers of training as this has been the implicit way through which they complemented their insufficient official financing. Unions are necessary for many things, but they have proven to be badly suited to offer good training. A reform that would simultaneously offer sufficient financing to trade unions and allow for a more competitive offering of courses would already be a great improvement. If such reform would be accompanied by the implementation of a worker profiling system (to improve ALMPs spending efficiency), personalised career counselling and a systematic evaluation of the results, this would be a massive improvement. These reforms would be politically viable, of course, if they were accompanied by a large increase in financing (the funding per unemployed worker of ALMPs remains comparatively low in Spain).

There are many other reforms Spain should address. This is just an (incomplete) exercise to help establish a sense of priorities. Not having one, in the present context, might mean that no reforms at all are implemented over the next few years and a huge opportunity for convergence would be lost in southern Europe.

8.9. CONCLUSIONS

When I became a full-time politician five years ago, as a member of the Spanish parliament for a newly created centrist party, Ciudadanos, I was young and inexperienced. I knew governments often hesitated to implement reforms to avoid political costs. But I thought, with a bit of work, political ability and goodwill, reforms were actually possible. When I left politics, about a year ago, I had a much more pessimistic view. I realised that transforming things, even when they seem obviously wrong, is actually much more difficult than what I had thought.

When looking at Spain's labour market this became sadly obvious: how was it possible that a country that had gone above 20% unemployment three times over the last thirty years was incapable of implementing ambitious labour-market reform? There are many reasons for this, I found: weak leaders and majorities, ideological bias, polarised electorates and established interest groups who benefit from the status quo. If Spain is to catch up with Europe, I concluded, we need to work much harder to understand how reforms are successful and sustained.

In this chapter, I have analysed the literature and evidence on the political economy of reforms in Europe. A first conclusion that arises from that review is that the present context could hardly be less favourable for reforms. With weak governments, poisonous politics and weak external constraints, Next Generation EU is unlikely to bring about the reforms needed to improve productivity and well-being in southern Europe. After a pandemic-induced crisis that has disproportionately hit southern countries, the dream of economic convergence seems further away than ever. Without a serious commitment for

reform, the generous funds committed by the EU might be of little use to correct the existing imbalances. Ultimately, if the generosity of the European core is not corresponded with responsibility in the South, and the funds are not used to correct these imbalances, the very project of the monetary union might be at stake, given the poisonous nature of politics everywhere.

European leaders need to rethink Next Generation EU governance if they want it to work. I suggest moving from the failed “laundry lists of reforms strategy” towards a more honest conversation, engaging governments and EU institutions, to discuss not only the objectives but also the political viability of achieving them. In such a debate, the EU should abandon the “spray-gun” approach to reforms and focus all efforts on, at least, implementing two or three key measures to address the most pressing binding constraints for inclusive growth in each country.

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9. THE STATE OF THE FISCAL UNION IN THE EUROZONE: ARE WE CLOSER TO A 'HAMILTONIAN' MOMENT?

ENRIQUE FEÁS¹

9.1. INTRODUCTION

One of Europe's founding fathers, Jean Monnet, used to say that "Europe would be forged in crises," although most likely he was not expecting two big crises in the first two decades of the 21st century. Another founding father – this time of the US – Alexander Hamilton, agreed in 1790 with Thomas Jefferson to convert the American confederation into a true federal republic by assuming the debt of the states.

The European Council decided in July 2020 that the European Commission would issue long-term debt to finance a Recovery Plan worth around 5% of the EU's GDP, with the sole backing of its future budgets, to allow Member States to implement expansionary fiscal policies to bounce back into growth without a further increase in their national debts. Issuing European debt to solve a European problem is, by any standards, a qualitative leap in terms of European integration.

Many then rushed into touting the arrival of the EU's 'Hamiltonian' moment, the advent of real fiscal integration.

Are we really in a 'Hamiltonian' moment or, simply in the moment of the *Hamilton* musical in which the lead actor, despite having sworn from the beginning that he was not going to "throw away" his shot, ends up renouncing to kill his nemesis by intentionally firing his pistol in the air? Has the EU gone the extra mile, or did it just fire blanks?

Probably, like almost everything in economics, neither one nor the other. Neither can we minimise the importance of Next Generation EU as a precedent for a joint fiscal

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response to a common crisis, nor should we expect – however much we consider it necessary – that the Recovery Plan for Europe will be triggering, at last, a fiscal union.

This article will review the current state of the fiscal union in the eurozone. After taking a step back and identifying the key components of a fiscal union – something less evident than is usually thought – we shall review their current state in the eurozone, and how they have been impacted by EU decisions as a result of the COVID-19 pandemic. Has the euro area advanced towards enforceable economic policy coordination together with effective fiscal discipline tools, common automatic or discretionary fiscal stabilisation tools, and a common safe asset financed with common resources? We will conclude discussing the pending issue which we consider to be the litmus test that will determine the historical importance of Next Generation EU: the Own Resources Decision. The content of this legislative act might determine whether we are witnessing a sort of Hamiltonian moment, or just another small step in the right direction.

2. THE LONG AND WINDING ROAD TO A FISCAL UNION

In a simple world, a fiscal union would be easy to define. But in a complex world, where monetary policy includes a wide range of non-conventional measures, where central banks buy debt massively in the secondary market and the liquidity of commercial banks depends on safe assets (mainly sovereign bonds), a neat separation of fiscal and monetary elements is not obvious. If it were, there would be no debate about the role of the European Central Bank, the proportionality of its measures and whether the Pandemic Emergency Purchase Programme (PEPP) constitutes or not government financing forbidden by the EU treaties. In the last decade, the boundaries between monetary and financial policy and fiscal policy are becoming more and more diffuse. So, to delimit the scope of our article, we need to go back to the essence of monetary unions.

In an economic and monetary union, the stabilisation function of monetary policy can only be exercised jointly. Crises that affect specific countries of the union (or general crises that have different effects on different countries depending on their different economic structures) must be addressed in other ways.

Asymmetric shocks can only be mitigated by three possible channels: the income channel, the credit channel, and the public policy channel.

The income channel refers to the prospect for households and companies to obtain income in other regions, which is only possible if there is labour mobility and if companies have geographically diversified their business. This channel could be complemented with a wealth channel via geographic diversification of financial assets in households' portfolios and on companies' balance sheets (especially equity).

The credit channel allows for the possibility of borrowing while the crisis lasts, which is only possible if the financial system is fully integrated and credit can be accessed from any region. On the contrary, if credit to households and companies is concentrated by region, risk is too concentrated for financial institutions.

The public policy channel refers to the ability of the public sector to compensate for the loss of household and business income, either via automatic stabilisers (unemployment insurance, weaker tax collection) or with discretionary measures (public spending that stimulates low demand) or the stimulation of credit via the provision, for instance, of guarantees. In the event of tensions in the financial sector, the public sector should be capable of stepping in to avoid further damage to the real economy. This, in turn, is only possible if the public sector has fiscal space, for which it is essential that markets perceive its public debt as safe.

In the eurozone, those channels are not particularly strong.

The *income channel* or possibility of obtaining income in other regions is not very high because labour mobility affects in practice only a small proportion of the population compared to other federations such as the United States or Canada. As for companies, the possibility of hedging income via regional diversification depends on the degree of development of the single market, which is deep for goods but not so much for services, and quite low in the financial sector. Additionally, investment in financial assets (especially equity) is not as geographically diversified as it could be, partly because of the absence of a true capital market union.

Regarding the *credit channel*, in the eurozone credit to a country's private sector is closely linked to the jurisdiction where the country's financial institutions are headquartered. In other words, most of the clients of a country's banks and insurers are households and companies from the same country. This means that, in the event of an economic crisis in a country, the balance sheets of the banks are weakened and their financing capacity is reduced, constraining credit to households and companies. To avoid this, the EU has promoted the Banking Union, a true single banking market to avoid the fragmentation of risks and the need to deploy public resources for banks in the event of a crisis. The idea of a banking union is based on three fundamental pillars or ideas.

First, banks that operate in several countries cannot be supervised by a single country, and that is why the supervision of large entities is now done in a unified way.

Second, in the event of a banking crisis, the most important thing is to guarantee customer deposits. But a major crisis could render national deposit guarantee systems insufficient, even if the state took over. This would lead to the absurdity of the eurozone having banknotes that are worth the same in all countries but bank deposits (almost equivalent in monetary terms) with different risk (and therefore different value) in different countries. To avoid this situation, it is essential that there is a deposit guarantee fund at the European level that guarantees the theoretical equivalence of a deposit in euros in any bank in any country. This idea is the one behind the proposal of the European Deposit Insurance System (EDIS), but unfortunately it has not yet been put into practice.

Third, the rescue of large banks may end up destabilising public finances in Member States, which makes it necessary to propose a rescue system at European level with sufficient funds. This system is the Single Resolution Mechanism, provided for this purpose with the Single Resolution Fund. The problem is that the endowment of this fund is insufficient for cases of rescue of large entities, which makes an emergency mechanism necessary, a backstop of sufficient endowment that has not yet been approved.

The *public policy channel* in the eurozone, obviously, has nothing to do with that of a federal state. That would require a common treasury with a budget of sufficient size to allow transfers to Member States to alleviate asymmetric shocks, with the possibility of issuing common debt financed with common taxes. That should be the aspiration in an ideal monetary union, but it would require a political will to cede sovereignty to EU institutions that does not exist today. We will not discuss here the need for a deeper political integration in the EU, although we agree with what Paul-Henri Spaak already said in 1956: “the European issue is not a technical issue, but a matter of political will and decision” (Spaak, 1956).

In the meantime, however, both economic and financial crises can end up sinking countries. This is so because, in practice, eurozone Member States are issuing debt in a currency over which they have no full control, and therefore the ability to repay public national debt is conditional on the ability for that country to obtain financing, which, if not internal (through fiscal surpluses), must be external.

There are two ways to reduce the risk of a countries’ debt, generally used in a complementary way: guaranteeing external financing in the event of liquidity problems, like the European Stability Mechanism (ESM) does, or guaranteeing the debt, either through its acquisition by a supranational body like the European Central Bank (ECB) or the ESM, or through its total or partial replacement by some type of joint debt.

A summary of our considerations is shown in Table 1. From that table, we shall not discuss the strengthening of the income channel through the deepening of the EU single market, nor the purely financial issues related to the banking union. We will not elaborate either on how to deal with fiscal-financial crises, whether by bailout of countries or the possible acquisition of national debts. We aim instead to focus on the six key elements (marked with an asterisk in the table) that we consider more closely linked to the concept of fiscal union. Two are related to the prevention of fiscal shocks: clear and enforceable fiscal discipline rules and the coordination of economic and budgetary policies; three are supranational fiscal instruments to deal with those shocks – and simultaneously help prevent the transformation of real sector crises into financial crises: automatic or semi-automatic stabilizers and discretionary fiscal policy tools (mainly linked to investment spending); and a safe asset² with which to raise funds to finance these tools.

² This coincides with most of the elements that the European Fiscal Board identify as the major gaps in the current European Monetary Union (EMU) architecture: a permanent fiscal capacity to address large shocks, which “should ultimately take the form of a larger EU budget financed by own tax resources, with a meaningful size, the capacity to borrow in the event of large shocks, and a focus on EU investment priorities”; a simplification of the EU fiscal framework; and a protection of “growth-enhancing expenditure” in times of crisis, “allowing certain increases in investment when assessing compliance with the expenditure rule” (European Fiscal Board, 2020).

Table 1. The handling of asymmetric shocks in a monetary union

Shock type	Shock prevention	Shock management
Economic & Fiscal	<ul style="list-style-type: none"> • Promotion of the single non-banking market (mobility of workers, diversification of business risks) • Fiscal discipline (deficit and debt limits, coercive measures) to limit deficit bias and generate fiscal space* • Common supervision of economic and budgetary policies* 	<ul style="list-style-type: none"> • Common automatic fiscal stabilisers* • Common semi-automatic fiscal stabilisers (rainy-day funds)* • Common discretionary fiscal measures (investment)*
Financial	<ul style="list-style-type: none"> • Promotion of the single banking market • Common banking supervision (SSM) 	<ul style="list-style-type: none"> • Common Deposit Insurance (EDIS) • Common bank resolution (SRM)
Fiscal-Financial	<ul style="list-style-type: none"> • Common debt issuance (safe assets) to be serviced with common resources* 	<ul style="list-style-type: none"> • Common acquisition of debt • Common bailout of countries (ESM)

* Key elements in a fiscal union. Fiscal tools to manage real shocks (top right of the table) also help prevent derived financial shocks. Source: Author

What is the state of those five elements today in the eurozone, and to what extent do the recent EU decisions stemming from the COVID pandemic, especially Next Generation EU, represent a step towards a fiscal union?

9.3. FISCAL DISCIPLINE: NORMS AND COERCION

In 1997, to make sure that all the future eurozone members would pursue the same fiscal discipline that had been established as a requirement to join the euro – through the ‘convergence criteria’ – the Stability and Growth Pact (SGP) became the cornerstone of the common fiscal framework. The financial crisis of 2008, however, proved that the lack of coordination of fiscal policies was a clear source of instability and that the SGP was insufficient for that purpose. Therefore, by the end of 2011 the SGP was amended (as part of the so-called “Six-Pack”); in early 2013 there came into force the intergovernmental Treaty on Stability, Coordination and Governance (which included the Fiscal Compact); and finally, in May 2013, a regulation on assessing national draft budgetary plans (part of the so-called “Two-Pack”) topped off the EU framework for fiscal policies.

The Stability and Growth Pact (SGP) has two limbs: one preventive, to ensure sound public finances through multilateral surveillance, and another corrective, based on the Excessive Deficit Procedure (EDP). As a result, maximum limits for deficit and debt are

established: public deficit should not exceed 3% of GDP, the structural deficit 0.5% of GDP (1% in those countries where debt is less than 60% of GDP), and debt 60% of GDP. These limits are complemented with the obligation – derived from the Fiscal Compact – to provide correct information and the enshrining of the 0.5% “golden rule” in Member States’ constitutions or in other parts of their national legislation, without which funds from the ESM cannot be accessed. The “Two-Pack” added a provision for common budgetary timelines, monitoring and assessment for all eurozone members – including the automatic triggering of a correction mechanism and enforced rules for countries under an EDP – and a system of enhanced surveillance in Member States suffering financial tensions.

The framework also includes a commitment to hold at least two summits per year among euro member countries, and the establishment of independent bodies to advise on fiscal issues: one for the Commission, the European Fiscal Board (EFB), and one national tax council in each eurozone member country.

Such a framework can only work if rules are simple, clear, and systematically applied. However, the Vade Mecum on the Stability and Growth Pact published by the Commission, even after being reduced to half of its size, still needs 108 pages³. Additionally, rules remain all but clear and they have not been rigorously applied. The European Court of Auditors (2019) has pointed out that “the Commission has so far only limited assurance that the EU requirements for national budgetary frameworks are properly implemented and applied.” Larch and Santacroce (2020) estimate that, on average, budgetary policies have been compliant in just over half of cases, with largely persistent differences across countries⁴. Budget drafts, on the other hand, have only been rejected once (for Italy, in Autumn 2018), but the tension was resolved bilaterally, and not according to the spirit of multilateral surveillance defined in the Treaty, as the European Fiscal Board (2020) correctly pointed out.

The EU fiscal framework is considerably complex, and complexity is always the best recipe for inconsistency. There is a wide consensus that the current framework is inefficient and should be rebuilt and simplified. The EFB (2020) insists on the need for a clear debt anchor and a credible expenditure rule that allows for country-specific adjustment speeds to reach the debt anchor. Crespo et al. (2020), for instance, propose the use of discretionary public spending growth net of discretionary income measures as the main fiscal rule, instead of the structural deficit.

Additionally, the EFB suggests the need for a general escape clause to be activated on the basis of independent analysis and advice, and, in order to strengthen governments’ incentives to abide by the rules, a link between compliance and access to a possible central fiscal capacity.

³ See European Commission (2019). The Vade Mecum of 2017 and 2018 had more than 220 pages.

⁴ Compliance scores range from two-thirds or more in Luxembourg, Sweden, Denmark, Bulgaria, Finland, Ireland and Estonia, to one-third or less in Portugal, Greece, Italy and France.

9.4. COORDINATION OF ECONOMIC POLICIES

The European sovereign crisis showed that the EU needed a better model of economic governance than the isolated system of economic and fiscal coordination which had been in force until then. Before 2011, economic policy coordination was lax except for the 3% excessive deficit limit (although in practice no Member State has ever been fined for breaching it). Since then, the entire system of bodies and procedures for economic coordination has been revised and reinforced.

The coordination of economic policies of the eurozone (and also of other EU member states) is done through the so-called European Semester, a series of months in which there is an exchange of views between EU members, the Commission and the Council, to make sure that budgetary and structural policies guarantee a sound and balanced growth. It runs from November to June (the “national semester” being July to October).

The semester (summarised in Table 2) begins in November with a series of documents presented by the Commission, including: the Annual Growth Survey (AGS), which sets the economic and social priorities of the EU; the Alert Mechanism Report (AMR), which identifies countries with potential macroeconomic risks that need an in-depth review (IDR); and the Opinions on the draft budget plans (DBPs). Those documents are discussed by the Council (and sometimes Parliament) in the following months.

In late February, the Commission issues its Country Reports that orientate Member States’ reform priorities and evaluate the progress of previous recommendations. In March, the European Council approves the EU priorities of the AGS. With all this information, each member country must send in April two documents: the National Reform Programme (NRP), which enumerates structural reforms to be undertaken (as well as strategic investments and expected use of structural funds); and the Stability Programme (termed “Convergence Programme” for countries outside the Eurozone), which details the budgetary policy orientation for the current and three following years, including a Medium-Term Budget Objective (MTO) and an account of how the country plans to achieve it. If the criteria are not met, the Council, based on the Commission’s recommendations, launches then an Excessive Deficit Procedure (EDP) which translates into a closer and more frequent monitoring of the accounts, a corrective action plan with deadlines, and fines in case of non-compliance.

In May the Commission publishes its proposal of Country-Specific Recommendations (CSRs), a list of macroeconomic, fiscal and budgetary reforms to be undertaken. EDP and Macroeconomic Imbalances Procedure (MIP) are then voted on.

In June, the Council of the EU in its different formations, as well as some advisory bodies, analyse and debate the CSRs, which are in turn discussed and formally approved by the European Council in July. Member States are then supposed to actively take these recommendations into account in their legislative strategy and in the national budget for the following year and to report these plans in the submission of the Draft Budgetary Plans.

The coordination will not resume until October, with Parliament's debate and resolution on the European Semester and the start of the debate on the AGS, and the presentation by Member States before mid-October of their DBPs, marking the beginning of a constant dialogue with the Commission.

Table 2. European Semester Calendar

	Member States	Commission	Council / EU Council	European Parliament
November		Annual Growth Survey (AGS) Alert Mechanism Report (AMR) Draft Joint Employment Report (JER) Recommendations for euro area Opinions on Draft Budgetary Plans (DBP)		Dialogue on AGS
December January	Adoption of national budgets	Bilateral meetings with Member States		
February		Country Reports (CR) per Member State		Resolution on AGS
March		Bilateral meetings with Member States	Economic priorities based on AGS	
April	Presentation of National Reform Programs (NRP) and National Stability/Convergence Programs (NSP/NCP)			
May		Proposal of Country-Specific Recommendations (CSR)		
June July			Discussion (EC) and approval (EUC) of final CSR	
August September				
October	Presentations of Draft Budgetary Plans (DBPs)	Assessments of DBPs		Debate/ Resolution on EU Semester Dialogue on AGS

Source: Author, based on information from the EU Commission

So far, the European Semester has been successful in organizing processes, but much less successful in generating recommendations that are eventually followed.

However, Next Generation EU has provided strong leverage for the enforcement of the recommendations of the European Semester by using the latter as the reference for the approval of funds from the Recovery and Resilience Facility (RRF). The lack of clarity of the conclusions of the EU Council of July 2020 regarding which year would be taken as the reference year to evaluate the recommendations was corrected a few months later by the EU Commission through its guidelines for the creation of national Recovery and Resilience National Plans, where they specifically stated that they would not only consider the extraordinary recommendations presented in the year of the pandemic, but “the full set of country-specific recommendations addressed to them by the Council, in particular under the 2019 and 2020 Semester cycles” (European Commission, 2020b). The introduction of a component of intergovernmental control by the Council of the EU can be considered reasonable, as it remains “European” (no individual country has the right of veto of other countries’ national plans). Of course, this increased power of the outcomes of the European Semester will be only linked to the deployment of the RRF funds, but it constitutes an interesting precedent of a good way of creating the right incentives for EU member states to effectively apply sound economic policies.

9.5. AUTOMATIC FISCAL STABILISERS

The EMU was created under the premise that countries would cope with asymmetric shocks by their own means, so in order for them to have fiscal space to do so, a strict coordination (mainly in a negative sense: which fiscal paths not to follow) was required. But coordination, useful though it might be as a preventive tool, is simply not enough to adequately respond to asymmetric shocks that effectively happen. In these cases, asymmetric policies are required.

The frequency of use of these asymmetric policies will crucially depend on the correlation between business cycles among countries of the monetary union. When the euro area was created it was not clear how the cycles would respond. Some thought that, according to the “specialization hypothesis”, monetary union would allow countries to exploit their comparative advantages and increase inter-industry trade (Draghi, 2019). This would expose countries to different industrial shocks, so business cycles would become less correlated. The alternative view, based on the “endogeneity hypothesis”, held that the euro would lead to greater intra-industry trade. Industrial structures would therefore become more similar and cycles more synchronised.

What happened, however, is that the vertiginous speed of global value chains led to both a diversification and a synchronisation at the same time, since now demand shocks are transmitted along the whole supply chain. In fact, trade along value chains has been found to generate more synchronisation than trade in final goods. Campos et al. (2017) find in a meta-study that membership of the monetary union explains at least half of the overall increase in business cycle correlation among euro area countries since 1999.

But this is not enough. While business cycles are now more synchronised, their amplitude across the euro area countries has diverged, at least since the crisis (Franks et al., 2018). Moreover, the pandemic of COVID-19 is a good example that common shocks can have asymmetric effects due to different economic structures and levels of public debt.

Therefore, standard fiscal tools are required to stabilise economies. Normal monetary unions usually take advantage of automatic stabilisers, mechanisms built into government budgets that automatically increase spending or decrease taxes when the economy contracts, thus offsetting part of the impact of the shock. Unfortunately, the EMU architecture relies on decentralised national fiscal policies, so the stabilisation function of fiscal policy is expected to be exerted at national level (within the limits of the SGP). Member States are therefore all alone in the task of responding to country-specific shocks. This, compared to federal states such as the United States or Canada, is inefficient.

There are two types of solutions. The first and less ambitious would be to create a common fund that could be used by countries experiencing economic downturns, a budgetary buffer built in good times that can be used during recessions. This contingency fund, popularly known as “rainy day fund”, is very common in the United States, normally established at state level and often complemented with another one at federal level to cover possible problems during hard recessions.

Such a mechanism could focus on asymmetric shocks or even address shocks that are common to the euro area. In any case, it should avoid “permanent transfers” across countries, so no country should be a net loser or gainer for a long time. Therefore, net transfers should not depend on absolute income differences – that can persist over the years – but on differences in cyclical positions.

The second solution would be an unemployment insurance system. Several types of euro area unemployment insurance arrangements have been proposed, among them a minimum common unemployment insurance (Allard et al., 2013), a common basic benefit scheme (Direction Générale du Trésor, 2014), a complementary European unemployment insurance scheme (Emmanouilidis, 2014), or a reinsurance of national unemployment benefit schemes (Beblavý et al., 2015). The European Commission presented in 2017 a list of the advantages and disadvantages of 18 alternative European unemployment benefit schemes (EUBS), with possible solutions to avoid moral hazard based on the history of usage (European Commission, 2017).

The German and French governments apparently took the baton in the Meseberg Declaration of 19 April 2018, when they committed to “examine the issue of a European Unemployment Stabilisation Fund, for the case of severe economic crises, without transfers”, but it never materialised, and in 2019 it seemed to be subsumed in the project of a general stabilisation function budget.

The pandemic brought, however, the creation of a European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE). It is not a complementary insurance scheme (not automatic, for sure), but at least it alleviates the financial costs for Member States of supporting short-term work schemes and similar measures to reduce the risk of unemployment and loss of income. Underpinned by a

system of voluntary guarantees from Member States, so each member’s contribution to the overall amount of the guarantee corresponds to its relative share in EU’s Gross National Income (GNI), the SURE system provides loans to Member States. Apart from its value-added of increasing Member States’ fiscal margin available during this crisis, it has several advantages: it is the Commission’s debt financing mutualised expenses; it is not based on the infamous Memorandums of Understanding present in the European sovereign debt crisis; the supervision of recipient countries falls to the Commission; and the instrument does not entail preferential creditor status, unlike the ESM instruments. Although in the unlikely event of a Member State’s sovereign debt restructuring the negotiation would be more political than legal, this detail is important in terms of signalling to the market (Crespo et al., 2020).

It is too soon to foresee whether the SURE mechanism could one day become a permanent mechanism to soften the impact of unemployment asymmetric shocks (that would include mechanisms to prevent moral hazard) but, as always happens with European Union policies, it is always convenient to have a legal precedent.

9.6. DISCRETIONARY FISCAL STABILISATION MEASURES

Automatic stabilisers are useful to cushion the impact of asymmetric shocks on households and companies’ income. But sometimes the decline in private demand can only be compensated from the public sector’s side with discretionary public measures. That is the purpose of public investment reinforcements. The problem is that, especially in the case of countries with high levels of debt, public investment spending is always the first sacrifice on the altar of an economic crisis. The European Financial Board has advised that the option of implementing an investment protection scheme is superior to the alternative fiscal stabilisation instruments in the short run (European Fiscal Board, 2017).

After the financial crisis, in November 2014, the European Commission launched an Investment Plan for Europe (EC IPE), also known as the “Juncker Plan” or the EU Infrastructure Investment Plan (EIIP), but this was only a temporary measure⁵. The proposal to create a common fund to finance national investment projects in case of asymmetric shocks came only in 2017, with the Commission’s proposal of a European Investment Stabilisation Function (EISF). It was designed as a back-to-back operation, with funds raised by the Commission through borrowing on the financial markets being lent to the Member State in difficulties (measured by an unemployment criterion). Member States

⁵ The Investment Plan for Europe has three pillars: the European Fund for Strategic Investments (EFSI), a managed account created in 2015 within the European Investment Bank (EIB) which uses public funds to mobilise additional private investment and give guarantees; an European Investment Project Portal providing information and a European Investment Advisory Hub providing technical assistance and support; and a strategy to improve the business environment particularly for SMEs. The fund, the hub and the portal will be integrated in the InvestEU programme within the Multiannual Financial Framework 2021-2027.

would be committed to maintain the average level of public investments of the past five years, with a maximum of 30 billion euros and subject to recommendations under the fiscal and macro-economic surveillance framework.

The debate over the EISF fell into the same moral debate of many other EU instruments of risk-sharing: the possibility of some countries overusing the instrument at the expense of others. However, it does not seem very difficult to design safe mechanisms to discourage the repetitive use of the funds by hardening access conditions. In any case, it fell into oblivion in 2018 and the European Council decided to replace it with a mere financial budget instrument for convergence and competitiveness (BICC) within the EU budget but excluding a stabilisation function.

The approval within Next Generation EU of the Recovery and Resilience Facility, which is precisely an investment instrument, has put the idea of an EISF on the back burner. However, they are not the same thing: Next Generation EU is supposed to be a one-off initiative, whereas the EISF would be available whenever a country experiences an economic downturn. In any case, some of the mechanisms devised to guarantee proper use of NGEU funds might prove useful for a future design of more permanent solutions.

9.7. CREATION OF A SAFE ASSET

In a monetary union, countries issue debt in a currency that is not strictly their own. As bluntly put by De Grauwe (2011), “member countries of a monetary union are downgraded to the status of emerging economies.” This lack of control makes countries vulnerable to financial markets, which can force them into default.

The creation of European bonds is justified by at least five reasons. First, the absence of a safe asset leads to financial fragmentation, as capital flows concentrate in assets of countries with better economic fundamentals (this fragmentation is stressed in moments of financial instability, when safe assets are quickly accumulated). Second, insofar as public debt is actively used by banks, a Eurobond will reduce the dangerous link between sovereign risk and banking risk that was dramatically seen in the past financial crisis. Third, financial fragmentation makes monetary policy much more difficult, as a European asset would provide a single risk-safe yield curve for all eurozone members. Fourth, such an asset, in a wide and liquid market, would improve financial integration and reduce financial costs for both the public and the private sector. And last, but not least, Eurobonds would strengthen the role of the euro as an international reserve asset (Hernández de Cos, 2018).

After the euro crisis of 2010, and in view of the lack of political support for further steps towards fiscal union, several proposals were put forward in a technical attempt to reduce the sovereign debt risk, either by increasing risk diversification or by creating different senior tranches of debt.

The most ambitious way of eliminating sovereign risk is, of course, replacing national debt – fully or partially – with a kind of “European debt” backed by a joint and several

guarantee of all Member States. That was the idea behind the “Stability Bonds” of the EU Commission Green Paper (2011), but it implied a total refurbishing of the Treaties. A second possibility was to divide national debt into two tranches: a first tranche of up to 60% of GDP (‘blue bonds’) with senior status and a joint and several guarantee; and a second tranche including all debt beyond 60%, issued as national ‘red’ bonds with junior status (Delpla & Von Weizsäcker, 2010). This possibility would provide a safe asset and at the same time encourage fiscal discipline, although in case of crisis the cost of ‘red’ bonds could skyrocket and become unacceptable, or create incentives for political pressure to change the debt limit.

Several proposals emerged then in an attempt to dispense with the need for a joint and several guarantee. First came the idea of creating securities backed by a diversified pool of euro area sovereign bonds and segmented into tranches arranged in an order of seniority (Brunnermeier et al., 2016). It was believed that, if the segment of junior tranches were big enough (30%, at least), the senior tranche (composed of European Senior Bonds, or ESBies) could be rendered as low-risk in terms of expected loss rate as a German government bond, without the need for further Member State guarantees. The advantage would be that, if issued in sufficiently large volumes, it could replace national sovereign bonds on bank balance sheets, thus contributing to financial stability and reducing financial fragmentation.

But there are shortcomings. Ultimately, the idea of ESBies is equivalent to a senior tranche of a collateralised debt obligation (CDO), in which many assets (typically corporate bonds and/or loans) are also sliced into different tranches. Senior tranches of CDOs can effectively enjoy a high credit rating, but the underlying pool of assets is normally discrete (each tranche is relatively small) and non-correlated. In the case of ESBies, however, sovereign bonds are limited to 19 – with some like Italy representing a substantial portion – and are highly correlated, thus making them a worse diversification tool than CDOs (Kraemer, 2017). Furthermore, De Grauwe and Ji (2018) have stressed the potential difficulties for junior bonds to be sold during crises and the likely increased cost of national bonds, had they to compete with ESBies.

The European Systemic Risk Board (2018) has analysed the technical and practical implications of developing sovereign bond-backed securities (SBBS) to facilitate the diversification and de-risking of sovereign bonds without mutualising sovereign risks, and concluded that such a solution would only work if accompanied by a regulation for banks and non-banks, and probably changes in the regulatory treatment of sovereign exposures (RTSE).

Those difficulties paved the way to more ambitious solutions, where a supranational institution could take charge of issuing debt. There are several options: an institution that issues debt against its own capital (the safety coming in this case not from tranching, but from the capital cushion of the institution – that is why this solution is called ‘capitalisation approach’), or against a diversified portfolio of sovereign bonds of the euro area (using diversification, but replacing the seniority of the tranches by the seniority of the issuer –E-bonds approach), or against a portfolio of assets which, in turn, can be invested internationally so the returns accrue to capital (wealth fund approach). Leandro and

Zettelmeyer (2018) have come to the conclusion that a safe asset issued by an intermediary that is both senior and endowed with a small capital cushion would lead to values at risk that are equal to or lower than those of ESBies, even in correlated default events affecting most euro area sovereigns.

Although the debate about a safe asset seemed to have come to a standstill, with Merkel apparently telling a group of Parliament deputies that there would be no Eurobonds “as long as she lived”, the pandemic changed everything. Extraordinary times call for extraordinary measures, and between the Eurogroup proposal of 9 April 2020 (ratified by the European Council of 19 May) and the joint proposal of the French and German governments of 18 May 2020 for an “Initiative for the European Recovery from the Coronavirus Crises” translated into the formal proposal of the Commission of 27 May and eventually fine-tuned in the long European Council special meeting of 17-21 July 2020, at least three types of European assets have emerged that represent a fundamental leap in terms of common debt.

First, the European Stability Mechanism (ESM) Pandemic Crisis Support, a sovereign credit line with the only requirement that “the euro area Member States requesting support would commit to use this credit line to support domestic financing of direct and indirect healthcare, cure and prevention related costs due to the COVID 19 crisis”, detailed in an individual Pandemic Response Plan. The debt is guaranteed by the capital of the institution (it is therefore a ‘capitalisation approach’). The lack of a specific conditionality for the proceeds of this debt (except for a guarantee of proper use of the funds) is quite relevant for a credit line of an intergovernmental institution such as the ESM. Nevertheless, this instrument has not yet been used.

Second, the European instrument for temporary Support to mitigate Unemployment Risks in an Emergency (SURE), which is common debt issued by the Commission with the only requirement that its funds be used in public expenditure for the preservation of employment. As already mentioned, the debt is in this case backed by voluntary guarantees from Member States. The Council has already approved a total of €87.9 billion, based on proposals from the Commission; the first instalments, worth €17 billion overall, have been disbursed to Italy, Spain and Poland after a successful issuing of two types of ‘Social Bonds’, one for €10 billion due for repayment in October 2030 and the other for €7 billion due for repayment in 2040⁶.

The third ‘European bond’, and the most important, will be the debt issued by the Commission to cover the expenditure of Next Generation EU. Its importance stems from the fact that this European debt, to be repaid between 2028 and 2058, is not only *guaranteed* by future European budgets, but also *repaid* from the budget. The European Council considers this case exceptional and has been very clear in limiting the power of the Commission “to borrow funds on the capital markets on behalf of the Union up to

⁶ The bonds were more than 13 times oversubscribed. The final new issue premiums have been estimated at 1 bp and 2 bp for the 10-year and 20-year tranches respectively, both values being extremely limited given the amounts printed (European Commission, 2020c)

the amount of EUR 750 billion in 2018 prices” by specifying that “new net borrowing activity will stop at the latest at the end of 2026” (European Council, 2020). But it has nevertheless allowed the repayment of principal through a temporary increase by 0.6 percentage points in the amount of the own resources’ ceiling until the debt is cancelled (no later than 31 December 2058).

The specifics are left to a future Decision on the system of own resources, opening up the possibility of calling for resources from Member States “on the basis of the respective applicable GNI keys”. So, if eventually there were no funds from new own resources, “the Commission could provisionally call more resources from Member States as last reserve (...) on a pro rata basis and, in any case, limited to their share of the temporarily increased own resources ceiling, i.e., 0.6% of Member States’ GNI.”

In other words, the proceeds to repay the 390 billion euros in transfers (the 360 billion euros in loans, of course, will be repaid by the creditors), i.e., the common expenditure, will come from new own resources. And if these new resources are not enough, from Member States, on a pro rata basis according to the GNI key.

There are several points here to be highlighted. First, the 390 billion euros in transfers will be pure transfers only to the extent that the EU is able to generate new resources. If it is not, then a part of those transfers will become a sort of zero-interest loans (albeit with a component of transfer, as the amount received by the countries most affected by the pandemic will always be lower than their theoretically due GNI-based share). Second, the premium to be paid by the EU for the issuing of the NGEU bonds will not only depend on the EU’s credit rating (currently AAA from all agencies except Standard & Poor’s, who gives AA), but also on the appeal of the bond issue. In this regard, the bigger the issuance, probably the bigger the appetite of the market for those bonds. In this context, the reluctance of several Member States to apply for loans (resorting in principle to national debt issuance) is to the detriment of the size of the number of NGEU bonds in circulation, and thus their liquidity⁷. And third, the bigger the issuance of NGEU bonds, the more appropriate as an experiment of what a Eurobond could be in terms of an investment asset for banks as collateral for monetary policy. It would be a pity that, once we have a sort of Eurobond, its issuance is limited by the lack of interest of the Member States that precisely would benefit the most from the existence of a common safe asset.

9.8. A HAMILTONIAN MOMENT? IT DEPENDS ON OWN RESOURCES

The Commission will issue European debt to obtain the resources for Next Generation EU. In that regard, common debt is one side of the Hamiltonian moment. But the other side, as important as the first, will come when the Own Resources Decision

⁷ In this regard, the ECB is clearly concerned that the EU misses this opportunity to issue a sufficient amount of European recovery bonds (a safe asset) and has conveyed – so far only informally – the need for Member States to ask for RFF loans (instead of taking for granted the guarantee of national debt’s safety through central bank’s asset purchases).

is developed. This legal act authorises the full amount of the borrowing to be used for exceptional expenditure and for loans to Member States.

This is not a minor issue: according to the TFEU, all the Union's activity must be financed within the limits of the multiannual financial framework (MFF) and own resources, and institutions must ensure that the Union can satisfy its financial obligations towards third parties. Therefore, liability from borrowing is only allowed if the Union can repay the debt including interest. This requires an own resources ceiling which secures sufficient resources each year to cover the Union's liability, as well as a mechanism ensuring the availability of resources in all circumstances. The proposed amendment to the proposal for the new Own Resources Decision makes sure that these pre-requisites of budgetary discipline are fulfilled, given that the Own Resources Decision "is of quasi-constitutional nature" (European Commission, 2020a).

The current Own Resources system rests on three main categories of revenue: Traditional Own Resources (mainly customs duties), a Value Added Tax-based Own Resource, and the Gross National Income-based Own Resource. In practice, the non-genuine EU Own Resources (VAT and GNI), which are in fact just national contributions to be made available by the Member States to the EU budget, have become the predominant components. In 2011, against the background of the financial crisis, the Commission proposed to simplify the Value Added Tax-based Own Resource and to create a new Own Resource based on a Financial Transaction Tax. This new tax was supported by the European Parliament, but never attracted a unanimous agreement among Member States. In 2018, the Commission proposed a basket of three new resources: a share of a Common Consolidated Corporate Tax Base, a share of the auctioning revenue of the European Emissions Trading System and a national contribution calculated on the amount of non-recycled plastic packaging waste. The EU Council of July 2020 agreed on the latter, a new own resource based on non-recycled plastic waste to be introduced as of 2021 and invited the Commission to come forward with a revised proposal linked to the Emissions Trading System (ETS) and to develop a new border carbon adjustment mechanism and a digital levy. But agreeing on those own resources appears to be a difficult task⁸.

The key issue is that an additional rule will allow the Union "to call on resources from the Member States where, in a given year, the authorised appropriations entered in the budget are not sufficient for the Union to comply with its obligations resulting from borrowing". So, if the EU is not able to increase its own resources and use them to pay the incurred debt, then the Member States will have to provide funds from their budgets.

⁸ While this article was being edited, the Council adopted in December 2020 the Own Resources Decision (which will require ratification by all Member States). It creates a new national contribution based on non-recycled plastic packaging waste and paves the way for other common resources to be negotiated, including a carbon border adjustment mechanism and a digital levy (expected for 2023), as well as a possible Financial Transaction Tax (with no date foreseen). Although the political will exists, the effective approval and implementation of these new resources remains to be seen.

And if, at that time, a specific member cannot honour its obligations, no country will pay for it.

Therefore, in this extreme case, the guarantee of the debt will prove to be not joint and several, and Next Generation EU could only be considered as a deferred payment, a zero-interest rate loan with a component of transfer (given that the amount of the NGEU received by Member States will depend on need, and the repayment will be based on a GNI key). A mutualisation of risk? Yes, but only partially. Only if Member States agree to create new resources that fully repay the debt (i.e., common debt paid with common resources) will we be witnessing something more like a true Hamiltonian moment.

9.9. CONCLUSIONS

The fiscal union remains the unfinished business of the euro architecture. With every crisis, the evidence of structural defects in the construction of the economic and monetary union becomes more and more evident.

The COVID-19 pandemic has slightly pushed forward the fiscal union in a subtle way. A fiscal union requires a clear fiscal framework, economic policy coordination, common automatic fiscal stabilisers, common discretionary public investment tools and a safe asset. The escape clause of the Stability and Growth Pact has served as a good reminder that the fiscal framework should be redesigned to make rules simpler and easily enforceable. The SURE mechanism to reduce the financial costs of national employment-support measures (without any strings attached) could one day become an automatic fiscal stabiliser for the Eurozone. The close link between the funds of the Recovery and Resilience Facility and the structural reforms defined in the European Semester serves both as a reinforcement of the economic policy coordination and a reminder that common investment-related fiscal discretionary measures can be designed with mechanisms to reduce moral hazard.

This strict but understandable conditionality of the RRF is perfectly compatible with the fact that the ESM Pandemic Support credit line and the SURE mechanism are linked only to a proper use of funds. It is a clear sign that different types of financial support to Member States in distress can have different levels of control.

Even though those measures are, in principle, temporary, and we cannot assert that the reluctance of many Member States to undertake further fiscal integration has substantially changed, we are at least witnessing legal precedents which, in a juridical entity such as the EU, could pave the way to potential future integration steps. And this is a reason for moderate optimism.

As for the debt of Next Generation EU to finance non-refundable investment spending, we will have to wait for the implementation of the Own Resources Decision to see if the EU is really using common resources for a common problem or just advancing money that will eventually have to be partially reimbursed to the EU budget. If common debt that finances common spending is eventually repaid with new common resources, we

shall be able to invoke – albeit remotely – the spirit of Alexander Hamilton, and dream that we are seeing the embryo of a potential safe European asset.

After all, the process of European integration has always been a fragile equilibrium between expectations, promises, ploys and effective decisions. It is well known that the Compromise of 1790 reached by Alexander Hamilton with Jefferson and Madison implied both the assumption of state debts and the location of the permanent national capital in the South. But historians like Endling (2007) have shown that, in that negotiation, the assumption was the critical issue and the location of the capital was just a bargaining ploy. Hamilton managed to force the payment of the face value of state debts, overruling Madison's intention to pay speculators less than 100%.

Likewise, Next Generation EU will effectively become a step towards fiscal union only if the future 'European' resources allow for repayment of 100% of the debt. The result of the implementation of the Own Resources Decision is therefore the critical issue; the mere creation of common debt, while relevant and helpful to reinforce the role of the euro as an international reserve asset, is, for fiscal union purposes, just a bargaining ploy.

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10. HOW TO IMPROVE SMALL AND MID-SIZED BANK CRISIS MANAGEMENT?

ANTONIO CARRASCOSA¹

10.1. INTRODUCTION

Bank crisis management is always challenging, as a consequence of banks' function in the economy, size, business and funding model, etc. The European Union, in line with the requirements of the Financial Stability Board (FSB)², has issued a set of banking resolution rules³. However, these are mostly applicable to large banks. All banks subject to this European framework can be resolved through uniform and efficient rules (single authority, resolution tools, single resolution fund, etc.). What happens with smaller banks? In this case, national, non-harmonized rules are applicable, namely: national insolvency proceedings and the national transposition of the Deposit Guarantee Schemes Directive (DGSD)⁴.

This article analyses different alternatives aimed at achieving a more homogeneous and efficient small and mid-sized bank crisis management framework. First, we shall focus on a key concept that will allow us to identify which banks should be resolved and which ones should be liquidated: public interest. We shall also discuss the possibility of

¹ The author is a former Board Member at the Single Resolution Board (2015-2020). He thanks Mario Delgado, Enrique Ezquerro and Sonia Pérez Romero for their comments.

² Financial Stability Board (2014).

³ Directive 2014/59 of the European Parliament and of the Council of 15 May 2014, establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD); Directive 2019/879 of 20 May 2019, amending the former one (BRRD2); Regulation 806/2014 of the European Parliament and of the Council of 15 July 2014, establishing uniform rules and a uniform procedure for the resolution of credit institutions and certain investment firms in the framework of a Single Resolution Mechanism and a Single Resolution Fund (SRMR); and Regulation 2019/877 of 20 May 2019, amending the former one (SRMR2).

⁴ Directive 2014/49 of the European Parliament and of the Council of 16 April 2014.

widening the scope of banks to be resolved under the European framework. Secondly, we shall pay attention to two alternatives to overcome the snags of having different national insolvency proceedings: a single European insolvency framework for small and mid-sized banks and the full or partial harmonisation of those national proceedings. Thirdly, we shall discuss the alternative measures that may be applied within the DGSD to achieve a more efficient liquidation of those banks, while identifying some obstacles to their application and options to make them operational. It is noted that these measures are compatible with any of the alternatives we shall mention for the insolvency regimes. Finally, we shall revise the application of the State aid regime to the financial sector, emphasising some misalignments with the resolution framework.

10.2. PUBLIC INTEREST

10.2.1. DEFINITION⁵

The presence of public interest to resolve a bank is needed to justify a measure that goes against the fundamental right to private property: that is, resolution is admissible only if there is an overriding interest. In particular, the existence of this interest is linked to fulfilment of the “resolution objectives”: resolution is justified mainly to ensure the continuity of the bank’s critical functions and to avoid significant adverse effects on the financial system, in particular, by preventing contagion, including to market infrastructures⁶.

The Single Resolution Board (SRB) must assess if these objectives are met by applying the national insolvency proceedings to the bank. Only if these objectives are better met by resolving the bank is the SRB’s action justified (i.e. there is public interest in the resolution). This public interest must be assessed when the supervisory authority (or, in some cases, the resolution authority) determines that the bank is failing or likely to fail, although a preliminary assessment is done when the annual resolution plan of the bank is drawn up (or updated).

This close relationship between the concepts of resolution and liquidation raises some questions. Let us suppose that the insolvency rules of a Member State are inefficient and cumbersome. In this case, it will be more difficult to meet the resolution objectives through the liquidation of a bank, and thus we could end up having more resolution cases and fewer insolvencies. The SRB applies similar criteria to the banks of different Member States, but following the pertinent national laws, so the public interest

⁵ Single Resolution Board (2019).

⁶ There are other resolution objectives in the BRRD and the SRMR: to protect public funds by minimising reliance on extraordinary public financial support; to protect depositors covered by the DGSD and investors covered by Directive 97/9/EC; and to protect client funds and client assets. The minimisation of resolution costs and the need of avoiding value destruction are also mentioned in the BRRD and the SRMR.

assessment for similar banks in different countries can produce different outcomes. For this reason, the SRB has repeatedly called for clarity and efficiency in these insolvency regimes. Ideally, these regimes should be homogeneous.

Regarding the objective of preserving the continuity of critical functions, there are two key elements for consideration: first, it must be determined whether the bank performs critical functions or not; and second, an assessment must be made as to whether the failure of the bank puts at risk the provision of those critical functions.

How to assess the criticality of some of the banking functions?⁷ Critical functions are defined in Article 2(1) (35) of the BRRD as “activities, services or operations the discontinuance of which is likely in one or more Member States, to lead to the disruption of services that are essential to the real economy or to disrupt financial stability due to the size, market share, external and internal interconnectedness, complexity or cross border activities of an institution or group, with particular regard to the substitutability of those activities, services or operations”. That is, the sudden interruption of these functions significantly harms their users and negatively affects the financial stability of a Member State (or the European Union). This impact depends on the market share of the bank and on the level of substitutability of these functions by other entities.

Generally, the criticality of a function is linked to its systemic relevance for third parties and the systemic relevance of the bank providing that function. The recovery plan prepared by the banks is the starting point for the work of the SRB and in its assessment considers the reports published by the FSB⁸ on the likely critical functions: deposits; lending; payment, cash, settlement, clearing and custody services; capital markets; and wholesale funding (and the corresponding subfunctions).

The identification of critical functions is a key step for the resolution authority in drafting the resolution plan (and when a bank prepares its recovery plan) and the outcome affects the determination of the minimum requirement for own funds and eligible liabilities (MREL) and the assessment of the bank’s operational and financial continuity, as well as the selection of the preferred resolution strategy, the resolvability assessment and the identification of impediments to resolvability⁹.

The assessment of the impact of a failing bank on the financial stability of one or more Member States refers to the possible direct and indirect ways of contagion to other parts of the financial system that could impact its stability. So, the direct contagion derives from the transmission of losses via own funds and debt instruments issued by the failing bank and acquired by other banks, as well as other interbank exposures; but losses transmitted to final savers, for example, do not create contagion effects (indeed, someone has to bear the losses). The indirect contagion is related to the existence of common exposures with other banks, the close correlation of spreads with other entities, the evolution of banks with a similar business model and risk profile, etc.

⁷ Single Resolution Board (2018).

⁸ Financial Stability Board (2013).

⁹ Carrascosa (2019).

In this analysis of financial stability and in relation to the objective of protection of covered deposits, we should include the impact on the DGS and, especially, on the banks paying the extraordinary contributions that should be raised to pay out the covered deposits in the case of liquidation. This impact is a modality of indirect contagion on the banking system as a consequence of a bank failure. However, note that a DGS funding gap does not necessarily imply a positive assessment of the public interest.

Finally, a few words on the debate surrounding the suitability of disclosing the assessment of public interest performed by the SRB in annual resolution plans. This publication would have a major disadvantage: the assessment done in the resolution plan may differ from the one done at the moment of the failure of the bank, as a consequence, for example, of the downsizing of its balance sheet. This line of argument can be appropriate for a mid-sized bank, but it is not realistic for large and very large entities. So, with the pertinent caveats and warnings, we would support more disclosure on the public interest assessment for large banks.

10.2.2. MAKING THE PUBLIC INTEREST ASSESSMENT MORE INCLUSIVE

The BRRD and the SRMR set the criteria for this assessment: if the liquidation of a bank meets all the resolution objectives to a greater extent than applying resolution tools to it, then that is the best option and there is no public interest in its resolution. In general, the SRB has taken a rather restrictive stance in interpreting this rule¹⁰, though it has indicated¹¹ that it is reviewing policy on this area. Any attempt to reform or redefine the assessment should respect that principle, although its interpretation by some Member States (e.g. Denmark) is completely different: in practical terms, it seems that all Danish banks can be resolved¹².

As any rule is subject to interpretation, we can see ways to make the assessment more flexible and, therefore, to increase the number of bank failures that would be addressed according to the European resolution framework. The first alternative is to consider a smaller geographical scope for the objective of ensuring the continuity of critical functions and preserving financial stability, for example, regional or local. It is recalled that the consideration of a national geographical scope led to the liquidation of Veneto Banca and Banca Popolare di Vicenza after the “failing or likely to fail” (FOLTF) decision taken by the European Central Bank (ECB). These banks went to liquidation with State aid, which resulted in a different treatment for some of the banks’ creditors compared

¹⁰ “In a nutshell: resolution is for the few, not the many”. In König, Elke (2020a).

¹¹ König, Elke (2020b).

¹² The lack of liquidations in Denmark does not mean a lack of burden sharing for the bank’s shareholders and creditors, as laid down in article 33 of the BRRD. See the letter sent by the Danish authorities to the European Banking Authority (EBA) of 13 September 2018 on the resolution of a bank: <https://eba.europa.eu/sites/default/documents/files/documents/10180/2386047/0e565d84-a113-45c1-b188-14e11ad276b0/Notification%20from%20Finansiel%20Stabilitet%20%282%29.pdf?retry=1>

to an alternative resolution scenario, due to the more benign burden-sharing regime of the EU State aid framework¹³ compared to the BRRD/SRMR. Different European rules, based on different criteria to identify public interest, led to a negative public interest assessment by the SRB and a positive one by the European Commission.

Another alternative of a flexible approach is to consider that there is public interest if the bank is classified as national systemic, regardless of the fact that one or more resolution objectives may be met. In this case, ABLV could have been resolved and not liquidated, as the bank was considered as national systemic by the Latvian authorities, pursuant to EBA standards. In any case, we must again bear in mind that the SRB or any resolution authority can make one assessment in planning and another at the moment of the FOLTF decision.

Indeed, as some national authorities have also suggested, a bank with a preliminary negative public interest assessment could be resolved in a scenario of systemic crisis. The challenge could be that these banks might not have built up enough MREL. Therefore, to make this proposal consistent, it would be advisable to simply draw up resolution plans for all European banks with an MREL corresponding to a resolution strategy.

Some authors¹⁴ put forward other alternatives, as they consider that the public interest assessment should result in the SRB managing the crisis of banks with significant financial needs for their resolution or liquidation. For example, Garicano suggests that the assessment should be positive for all the banks within the scope of the SRB (i.e. banks under the supervision of the ECB (Single Supervisory Mechanism, SSM) plus cross-border banks)¹⁵ and some objective thresholds (based on total assets or market shares) should be set with an automatic positive assessment beyond those thresholds¹⁶.

Resolution authorities should try, when pursuing the resolution objectives, to minimise the cost of resolution and avoid destruction of value unless necessary to achieve the resolution objectives. Indeed, it is not easy to operationalise these goals. A similar conclusion can be reached regarding the strength of market discipline and the introduction of incentives to ease market solutions as a way to achieve the resolution objectives.

As the SRB has taken decisions based on current criteria, it may be prudent to wait for a legislative change before implementing any significant reform of the policy.

10.2.3. IMPACT OF THE FLEXIBILISATION ON MREL

It is worth noting that a more flexible public interest assessment may have significant effects on MREL. If the SRB finds in the planning phase that, in case of failure, the

¹³ European Commission: “Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis”, 30 July 2013.

¹⁴ See, for example, Garicano, Luis (2019).

¹⁵ Angeloni, Ignazio (2020) supports this proposal.

¹⁶ Objective thresholds are used in the UK, but the SRB has tried to catch, with other tools, the peculiarities of every individual bank. Some thresholds have been introduced in the BRRD2 to set when the subordination of MREL instruments is compulsory (€100 billion of total assets).

bank can be wound down under normal insolvency procedures, the required MREL is equal only to its own funds requirement. However, if the plan foresees that it would go to resolution, according to legislation and the SRB MREL policy¹⁷, the required MREL would normally be about twice as much. But small and mid-sized banks would generally struggle to meet this higher requirement, as they often do not have the possibility to issue MREL instruments. In that case, the resolution authority would be left with no alternative but to bail in uncovered deposits in case of failure, triggering likely financial stability problems (as a consequence of deposit runs).

An alternative for these banks could be to use the Single Resolution Fund (SRF) to avoid the absorption of losses by uncovered depositors without complying with the 8% rule (i.e. the requirement to bail in at least 8% of total liabilities before using the SRF). Nevertheless, this would require a regulatory change, which does not seem likely in the near future.

Maybe it is more realistic to work on the operationalisation of the transfer strategies, especially the sale of business, aimed at these smaller banks. Such strategies could require a lower amount of MREL. Indeed, the SRB MREL policy already considers the peculiarities of those strategies. Making these strategies more operational and therefore improving banks' resolvability may well be a driving force for a further adaptation of MREL requirements.

MREL is considered, sometimes, as necessary only for a bail-in strategy, but this is not correct. The credibility of any resolution strategy requires a solid capacity for loss absorption. For example, when applying the sale of business, losses could exceed the "loss absorption amount" (own funds). MREL requirements could be lower only if the strategy is credible: this requires a suitable market structure for the transaction (i.e. potential acquirers), excellent capabilities for the bank to provide with information and a high level of separability of assets and liabilities.

10.3. INSOLVENCY RULES

10.3.1. INTRODUCTION

Nowadays every Member State has its own insolvency rules and procedures. We can cite many examples of this diversity of rules. As to the applicable liquidation regime, whereas Ireland and Italy have a specific regime for banks, in Germany, France and Spain banks are liquidated following general rules. Moreover, Greece, Italy and Slovenia

¹⁷ SRB MREL policy can be found here:
https://srb.europa.eu/sites/srbsite/files/srb_2018_mrel_policy_-_first_wave_of_resolution_plans.pdf
https://srb.europa.eu/sites/srbsite/files/public_mrel_policy_2018_-_second_wave_of_plans.pdf
https://srb.europa.eu/sites/srbsite/files/srb_mrel_policy_update_2020.pdf

have administrative insolvency procedures, while Ireland, Luxembourg and the United Kingdom follow judicial procedures¹⁸. There are other examples of different national rules with regard to the availability of liquidation tools, the insolvency hierarchy, etc. This heterogeneity results in a different treatment for shareholders and creditors of a failing entity, depending only on the national legislation to be applied.

A basic principle of banking resolution is that a creditor cannot be worse off in resolution than in liquidation (NCWO). If every jurisdiction has its own insolvency proceedings, to apply the NCWO principle may be complex, especially if for a cross-border bank. This problem could favour litigation against resolution decisions and a higher risk of using the SRF.

How to solve this situation? We should propose measures to tackle two problems surrounding national insolvency regimes. Firstly, the lack of homogeneity of these rules. The optimal solution would be a Regulation laying down a single (European) regime, directly applicable to bank liquidation (normally small and mid-sized banks). As the DGS plays a key role in bank liquidations, we should add the approval of a European Deposit Insurance Scheme (EDIS). However, as this solution is only realistic in the long term, we could move forward harmonising national rules as much as possible: just as the European regulator has done recently with the insolvency ranking, the tools to be used in the liquidation of banks could also be harmonised. A second issue is the lack of efficient insolvency rules. In this case, the optimal solution would be to have an efficient regime for application at European or national level. Considering both problems, the optimal solution would be a European insolvency regime with efficient procedures.

Consequently, the homogenisation of national insolvency proceedings to be applied to banks should be a key part of the political agenda to complete the Banking Union. The goal should be to have a European liquidation regime, as we have for resolution.

10.3.2. ELEMENTS OF AN EFFICIENT LIQUIDATION REGIME

A **specific liquidation regime for banks** is advisable because they perform vital functions for an economy and show some significant peculiarities with regard to other companies: banks have a role in money creation, the possibility of deposit runs, banks have franchise value only as a going concern, the possibility of crisis spreading to other banks with similar business and funding models, etc. Such recommendation is also supported by the fact that the liquidation of a bank requires high technical skills.

In this specific legal regime, the traditional goal of maximising the recovery of value for creditors is complemented with those of **protecting depositors and ensuring financial stability**. That implies that the role of ordinary creditors is less significant than in a general insolvency regime applicable to corporations in general.

¹⁸ Baudino, Patrizia, A. Gagliano, E. Rulli y R. Walters (2018).

In designing a specific regime for banks, we have to opt for **administrative proceedings or for judicial ones**. The arguments we put forward to justify a specific liquidation regime for banks tend to support administrative proceedings. Moreover, as there are public institutions with a lot of experience managing bank crises, the resolution authorities, they could be the liquidator of failed banks (or be in charge of appointing the liquidator), and could open the proceedings - on the understanding, of course, that any creditor may have recourse to court should he consider himself harmed by the liquidation.

Administrative proceedings have clear advantages: in particular they should be able to manage liquidations faster, which is crucial when tackling a bank failure (especially, because of the need to protect depositors). Nevertheless, faster proceedings could also imply more litigation (as creditors might consider that they have lower protection under an administrative regime). Some measures may mitigate this higher risk of litigation: for example, transparency and predictability of decisions taken in these proceedings¹⁹.

Another element to consider here is the kind of **events triggering the liquidation**. This specific regime for banks should contain, apart from the traditional grounds for insolvency, the decisions taken by the supervisory (or resolution) authority that a bank is FOLTF²⁰. This approach is riskier, because the authority could adopt a decision without the existence of a pure insolvency, but, on the other hand, the value of the entity could be better preserved and depositors could be better protected.

The **creditor hierarchy** in case of liquidation should be perfectly specified in the new regulation. That could simplify the assessment of the NCWO principle, especially when there are different kinds of creditors at the same hierarchy level (e.g. in some jurisdictions, senior bondholders and non-covered depositors).

The available **tools** for a liquidation should be similar to those laid down in the resolution framework. If the liquidator has a wide range of efficient tools available, the liquidation of small and mid-sized banks would be more successful. In particular, selling perimeters of assets and liabilities (deposits) could protect depositors properly and minimise the loss of value.

The use of some liquidation tools could require an **effective external financing source**. In principle, the DGS should be able to finance these measures (see next section). If there are doubts on the feasibility of applying market mechanisms to absorb losses in a liquidation²¹, there is room for a more active role of the DGS (and EDIS in the future), or for more State aid for failed mid-size and small banks. A more orthodox alternative would be to require banks to have issued the MREL instruments capable of absorbing losses in liquidation. As these banks have limited market access, this requirement should be met with own funds.

¹⁹ Baudino, Patrizia, A. Gagliano, E. Rulli and R. Walters (2018).

²⁰ Doing that, we could have avoided what happened with ABLV Bank Luxembourg S.A, a subsidiary of ABLV Bank AS.: the court in Luxembourg did not open the liquidation proceedings, after the decisions taken by the ECB (declaring the failure of the bank) and the SRB (rejecting the existence of public interest in the resolution), because the bank was not in a technical insolvency.

²¹ Restoy, Fernando, R. Vrbaski and R. Walters (2020),

Lastly, we know that if we want to succeed when executing a resolution, we need to draw up resolution plans and keep them updated. In the case of banks to be liquidated, we do not have compulsory **liquidation plans**, although the resolution authorities prepare plans with a limited scope, including the basic information of entities. Authorities should prioritise information requests to favour a fast transfer of deposits of the failing entity or the immediate recovery of the money after the bankruptcy. And in this preparatory work we have to bear in mind, as already commented, that there is currently no requirement of liabilities to absorb losses in liquidation beyond the banks' own funds.

10.3.3. THE EUROPEAN REGIME VS HARMONISATION OF NATIONAL PROCEEDINGS

10.3.3.1. European regime

An efficient European regime could be very helpful in three aspects: minimising the value destruction that results in a liquidation; harmonising the treatment of bank creditors after the bankruptcy, both among different jurisdictions and between liquidation and resolution; and reducing incentives to the use of State aid in liquidation.

In a fully European solution, these rules should be included in a Regulation that is directly applicable in all Member States. Indeed, a European authority should manage these liquidations. A clear candidate to do so is the SRB. This nomination is compatible with delegation rules in favour of national resolution authorities to deal with less significant banks, always under the coordination of the SRB, as is the case for resolution.

In this context, the EDIS should be able to finance the so-called alternative measures (basically, the transfer of deposits and assets of the bank in liquidation to another bank). The new rules should also clarify the financial links (mostly liquidity support) between EDIS and the SRF, especially if a single European institution, the SRB, manages both funds.

Assuming that a European regime (i.e. directly applicable) is a long-term goal, the SRB²² has proposed to set up a centralised administrative “pre-liquidation” tool to be applied by the SRB to mid-sized banks. What does this mean? The SRB could apply any of the resolution tools to save the healthy part of the bank, without opening a liquidation process. This proposal does not need a single European liquidation regime and follows the model of the US Federal Deposit Insurance Corporation (FDIC): a centralised authority with harmonised pre-liquidation procedures (including the transfer of deposits and assets and the bridge bank) and competence on the DGS. For small banks, national insolvency proceedings would remain applicable. The scope of this “pre-liquidation” tool is not clear, but it could make sense to apply it to all banks within the remit of the SRB and other non-significant entities that exceed certain thresholds.

²² König, Elke (2018).

F. Restoy, R. Vrbaski and R. Walters have recently proposed another partially centralised alternative. A modified transfer tool (basically, sale of business) could be established to be used in liquidation and be funded by the EDIS, applying a more flexible least-cost principle, which in turn would be reformed through the replacement of the super-preference of covered deposits with a general depositor preference (applicable to both covered and uncovered deposits)²³. Other elements of the proposal are: a single authority (the SRB), the performance of a public interest assessment (the proposed tool should be applicable if the result is negative), a valuation of the assets of the failing bank, the selection of assets to be transferred in a sale of business and the cost estimate for the DGS to pay out all the covered deposits. If this tool is not applicable to a bank, it should be resolved by applying the ordinary resolution framework (MREL for transfer strategies, use of the SRF with a previous bail-in of 8% of total liabilities, etc.)²⁴. This proposal focuses on more flexible rules for the future EDIS to fund the liquidation of mid-sized banks using a sale of business tool. If the approval of a simplified version of EDIS seems already quite difficult, adding some capacity for EDIS to absorb (and mutualise) losses in the liquidation of small and mid-sized credit institutions, the probability of getting political support is very low.

10.3.3.2. Harmonisation of national proceedings

If we cannot have a (directly applicable) European regime, the best alternative is to promote as much harmonisation of national insolvency proceedings as possible. For example, all the Member States should have in place efficient and flexible liquidation tools (as we have seen in section 3.2) to try to recover the maximum franchise value of the failing entity, ensuring depositor protection. Some of these tools, for example, the sale of business, may be efficiently executed at a national level (with support from the national DGS and with decisions taken by the national authority in charge of liquidation).

In this scenario, some of these tools could be funded by one or more DGS. What to do if a DGS does not have enough liquidity to tackle a bank liquidation? Funding from another DGS or the SRF could be an option. We should define the role of the SRB, as future manager of EDIS, in the coordination of the use of DGS while they finance alternative measures.

An interesting issue to comment on is the role (veto power) that the European Commission and the Council have in the discretionary elements of SRB's decisions and, in particular, on a resolution using the SRF (following the Meroni doctrine). Should this institutional involvement be extended to the use of EDIS as a financing body of alternative measures decided by the SRB? If the legal status of the SRB does not change, yes.

We realise that more efficient national insolvency procedures strengthen the role of Member States in the management of bank crises: that means market fragmentation and

²³ In section 4.3 there is a more detailed discussion on these alternatives.

²⁴ Restoy, Fernando, R. Vrbaski and R. Walters (2020).

more room for the well-known sovereign-bank doom loop. This is not desirable, but the current situation is even worse: we run the same risks with a bank liquidation, but the procedures are very inefficient.

Another hitch is that a more efficient liquidation procedure could reduce the scope of the resolution framework, which is just the opposite of what we were looking for in section 2. Indeed, in the public interest assessment we compare the possible effects of a resolution with those of a liquidation, so more efficient liquidation procedures leave less room for (European) resolution.

10.4. THE ROLE OF DGS

10.4.1. INTRODUCTION

As we have seen, even with a more flexible public interest assessment, most European banks (more than 3,000) would go to liquidation in case of failure. In this section we shall see some elements to get a more homogeneous and efficient liquidation, from the point of view of the use of the DGS²⁵.

The DGSD considers three actions under these schemes: first (Article 11(1)), to pay out to covered depositors after the opening of the liquidation of a bank (reimbursement function); second (Article 11(3)), to implement alternative measures to avoid the failure (and liquidation) of a bank; third (Article 11(6)), to carry out measures to manage a liquidation in a more efficient way. In this section, we shall focus our analysis on the last two actions.

It must be clear that progress in terms of a wider application of Article 11(6) does not mean that EDIS is not needed. Without EDIS, national DGSs' different financial capacity can create competition distortions among banks, taking us back to the sovereign-bank "doom loop". EDIS is also required if we consider that the provision of liquidity among national DGSs in case of a global crisis is unlikely.

We shall not discuss in this paper the use of a DGS in resolution (sale of business), because, according to the current rules, this is an exceptional case: the DGS can only fund resolution in cases where losses would hit covered deposits. In these cases, the DGS would compensate these depositors. If the SRB can bail-in at least 8% of liabilities before hitting covered deposits, the SRF could be used for up to a further 5% of total liabilities. Beyond that percentage, the DGS could be used. But what happens if the minimum requirement of 8% is not met? In that case, the DGS could be used within the limits set by Article 109 of the BRRD (the lowest amount between the net loss foreseen for the DGS

²⁵ The role of the DGS in managing a banking crisis can be seen in Baudino, Patrizia, R. Defina, J.M. Fernández Real, K. Hajra and R. Walters (2019). Disparities in the transposition of the DGSD have been well summarised in Centre for European Policy Studies, CEPS (2019).

in its pay-out function of covered deposits in liquidation, and 50% of the DGS target size according to the DGSD).

10.4.2. MEASURES TO PREVENT THE FAILURE OF A BANK

Article 11(3) of the DGSD states: “Member States may allow a DGS to use the available financial means for alternative measures in order to prevent the failure of a credit institution, provided that the following conditions are met: (a) the resolution authority has not taken any resolution action under Article 32 of Directive 2014/59/EU; (...) (c) the costs of the measures do not exceed the costs of fulfilling the statutory or contractual mandate of the DGS; (...) (f) the ability of the affiliated credit institutions to pay the extraordinary contributions (...) is confirmed in the assessment of the competent authority.”

Recital 16 of the Directive adds two additional elements: national legislation should allow the DGS to go beyond a pure reimbursement function and these measures should comply with State aid rules.

There are a couple of relevant issues that merit a discussion: first, these preventive measures (Article 11(3) of the DGSD) require that the resolution authority had not taken any resolution action (Article 27 of the BRRD). There is a kind of circular argument: before concluding that a bank is failing (and taking any resolution action), the supervisory authority (or the resolution one) has to assess the existence of private alternative measures to avoid the failure, and among those measures, we could find the measures included in Article 11(3) of the DGSD. Clearly, a legal reform is needed to clarify this issue. Secondly, these actions by the DGS should be analysed by European competition authorities. The decision of the European Court of Justice on the *Tercas* case²⁶ implies that under certain circumstances the use of the DGS cannot be imputed to the State and therefore does not constitute State aid. This implies that having a “private section” in the DGS (with an amount beyond the minimum legal target - 0.8% of covered deposits) and, even more, to set up a private governance of the DGS can be two ways to deploy preventive measures without the risk of having them considered as State aid²⁷.

²⁶ <http://curia.europa.eu/juris/document/document.jsf?jsessionid=696C65DA2AF35501AB-775FB9F17119A2?text=&docid=213824&pageIndex=0&doclang=en&mode=lst&dir=&occ=first&part=1&cid=296909>

Here is a summary in the press release: <https://curia.europa.eu/jcms/upload/docs/application/pdf/2019-03/cp190034en.pdf>

²⁷ In the *Tercas* judgement, the ECJ concludes that preventive use of the DGS, given its fully private governance, does not constitute State aid even if it uses “compulsory funds” - included in the 0.8%. The European Commission has appealed against the Court decision. On 29 October 2020, the Advocate General proposed that the Court dismiss the appeal: <http://curia.europa.eu/juris/document/document.jsf?jsessionid=63DDAAE0579B276CD401F60B4BFF3DF5?text=&docid=233042&pageIndex=0&doclang=en&mode=req&dir=&occ=first&part=1&cid=10631155>

We have seen that the use of these measures is controversial, because they can interfere with the process of deciding the failure of a bank. Likewise, those measures can undermine the market discipline derived from a liquidation or a resolution and can endanger the financial capacity of the DGS and the system as a whole. Consequently, it is preferable to make progress with more flexible and efficient insolvency proceedings (as we have in resolution), making the use of those preventive measures less useful²⁸.

10.4.3. MEASURES FOR A MORE EFFICIENT LIQUIDATION

Article 11(6) of the DGSD states: “Member States may decide that the available financial means may also be used to finance measures to preserve the access of depositors to covered deposits, including transfer of assets and liabilities and deposit book transfer, in the context of national insolvency proceedings, provided that the costs borne by the DGS do not exceed the net amount of compensating covered depositors at the credit institution concerned”.

This rule is very significant, because a DGS could fund the transfer of deposits of a bank in liquidation (if we add a transfer of assets, the money to be transferred to the bank that is getting the deposits will be reduced). The remaining assets and liabilities should be liquidated. This action avoids the pay-out of covered deposits to many depositors and that means less uncertainty for depositors and less financial needs for the DGS.

What are the obstacles for the use of these measures? First, the transposition to national law is not compulsory and, in fact, most jurisdictions have not done it²⁹.

Secondly, the least cost principle that is applicable to these measures, in practice, hinders their use³⁰. This rule requires that the costs of the measures do not exceed the net cost of the pay-out of covered deposits of the bank (that is, less the amount recovered by the DGS from the estate in bankruptcy). Given the super-preference of covered deposits (the DGS is subrogated to that position) with regard to other creditors of the bank, including deposits not covered by the DGS, the transfer of all the deposit book to another bank is unfeasible (even transferring only some assets), because its cost will be higher than that derived from the pay-out function. Furthermore, in practice, to estimate the least cost principle is very complex, considering that we would have to compare valuations of assets in liquidation with valuations of those assets transferred to a going concern bank; it is not easy to have long term historical series of comparable liquidations; the time span to execute the liquidation should be considered; competition authorities may consider the transfer of assets and liabilities as a going concern action, so within their remit, etc.

²⁸ Another preventive action, in this case with public funding, is the precautionary recapitalisation specified in Article 32(4)(d) of the BRRD, as an exception to the rule included in that Article whereby State aid automatically triggers the failure of a bank. See Section 5.2.2.

²⁹ Baudino, Patrizia, A. Gagliano, E. Rulli and R. Walters (2018).

³⁰ Restoy, Fernando (2019).

In the United States, the interpretation of the least cost principle is more pragmatic: the FDIC has to compare the cost (negative prices) of bids presented for the sale of the bank, to the cost for the FDIC to liquidate the bank (including the pay-out to covered depositors), net of the expected amount recovered in the liquidation. That means that the FDIC implements objective, fair and open procedures to transfer deposits and assets from a bank in crisis (applicable to small banks)³¹.

An alternative to have a more flexible approach is to replace the super-preference of covered depositors by a general depositor preference: that is, that all depositors (covered or not) should be senior to the remaining liabilities, but they would be “*pari passu*” among themselves. Therefore, the recovery capacity of the DGS in a liquidation would diminish, to compensate for the pay-out of covered deposits. As a consequence, the least-cost criterion would be simpler to meet and the DGS would be able to fund more alternative measures. As F. Restoy, R. Vrbaski and R. Walters³² have stated, that change does not imply a lower protection for covered depositors: they would still be guaranteed by the DGS.

Another possibility would be to take into account, when computing the cost of a DGS intervention in a liquidation, all the negative externalities for the financial sector that the liquidation would generate (higher funding costs, instability, etc.), considering that those externalities would impact the DGS and its members.

Thirdly, the use of a DGS, beyond its “private” actions, is within the scope of European State aid rules. This could have a negative impact on the shareholders and creditors of the bank that receives DGS support (if the Commission were to conclude that a purchaser of assets and liabilities from a bank insolvency received State aid, it could impose compensatory measures on the purchaser). These legal aspects should be clarified.

All in all, the following measures are clearly positive:

- A more flexible definition of the least-cost principle (following the US model or modifying the super-preference of covered depositors); and
- A more flexible application of State aid rules (in any case, the DGS should take the necessary measures to consider these actions as private and, consequently, to place them out of the scope of State aid rules).

Their wider application would require a European Regulation to be directly applicable in all the Member States. With this, something that is common in the United States (the transfer of deposits in liquidation), could become a reality in Europe³³.

³¹ International Monetary Fund (2018).

³² Restoy, Fernando, R. Vrbaski y R. Walters (2020). These authors prove that, no matter the kind of depositor preference we have, the least cost principle will be more restrictive (i.e. it will be more difficult to finance these alternative measures) when the proportion of non-covered deposits over total assets is higher, and the value-destruction of the liquidation is lower.

³³ See, for example: Federal Deposit Insurance Corporation (2017) and Gelpert, Anna and N. Veron (2019).

10.5. STATE AID: AN ALTERNATIVE TO RESOLUTION?

10.5.1. STATE AID: THE ONLY FEASIBLE WAY TO TACKLE THE 2008 FINANCIAL CRISIS

The financial crisis of 2008 was managed with the tools that were available at that time. As the current European resolution framework was approved in 2014 (as a reaction to the financial crisis), the only recourse for European authorities was the State aid regime. We have heard several times that the European Commission (DG Competition) was the “de facto” resolution authority in the EU during the financial crisis and that statement is fully correct.

During the crisis, State aid rules (namely, the 2013 Banking Communication³⁴) had three main pillars: to restore long-term viability of banks without further need for public support in the future; to minimise the use of taxpayers’ money, through appropriate burden-sharing measures; and to limit distortions of competition through proportionate remedies. We can see many similarities between the two first pillars and the goals of the Single Resolution Mechanism.

Concerning burden-sharing, the State aid rules were original. Before implementing those rules, creditors were not required to contribute to the rescue of a bank, considering the negative effects on financial stability that such contribution would have. To the contrary, the Banking Communication required burden-sharing from shareholders and subordinated (junior) creditors.

10.5.2. STATE AID AFTER THE APPROVAL OF THE EUROPEAN RESOLUTION FRAMEWORK

10.5.2.1. Introduction

In this paper, we have seen that the existence of a new resolution framework has not prevented many cases of State aid to support the financial system. In some cases, the BRRD or the SRMR themselves allow State aid without triggering the resolution of the bank. In other cases, a different European regulation also considers that possibility, for example, the DGSD (and the interpretation of the European Court of Justice in the *Tercas* case).

Given that an overarching goal of the European resolution framework is to avoid State bail-outs, how to interpret the permanent use of State aid to tackle bank crises? This question is behind the European Court of Auditors’ report on the State aid granted

³⁴ European Commission: “Communication on the application, from 1 August 2013, of State aid rules to support measures in favour of banks in the context of the financial crisis”, 30 July 2013.

to financial institutions: the fact that 10 years after the financial crisis erupted, the EU banking sector remains an important beneficiary of State aid, despite the EU's significant efforts to make bailouts of banks unnecessary. This audit provides a couple of relevant lessons: "it is important to ensure that aid to mitigate a crisis is limited to damage caused by the crisis; and the use of crisis rules should be re-evaluated once the crisis abates³⁵."

In fact, the European Court of Auditors concluded the audit with a recommendation linked to this issue: the European Commission should carry out an evaluation of whether State aid rules continue to be appropriate for market realities and the applicable regulatory framework, and take, where needed, corrective actions. In this context, the Court recommends an adjustment of the conditions for precautionary measures and aid in resolution.

In this section we will revise the modalities of State aid in the financial sector and we will discuss some misalignments with the resolution framework.

10.5.2.2. Precautionary recapitalisation

Article 18 of the SRMR (and 32(4)(d) of the BRRD) sets a general rule: if a bank gets extraordinary public financial support, it should be considered FOLTF (failing or likely to fail). In the same provision, we find an exception to this rule. A precautionary public recapitalisation is allowed if the conditions spelled out in that article are met, namely: serious economic disturbances and a threat to financial stability in a Member State; the support must be precautionary and proportionate to remedy the consequences of the serious disturbance; the bank must be solvent; the public funds cannot be used to offset losses that the bank has incurred or is likely to incur in the near future; and the injections are necessary to address capital shortfall established in a SSM-wide stress test or similar exercise.

In the context of the third economic adjustment programme for Greece, in November 2015, the European Commission approved a public precautionary recapitalisation to Piraeus Bank (€2.72 billion) and National Bank of Greece (€2.71 billion). The SSM identified a capital shortfall of €4.93 billion for Piraeus Bank and €4.6 billion for NBG. Both banks covered with private means the provisioning needs identified in the asset quality review and the baseline scenario capital needs in the stress test; both processes were carried out under the SSM's comprehensive assessment. The remaining portion of those capital needs (as identified in the stress test adverse scenario) was covered with State aid.

In June 2017, the European Commission approved Italy's plan to support a precautionary recapitalisation of Monte dei Paschi di Siena with State aid of €5.4 billion. The SSM confirmed that MPS was solvent and met capital requirements, and Italy obtained a formal commitment from private investors to purchase the bank's non-performing loan portfolio (the sale of impaired assets is not a requirement of the precautionary

³⁵ European Court of Auditors (2020).

recapitalisation, but as it helped to prove the viability of the entity, it became a formal requirement). As a requirement of that approval, MPS's junior creditors contributed €4.3 billion to limit the use of taxpayer money (shareholders were diluted). Finally, there was a further compensation to retail tier 2 bondholders.

The assessment of these precautionary recaps cannot be very positive. Impaired assets should be fully recognised and that is the only way for banks to recover their solvency and viability. In this regard, it is noted that more than three years after the recapitalisation of Monte dei Paschi, the Italian authorities want to privatise the bank, but only after getting rid of a further €8.1 billion of impaired assets, by transferring them to a State-owned asset management company.

10.5.2.3 Public interest assessment and liquidation

As we have seen before, a negative outcome in the public interest assessment means the liquidation of the bank. In that case, State aid is possible, as we saw, for example, in the cases of Veneto Banca and Banca Popolare di Vicenza, after the FOLFT decision taken by the ECB. It is already history that these banks went to liquidation proceedings with State aid, which resulted in a treatment for some of the banks' creditors that differed from what they would have had in a resolution scenario, due to the fact that the burden-sharing regime is more favourable under the State aid framework (e.g. losses are not absorbed by senior creditors).

The European Court of Auditors deems that in cases of liquidation aid there are no clear rules for Member States to justify how a potential bank failure constitutes a threat to financial stability. It is noted that the decisions on liquidation aid analysed by the Court of Auditors³⁶ were based on statements on potential threats to financial stability provided by Member States. The banks concerned had market shares ranging from 0.02 % to 2 %, so, in principle, the negative impact on financial stability is not fully clear. As a consequence, the Court of Auditors has urged the Commission to explain why the failure of a non-systematically important bank could pose a potential threat to financial stability.

10.5.2.4. Other modalities of State aid

In the SRMR there is some leeway for State aid to support failed institutions. First, despite the fact that the funding of the SRF is fully private and the decisions regarding its use are taken by a European agency, the SRMR establishes that the use of the SFR is considered State aid. That means that if the resolution action, as proposed by the Board, involves the use of the Fund, the SRB must notify it to the Commission, which must in turn determine whether the use of the Fund would distort, or threaten to distort, competition (Article 19 SRMR).

³⁶ European Court of Auditors (2020).

Indeed, after a contribution to absorb losses by shareholders, capital instrument holders and other eligible creditors not lower than 8 % of the total liabilities including own funds, the SRF can be used, but with a clear ceiling: 5 % of the total liabilities including own funds of the institution under resolution (Article 27 SRMR). What can the authorities do if losses are larger and more funds are needed? At that moment, the SRB could impose more bail-in. In extraordinary circumstances, the BRRD does allow the resolution authority to seek further funding from alternative financing sources (presumably public) only if the 5 % limit has been reached and all unsecured, non-preferred liabilities, other than eligible deposits, have been written down or converted in full.

10.5.2.5. Regulatory differences between the resolution framework and State aid rules

There are three main differences between State aid and the resolution framework, namely: the State aid regime does not have a cap on public support; senior creditors and depositors do not contribute to the absorption of losses in the restructuring of the bank; and no minimum requirement of bail-in is imposed (unlike the 8% in resolution).

Although we should welcome the burden-sharing rules introduced in the 2013 Banking Communication, it is also true that a problem arises when the new resolution framework widens these burden-sharing rules to all creditors, including preferred senior bondholders and uncovered depositors. This divergence is very negative and is a clear incentive to apply precautionary recapitalisation and liquidation with State aid instead of resolution.

The existence of the SRF and MREL rules are a strong tool to avoid the cases in which the cost of a bank bail-out significantly weaken a State's fiscal position. These cases pose a threat to the integrity of the Single Market and risk undermining the level playing field, which State aid control aims to protect.

10.5.2.6. State aid and the bank-sovereign loop

The use of State aid (provided by Member States) depends on the fiscal capacity of the government involved. We have seen in the past how governments have raised debt to recapitalise banks and how that increase in public debt has hiked sovereign risk (lowering the price of the country's public debt). This, in turn, generates potential bank losses via their sovereign bond holdings. This situation illustrates how an initial shock originating either in the banking or sovereign sector is amplified by the feedback relation³⁷.

³⁷ Fontana, Alessandro & S. Langedijk (2019). These authors conclude that the effects of the feedback loops in most cases more than double the effect of the initial shock on bank losses and the sovereign risk premium.

In my opinion, the EU bank resolution mechanism (including MREL policy and bail-in rules) is an effective tool to dampen the bank-sovereign loop. Therefore, we should try to minimise State aid to the financial sector as much as possible³⁸.

10.5.2.7. State aid rules and COVID-19

The pandemic is triggering a severe economic crisis in Europe. The European Commission reacted timely to palliate the effects of the crisis by adopting on 19 March 2020 a “Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak”. So far, that temporary framework has not been used with banks, but I would like to remark that this shows that the traditional burden-sharing rules applied widely in the last financial crisis (to shareholders and subordinated debt investors) can be exempted.

The European Commission decided on 28 January 2021 to extend the temporary framework. All its sections are extended until 31 December 2021.

10.6. CONCLUSIONS

We have seen in this paper different alternatives to achieve a homogeneous and fair treatment for the creditors of a bank in crisis, independently of the home country of the bank and the applicable rules (resolution or liquidation).

As we have a single resolution framework in the Banking Union, the first way to get a more homogeneous and fair treatment for the creditors could be to increase the share of resolution versus liquidation cases. The criteria used by the SRB to assess the public interest are linked to a basic principle of the BRRD and the SRMR: if the liquidation of a bank allows to meet, to a larger extent, the resolution objectives, that is the preferred option and there would be no grounds to apply resolution tools. However, we have seen in this paper that there are different ways to adopt a more flexible approach to such criteria, inter alia, a regional or local scope could be applied to determine the concepts of critical functions and financial stability; the classification of a bank as a domestic systemically important bank could be considered a key element of the public interest assessment; all the banks within the remit of the SRB could have a positive public interest assessment; etc. We cannot forget that the increase of banks going to resolution implies the need of building up MREL buffers.

The second alternative is the harmonisation of national insolvency proceedings to be applied to banks. The final goal should be to adopt a European liquidation regime, as we have for resolution (applying similar tools). A (directly applicable) efficient European

³⁸ Gortsos, Christos, M. Siri & M. Bodellini (2020) have proposed a precautionary recap funded by the European Stability Mechanism. The bank-sovereign loop is not effective with this proposal, but it is politically unfeasible.:

regime could be very helpful in three aspects: minimising the typical value destruction of a liquidation; harmonising the treatment of bank creditors after the bankruptcy, considering jurisdictions, and between liquidation and resolution; and reducing incentives to the use of State aid in liquidation.

The third route is to have a wider scope for the use of DGS schemes to prevent bank liquidations, and if this is not possible, to use its funds in liquidation in a more flexible and efficient way. The DGSD allows the transfer of deposits of a bank in crisis with the support of a DGS. The remaining assets and liabilities should be liquidated. These actions avoid the pay-out of deposits to many depositors and reduce the financial needs of the DGS. A wider use of these measures would require a European Regulation, directly applicable in all the Member States; and a more flexible definition of the least cost principle (following the US model or modifying the super-preference of covered depositors). In addition, setting up and using the EDIS in these transactions could be very helpful to avoid the bank-sovereign loop.

Finally, the use of State aid is another way to avoid the resolution or liquidation of a bank (in certain cases, it is compatible with a liquidation). As State aid implies the involvement of taxpayers, it should be reduced as much as possible, given that the resolution framework has been developed precisely to avoid this involvement. Moreover, as there is a misalignment between some State aid rules and those of bank resolution (e.g. the divergence in the burden-sharing rules), the use of State aid in liquidation and precautionary recapitalisation could imply that some bank creditors are treated differently than in a resolution scenario.

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PART IV
ISSUES IN REGULATION

11. FINANCIAL STABILITY AND BANKING REGULATION IN THE CONTEXT OF THE COVID-19: SOME EARLY POLICY REFLECTIONS¹

CHRISTIAN CASTRO AND ÁNGEL ESTRADA, BANK OF SPAIN

11.1. SUMMARY

The Covid-19 has shaken the world as we know it. The nature of the pandemic and the measures to curb its spread are having an unprecedented impact on the economy and financial systems around the globe. In part thanks to the reforms introduced after the last global financial crisis – giving rise to what is known as the Basel III framework – banks were now in a better place to face this shock. However, the size of the shock was so far-reaching that swift and decisive policy measures – monetary, fiscal and also regulatory – were also required to help mitigate its social, economic and financial impact. With a focus on financial stability and banking regulation, we begin this paper by briefly reviewing the role that Basel III has played to strengthen the resilience of the banking sector and we provide a brief overview of the main policy responses to the Covid-19 taken thus far. We next discuss a series of broad policy implications, identify short-term term challenges resulting from the Covid-19 crisis, and draw some initial lessons for the future based on the experience up to date.

Keywords: financial stability, banking regulation, prudential regulation, financial system, banking system, Covid-19, pandemic.

JEL-codes: G21, G28, E32

¹ This paper is the sole responsibility of its authors. We are grateful to Eduardo Pérez for his excellent assistance. The views represented here do not necessarily reflect those of the Bank of Spain or the Eurosystem.

11.2. THE BANKING REGULATORY CONTEXT AT THE ONSET OF THE COVID-19 PANDEMIC

The global financial crisis has not only triggered a major overhaul in financial regulation but it has also left some clear lessons learned: i) that is better to act preventively than reactively and, consequently, that regulation should try to counteract a possible procyclical bias; ii) that banks' incentives (including owners, managers, bonds holders and customers) should be adequately aligned in order to avoid imbalances; iii) that risks should properly be reflected in those prudential indicators in use; iv) that the size and complexity of financial institutions matters; and v) that the financial health of individual financial institutions is just a precondition to ensure system-wide financial stability. The post-crisis reforms to financial regulation were guided by these and other lessons learned.

In the banking sphere, the reforms to the Basel framework were introduced gradually over a period of years and gave rise to a new regulatory framework known as Basel III. The first stage of the reforms began in 2010 and 2011 and they finalised with a second wave that was published in December 2017. The first wave of reforms increased the level and quality of banks' minimum capital requirements and introduced additional capital buffers (the Capital Conservation Buffer (CCB), the buffers for Globally Systemically Important Banks (G-SIBs) and the Countercyclical Capital Buffer (CCyB)) over and above the minimum. Aside other specific objectives, these buffers provided an extra layer of loss absorbency capacity for banks and contributed to reduce banks' risk-taking by increasing their 'skin in the game'.² Further, a leverage ratio and two liquidity risk standards were introduced. One of the liquidity standards (the Liquidity Coverage Ratio, LCR) was aimed to address short-term liquidity risks, and the other (the Net Funding Stable Ratio, NSFR) targeted medium-term liquidity risks.³

The additional capital buffers for G-SIBs sought two specific objectives (further to increasing banks' loss-absorbing capacity): to incentivise G-SIBs to internalise the externalities they create for the system and to reduce the implicit subsidies generated by their 'Too big to fail' (TBTF) status. In addition, Basel III also expanded authorities' policy toolkit by introducing a time-varying macroprudential instrument to address cyclical systemic risks stemming from excessive credit growth. Conforming to its purpose, this buffer was called Countercyclical Capital Buffer (CCyB). As a result, these two macroprudential buffers aimed to address the cross-sectional and cyclical dimension of systemic risk, respectively. In addition, forward-looking analytical tools, such as stress tests, became commonly used by authorities and banks to enrich their policy decision processes.

Meanwhile, in Europe, as in other regions and countries, there was a strong need to regain the trust in the financial system lost during the 2008 crisis, especially following

² 'Skin in the game' measures, as for example increasing minimum capital requirements, are motivated by a well-known moral hazard argument: if banks' owners have more to lose in the event that banks' get into difficulties, they will pay greater attention towards risks taken in advance.

³ The NSFR was not yet into force when the Covid-19 crisis started at the beginning of this year.

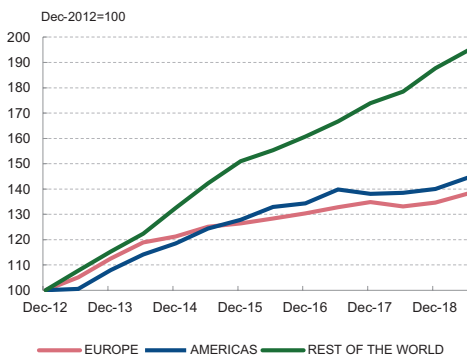
the sovereign crisis and the growing nexus between sovereigns' and banks' risks. As a result, in 2012, European governments agreed to advance towards the creation of the EU Banking Union which would be based on three pillars: A Single Supervisory Mechanism (SSM), a Single Resolution Mechanism (SRM) and a Common Deposit Guarantee Scheme (EDIS), all this under the umbrella of a single legal framework (the 'single rulebook').

The SSM sought to ensure an appropriate and homogeneous supervision of the European banking system, contributing to financial stability and integration within the euro-area. The main objectives of the SRM were to centralise the resolution decision-making process and to ensure consistent resolution financing practices. In turn, the EDIS was expected to provide the same level of protection to all EU depositors regardless their localisation, to decrease the possibility of distrust which may give raise to deposit runs, and to weaken interlinkages between banks and sovereigns. The first two legs of the EU Banking Union have already been implemented. But the EDIS, probably the most important element for consolidating the EU banking system, is still pending.

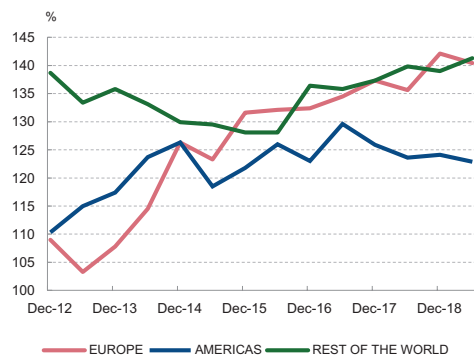
Some of the benefits of these regulatory reforms were patent at the onset of the Covid-19 crisis. Banks entered this crisis with more and better capital, and higher liquidity reserves than in the last financial crisis (**Chart 1**). On the macroprudential side, while most of the new buffers had already been implemented, only few authorities have activated their time-varying macroprudential instruments such as the CCyB, since common guiding indicators, especially on credit growth, did not suggest excessive accumulation of systemic risks. Ten years after the last global financial crisis, the absence of signs of macro-financial imbalances (apart from those in some housing markets and high-yield companies) in a context of very low interest rates and increased scrutiny and proactivity by prudential authorities, serve as a reminder of the importance of having effective preventive measures in place.

CHART 1. CET1 RATIO AND LIQUIDITY RATIO IN MAIN WORLD REGIONS

1 CET1 RATIO, BY REGION



2 LIQUIDITY COVERAGE RATIO, BY REGION

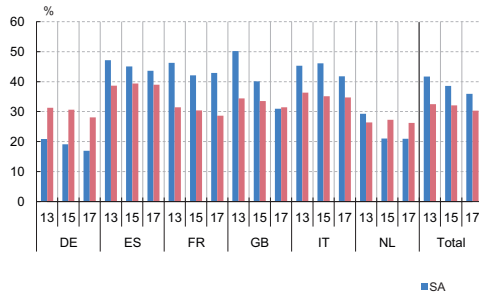


SOURCE: Basel Committee on Banking Supervision.

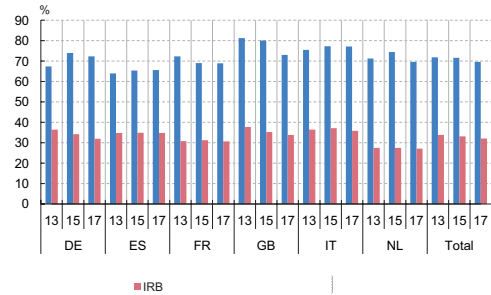
The second wave of the Basel reforms (still to be implemented) focused on the calculation of the risk-weighted assets (RWAs), the denominator of the minimum capital ratio in the Basel standards. Existing evidence suggested that the observed variation in RWAs across banks was not entirely reflecting actual differences in risk-taking (see for example **Chart 2**). Therefore, a key motivation for these reforms was a need to restore the credibility of banks' risk-based capital ratios brought into question during the last financial crisis. This in turn would also help improve comparability of capital ratios between banks. A crucial element to address these shortcomings was the 'output floor'. It introduced a limit to the benefits that banks can derive from using internal models to calculate minimum capital requirements.

CHART 2. RWAS DENSITIES IN MAIN EUROPEAN COUNTRIES

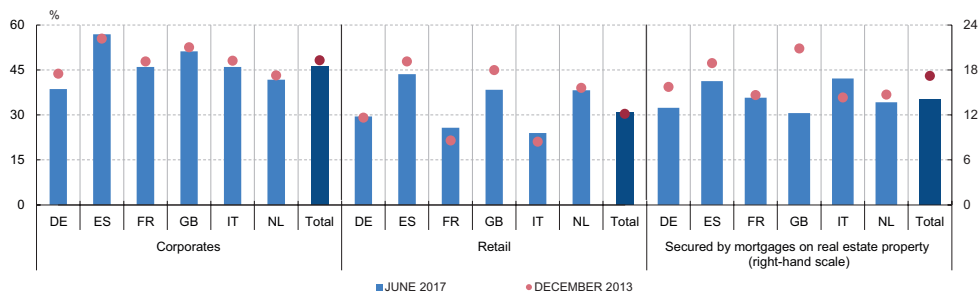
1 RWAS DENSITY. IRB AND SA APPROACHES
 TOTAL PORTFOLIO



2 RWAS DENSITY. IRB AND SA APPROACHES
 PRIVATE SECTOR PORTFOLIOS



3 RWAS DENSITY UNDER IRB APPROACH. PRIVATE SECTOR PORTFOLIOS
 December 2013 and June 2017



SOURCE: EBA.

Just before the Covid-19 outbreak, the BCBS work-agenda was mostly focused on the implementation and evaluation of the agreed reforms, and on the analysis of emerging risks – as for instance those derived from fintech, cyber-risks, and crypto-assets.

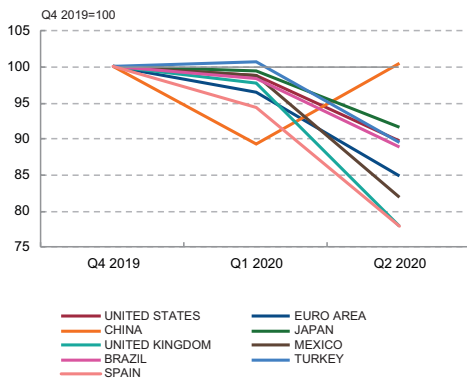
The emergence of new financial actors, as for example insurance companies and investment funds engaged in financial intermediation services, was also receiving

increasing attention at the international level. There was a growing debate about the need to deliver a more homogenous prudential treatment of financial activities with similar characteristics, and to provide competent authorities with adequate tools to address common systemic risks.

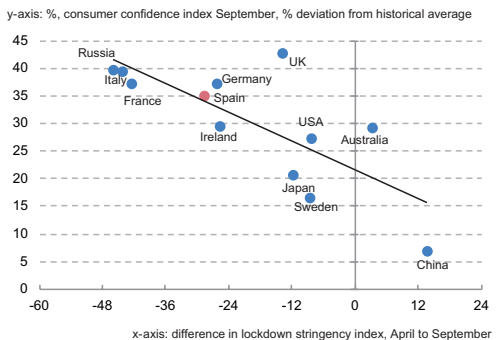
But then the Covid-19 hit hard between February and March. Although banks were better prepared and more resilient, the size of the shock was so unprecedented (**Chart 3**) that swift actions on broad range of policies – monetary, fiscal and also regulatory – were necessary to help mitigate its social, economic and financial impact. The broad range of policy measures adopted in response were intended to address the specific characteristics of the Covid-19 shock: exogenous, (hopefully) temporary, and global. On the regulatory side, as in other policy areas, the pandemic demanded a general re-prioritisation of the work agenda.

CHART 3. GDP, LOCKDOWN STRINGENCY AND ECONOMIC ACTIVITY IN MAIN WORLD ECONOMIES

1 GDP: MAIN WORLD ECONOMIES



2 LOCKDOWN STRINGENCY (a) AND ECONOMIC ACTIVITY (PURCHASING MANAGERS' INDEX (PMI))



SOURCES: national statistics, IHS Markit, OECD and Oxford COVID-19 Government Response Tracker.

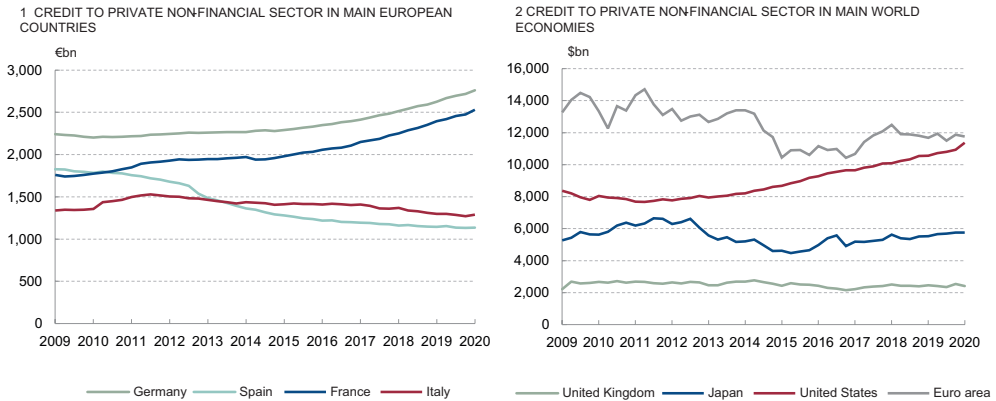
a The lock down stringency index measures the severity of the measures taken to contain the spread of the disease, taking values between 0 (zero measures) and 100 (total lockdown).

The strengthened positions of banks at the onset of the pandemic and the decisive measures adopted by policy-makers permitted to effectively cushion the first wave of effects from the Covid-19. Notably, the banking sector has contributed to avoid a ‘credit crunch’ that would have exacerbated the initial economic impact of the Covid-19 shock.⁴

⁴ Bedayo, Estrada and Saurina (2018) analyse the effect of bank capital on lending expansion and contraction for nearly 150 years in Spain. They find evidence suggesting that a too depleted level of bank capital when entering in a recession has a severe impact on lending (it may even give rise to a credit crunch) with quite negative and lasting effects.

In Spain for example, financing to the non-financial private sector has even increased up to the moment (**Chart 4**).

CHART 4. CREDIT TO PRIVATE NON-FINANCIAL SECTOR FROM BANKS IN MAIN WORLD ECONOMIES



SOURCE: Basel Committee on Banking Supervision.

Nevertheless, the ongoing economic downturn has substantially increased the risks for global financial stability. Though uncertainty has also increased significantly since the end of summer, in particular regarding the future evolution of the pandemic, some of the economic effects from the Covid-19 pandemic are likely to be longer than expected, or even permanent in some cases.

This paper is structured as follows. In section 2 we provide an overview of the regulatory response thus far. Next, in section 3 we discuss a series of policy implications for the design of policy responses, we identify short-term term challenges that policy-makers are facing as result of the Covid-19 crisis, and we draw some initial lessons for the future based on the experience up to date. Section 4 concludes with final thoughts.

11.3. THE REGULATORY RESPONSE TO THE EFFECTS OF THE PANDEMIC UP TO THE MOMENT

It was clear from the beginning that the exogenous and sudden nature of the Covid-19 shock required immediate and bold responses by regional and national authorities. Further, being a global shock, all this had to be made in close coordination and cooperation with international regulatory and supervisory bodies.

During the first phase of the pandemic a prevalent objective was to contain its impact on the economy with measures to help financial institutions to maintain lending to the real economy, thereby averting the risk of ‘credit crunch’ without compromising their resilience. Its abrupt and unprecedented impact required a system-wide response to

cushion the initial impact of the Covid-19. Initial measures in this context included, for example, those seeking to free up banks and supervisory operational capacity to better respond to the Covid-19 and those encouraging the usage of the flexibility embedded in the standards in order to avoid mechanistic reactions in such exceptional circumstances.

As the crisis progresses and new information become available, policies responses should continue evolving. They will need to adjust to the changing conditions and it can be expected they turn more selective in order to contribute to the economic recovery while also monitoring and preventing financial stability risks.

Against this background, the Financial Stability Board (FSB), the Basel Committee on Banking Supervision (BCBS), the European Banking Authority (EBA) and the European Commission took a range of prompt and decisive actions in light of the Covid-19 shock.⁵

11.3.1. FINANCIAL STABILITY BOARD (FSB)

The FSB is the body in charge of coordinating at the international level the work of national financial authorities and international standard setting bodies (SSBs), and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies. As such, since the outbreak of the Covid-19 pandemic, the FSB has supported the cooperation and coordination among its members to avoid unintended spillovers and to maintain financial stability.⁶ In addition, the FSB, as well as SSBs, have reprioritised their work-programs to adapt to the more urgent needs created by the pandemic.⁷

The FSB's overall work on Covid-19 has been guided by five common principles⁸ and involved three broad areas: financial risks and vulnerabilities, information sharing, and coordination of policy responses. The main findings and policy implications from the FSB work have been presented in reports submitted to the G20 Finance Ministers and Central Bank Governors.⁹

⁵ The BdE is member of the FSB (jointly with the Ministry of Economic Affairs and Digital Transformation) and of the BCBS. The Governor of the BdE, Mr Hernández de Cos, is the Chair of the Basel Committee since March 2019. The BdE is an active participant in the different organisational sub-structures, committees and working groups in the FSB and the BCBS. Likewise, the BdE participates in the governing structures of the EBA and in several of its committees and working groups.

⁶ See for example FSB (2020a).

⁷ FSB (2020b).

⁸ These principles are: 1) “To monitor and share information on a timely basis to assess and address financial stability risks from COVID-19”; 2) “to recognise and use the flexibility built into existing financial standards to support our response”; 3) “to seek opportunities to temporarily reduce operational burdens on firms and authorities”; 4) “to act consistently with international standards, and not roll back reforms or compromise the underlying objectives of existing international standards”; and 5) “to coordinate on the future timely unwinding of the temporary measures taken”.

⁹ FSB (2020c), FSB (2020d).

On the first area of work (risks and vulnerabilities), the FSB has prioritised the analysis of the following issues: vulnerabilities related to the solvency of non-financial corporates; potential procyclicality of credit rating downgrades specially affecting corporates (in particular, credit downgrades of BBB-rated corporate bonds); and possible sources of further liquidity stress (as for example, those implied by non-bank financial intermediation and its interconnections with the rest of the financial system).

Regarding information sharing, the FSB noted that the measures adopted evolved from those focused on supporting business continuity and containing operational risk during a very early phase of the pandemic, to more far-reaching actions in a following phase when the economic and market conditions started to deteriorate.

The FSB has also underlined the potential cross-border and cross-sectorial financial implications of the policies if they are not coordinated, especially during a shock as the Covid-19.

11.3.2. BASEL COMMITTEE ON BANKING SUPERVISION (BCBS)

The BCBS, as the global body entrusted with the prudential regulation of banks –in particular their solvency – has been monitoring risks and vulnerabilities stemming from the Covid-19 and has coordinated its policy responses with the FSB and other SSBs. The BCBS has also provided input to the G20 meetings regarding policy responses in international banking regulation and supervision.

As early as March this year, the BCBS announced a set of measures to address the immediate financial stability priorities resulting from the impact of the Covid-19 on the global banking system.¹⁰ The objective was to contribute to freeing up banks and supervisors' operational capacity to respond to the Covid-19. To this purpose, and while reaffirming its expectation of a full, timely and consistent implementation of the Basel III standards, the BCBS announced a one-year deferral to the original implementation dates of the Basel III revisions finalised in December 2017, the revised market risk framework finalised in January 2019, and the revised Pillar 3 disclosures requirements finalised in December 2018 (all these revised standards were originally due by January 2022).

Soon afterwards its first set of measures, the BCBS published a second set at the beginning of April to help alleviate the impact of the Covid-19 on the global banking system.¹¹ These complementary measures were three-fold. First, the BCBS set forth technical clarifications to ensure that the risk-reducing effects of government guarantees and payments moratoria granted or initiated in response to the Covid-19 were reflected when banks calculate their regulatory capital requirements. Second, the Committee reiterated the importance of the expected credit loss (ECL) accounting frameworks as forward-looking measures of credit losses, but it also made clear that banks should not apply the ECL frameworks mechanistically. To provide greater flexibility, the Committee

¹⁰ BCBS (2020a).

¹¹ BCBS (2020b).

also amended the existing transitional arrangements for the regulatory capital treatment of ECL accounting. Finally, the BCBS announced three new measures to provide additional operational capacity for banks and supervisors: to defer by one year the final two implementation phases of the framework for margin requirements for non-centrally cleared derivatives (in agreement with the International Organisation of Securities Commissions, IOSCO); to continue with the 2020 G-SIBs assessment exercise as planned but without collecting memorandum data; and to postpone the implementation of the revised G-SIB framework¹² by one year (from 2021 to 2022).

When announced its measures in April, the BCBS also reiterated that capital resources should be used by banks to support the real economy and absorb losses. Then, in June, the Committee stated that it viewed “measured drawdown of banks’ Basel III buffers to meet these objectives as both anticipated and appropriate in the current period of stress”.¹³ In addition, the Committee clarified that supervisors should give banks sufficient time to restore buffers taking account economic and market conditions and individual bank circumstances.

The Committee has committed since then to pursue additional measures if necessary and to continue coordinating its work on cross-sectoral financial issues with the FSB and SSBs. The BCBS has also updated its work-plan on the evaluation of the post-crisis reforms to incorporate lessons learned from the Covid-19 crisis.

11.3.3. EU REGULATORY RESPONSES

11.3.3.1. European Banking Authority (EBA)

The EBA is an independent EU Authority which, as part of the European System of Financial Supervision (ESFS), works to ensure effective and consistent prudential regulation and supervision across the EU banking sector. The EBA’s work in response to the Covid-19 focused on providing clarity to banks and consumers on the application of prudential and supervisory European measures to support lending into the real economy, while maintaining high standards of conduct, consumer protection and measures to tackle financial crime. To this aim, since March this year the EBA made a number of public statements, and published several guidelines, technical standards and reports on relevant issues.

One of the EBA’s first actions, announced in March, was to postpone the EU-wide stress-tests to 2021,¹⁴ though committing to produce an additional EU wide transparency

¹² BCBS (2018).

¹³ BCBS (2020c). This message was also emphasised in a press release of September where the BCBS suggested banks to make use of their Basel III capital and liquidity buffers during the crisis to absorb financial shocks and to support the real economy by lending to creditworthy households and businesses (BCBS 2020d).

¹⁴ EBA (2020a).

in 2020.¹⁵ The objective was to help banks to focus on and ensure continuity in their core operations, including support to customers. The EBA also suggested to structure on-site inspections in a pragmatic way and, as well other bodies, to make full use, where appropriate, of the flexibility embedded in existing regulation, including using the available capital and liquidity buffers. However, the EBA also recalled that the classification of exposures should accurately and timely reflect any deterioration of asset quality.

Also in March, the EBA published a statement urging banks to follow prudent dividend and other distribution policies, including variable remuneration, and use capital for ensuring continuous financing to the economy.¹⁶ Several financial authorities, including the European Central Bank (ECB) and the Banco de España, as well as macroprudential supervisors such as the European Systemic Risk Board (ESRB),¹⁷ have also recommended that institutions temporarily suspend dividend pay-outs and apply prudent criteria in their variable employee compensation schemes, so that they may channel their resources into shoring up their capital positions. In addition, the EBA published in March a statement on actions to mitigate financial crime risks – including a call on relevant competent authorities to support credit and financial institutions ongoing AML/CFT efforts, for example by continuing sharing information on emerging ML/TF risks.¹⁸

The prudential treatment of non-performing and forbore exposures is a central area of attention in the context of the Covid-19 crisis given the broad range of support measures adopted. On this matter, the EBA clarified that the public and private moratoria in response to the Covid-19 signed until September 2020 that fulfilled certain characteristics, do not have to be automatically classified as forbearance measures.¹⁹ The EBA, in coordination with the European Securities and Markets Authority (ESMA), also reminded that IFRS 9 is based on a set of principles that, by nature are not mechanistic and require certain degree of judgment. As such, any significant increase in credit risk of banks exposures should be based on the identification of significant changes over the total expected life of the exposure. The Banco de España has modified its secondary legislation to permit institutions to apply this principle.

As a complement, the EBA issued guidelines for banks to report and disclose the impact of these and all other measures affecting their balance sheets, along as other related issues.²⁰ These new informational requirements, together with later clarifications

¹⁵ The Spring 2020 EU-wide transparency exercise provided detailed bank-level data as of September 2019 and December 2019, thus showing the state of the EU banking sector prior to the beginning of the crisis. The second transparency exercise, with expected publication at the beginning of December 2020, will provide information on EU banks' financial conditions as of June 2020, thus assessing the preliminary impact of the Covid-19 on the sector.

¹⁶ EBA (2020b).

¹⁷ The ESRB is the institution in charge of macroprudential surveillance of the EU financial system.

¹⁸ EBA (2020c).

¹⁹ EBA (2020d). The expected treatment of moratoria was further detailed in the EBA Guidelines on legislative and non-legislative repayment moratoria (EBA 2020e).

²⁰ EBA (2020f).

for their effective implementation, laid down a coordinated approach in Europe to data collection of the support measures in place.²¹

Moreover, the EBA has announced a range of measures to provide additional flexibility and relief to supervisors in certain areas during the Covid-19 extraordinary circumstances. These include the supervisory approaches in relation to the Supervisory Review and Evaluation Process (SREP), recovery planning, digital operational resilience and the treatment of payment moratoria to securitisation;²² and the common procedures and methodologies for the SREP process, including cross border issues.²³

The EBA also took actions to address some specific effects that the Covid-19 was creating on the prudential requirements. In particular, it issued statements to help prevent excessive impact on market risk requirements due to extreme volatility, overshootings and procyclicality.²⁴ In the area of resolution, the EBA published in July a statement re-affirming the role of proper resolution planning in times of uncertainty as in the Covid-19 crisis to the purpose of ensuring that resolution remains a credible option in case of banks failure.²⁵

11.3.3.2. European Commission

The EU, in addition to the existing areas of flexibility already embedded in the European regulatory framework, approved in June a number of amendments to the Capital Requirement Regulation (CRR), known as CRR ‘quick fix’. It comprised a set of measures, included temporary ones, with the purpose of enhancing credit flows to companies and households, thereby supporting the EU’s economy.

More specifically, the CRR quick fix included: an extension by two years of the current transitional arrangements in the CRR for mitigating the impact of IFRS 9 provisions on regulatory capital (in line with the BCBS proposal), a one-year deferral (to 2023) in the application of the leverage ratio buffer for G-SIBs,²⁶ a more favourable treatment of publicly guaranteed loans under the non-performing loans (NPLs) prudential backstop,²⁷ an earlier application of the more favourable treatment (provided in the last revision of the CRR) of certain loans backed by pensions or salaries, an earlier application of the corresponding supporting factors to the SME and infrastructure sectors (factors

²¹ EBA (2020g), EBA (2020h), EBA (2020i). EBA (2020j).

²² EBA (2020k).

²³ EBA (2020l).

²⁴ See for example EBA (2020m).

²⁵ EBA (2020n).

²⁶ The leverage ratio buffer for G-SIBs is a non-risk based measure in addition to the 3% minimum leverage ratio requirement that was mentioned in section 1. As such, it complements the existing capital surcharges for G-SIBs based on risk-weighted assets (RWAs).

²⁷ The NPL backstop is a minimum loss coverage requirement for banks’ NPLs to ensure that they set aside sufficient funds to cover the risks associated with loans that have become non-performing.

also specified in the last revision of the CRR),²⁸ a more favourable treatment of software, and some specific adjustments to the treatment of central bank reserves in the leverage ratio minimum requirement.

Chart 5 provides a quick overview of the broad orientation and main measures adopted by the FSB, BCBS, EBA and the European Commission in response to the Covid-19 thus far.

CHART 5. OVERVIEW OF THE REGULATORY RESPONSE

<p style="text-align: center;">FSB</p> <p>Broad orientation:</p> <p>Support international cooperation and coordination to maintain financial stability during the time of market stress caused by the Covid -19. Developed a set of principles to guide national and international regulatory and supervisory responses to the Covid -19.</p> <p>Focus areas and main actions:</p> <ul style="list-style-type: none"> – Facilitate information sharing on evolving financial stability threats and on the policy measures that financial authorities are taking. – Coordinate policy responses to maintain global financial stability, keep markets open and functioning, and preserve the financial system's capacity to finance growth. – Assess financial risks and vulnerabilities with particular attention to cross -sectoral financial issues. 	<p style="text-align: center;">BCBS</p> <p>Broad orientation:</p> <p>Set out prudential policy measures to respond to immediate financial stability priorities resulting from the impact of the Covid-19. Assess on a continuous basis the possible need of additional measures. Coordinate policy work with the FSB and SSBs.</p> <p>Focus areas and main actions:</p> <ul style="list-style-type: none"> – Free up banks and supervisors' operational capacity by deferring implementation dates of certain standards and reducing reporting burden. – Support the provision of banks' lending to the economy by setting forth clarifications on the treatment of government measures and in relation to the application of the ECL framework. – Monitor and assess risks and vulnerabilities to the global banking system.
<p style="text-align: center;">EBA</p> <p>Broad orientation:</p> <p>Supported the measures taken and proposed by national governments and EU bodies to address and mitigate the adverse systemic economic impact of Covid -19 on the EU banking sector. Set out specific technical guidance and standards in the light of the Covid -19.</p> <p>Focus areas and main actions:</p> <ul style="list-style-type: none"> – Provide clarity to banks and consumers on the application of prudential and supervisory measures to support lending to the real economy. – Adopt measures to help banks to focus on core operations, maintain high standards of conduct and consumer protection, and to tackle financial crime during the Covid-19 pandemic. – Assess risk and vulnerabilities in the EU banking system. 	<p style="text-align: center;">EU COMMISSION ('QUICK FIX')</p> <p>Broad orientation:</p> <p>Set forth a set of amendments to the CRR, including temporary measures, with the purpose of enhancing credit flows to companies and households, thereby supporting EU's economy.</p> <p>Focus areas of work and main actions:</p> <ul style="list-style-type: none"> – Changes to the implementation schedules of certain standards (IFRS9 and leverage ratio buffer for G-SIBs). – Earlier application of the supporting factors to SME and infrastructure, and the more favourable treatment of certain loans backed by pensions and salaries. – More favourable treatment of publicly guaranteed loans under the NPLs backstop, and of software. Changes to the treatment of central bank reserves in the leverage ratio requirement.

SOURCE: own elaboration.

²⁸ The supporting factors to the SME and infrastructure are basically discounts in the applicable capital requirements for banks' exposures to these sectors.

11.3.4. OTHER EARLY SUPPORT MEASURES IN THE EU

In addition to and underlying some of the regulatory responses just described, European institutions and governments have also taken a wide range of measures –including fiscal and monetary stimulus.

In particular, the regulatory measures announced have been accompanied of actions by the SSM (on the banking supervisory side), the Single Resolution Board (SRB, on banking resolution) and the ESRB (on macroprudential supervision). For example, the SSM clarified in early March that banks could fully use their capital and banking liquidity buffers (including the Pillar 2 Guidance). It also provided relief for banks in the composition of their capital for Pillar 2 Requirements (bringing forward provisions already included in the revisions to the CRR), and considered operational flexibility in the implementation of bank-specific supervisory measures.²⁹ In turn, the SRB, circulated in March a letter announcing relief measures in relation to the reporting requirements for banks.³⁰ Following that, additional clarifications and guidance have also been provided on different aspects of resolution, as for instance on the SRB’s approach to minimum requirements for own funds and eligible liabilities (MREL), taking the impact of the COVID-19 crisis into account.³¹ On the macroprudential policy side, the ESRB issued several recommendations, including those related to the analysis of financial stability implications of the support measures adopted, or in relation to the exposure of investments funds to corporate debt and real estate.

Likewise, governments and central banks have also taken a range of decisive actions. In particular, a large number of governments have introduced measures with a direct impact on banks’ balance sheets, such as public guarantees on loans to business activities or moratoria, to facilitate loans repayments by corporates and households.^{32 33} On the monetary policy side, the Eurosystem has provided large-scale liquidity support to the financial sector, bolstering its asset purchase programme. In this regard, the temporary pandemic emergency purchase programme (PEPP), with an overall envelope of €750 billion, has been a core element. The ECB has also increased the incentives for bank lending to the real economy by easing the conditions for targeted longer-term refinancing operations (TLTRO) and has introduced additional longer-term refinancing operations (LTROs). Furthermore, it has expanded its US dollar swap lines in a coordinated action with other central banks.

²⁹ ECB (2020a).

³⁰ SRB (2020a).

³¹ SRB (2020b).

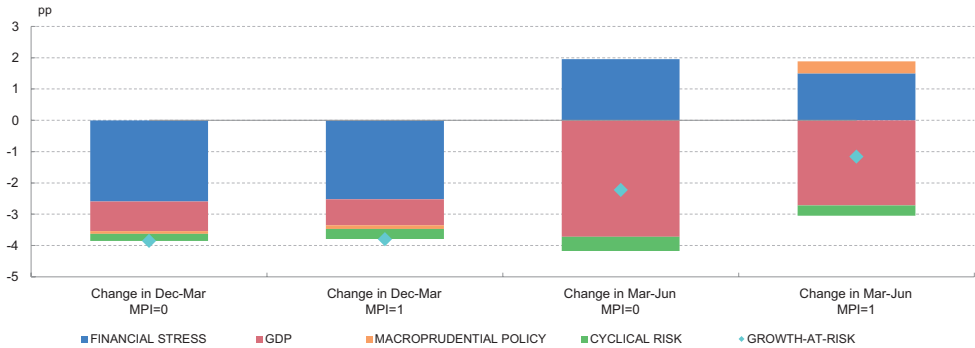
³² For further details and analysis on the situation of the Spanish non-financial corporate sector, see Box 4.3, “Developments in bank finance for productive activities in the context of the COVID-19 crisis” in Banco de España (2020a), and Blanco, Mayordomo, Menéndez and Mulino (2020).

³³ On the application and use of moratoria in Spain, see Banco de España (2020b).

All in all, the situation in Spain at this stage is that credit has continued flowing to the economy and that markets functioning has stabilised. On the corporate side, massive exits or ratings downgrades have not been observed, nor marked increases in NPLs in the sector. In parallel, banks' balance sheets have not yet reflected a sharp increase in credit risk, though it can be expected that loan impairments will materialise in the coming quarters. Estimates of growth-at-risk help to illustrate the potential tail effects of the Covid-19 shock and the factors explaining it (Chart 6). Against this background, a right balance should be achieved between the need to sustain credit to the economy while also promptly recognising possible deteriorations in credit quality, so avoiding the need of abrupt adjustments.

CHART 6. GROWTH-AT-RISK ESTIMATES

1 BREAKDOWN BY FACTOR OF THE QUARTERLY CHANGE IN ESTIMATED GROWTH-AT-RISK IN COUNTRIES THAT HAVE AND HAVE NOT EASED MACROPRUDENTIAL MEASURES



SOURCES: ECB, BIS and Banco de España.

a The bars represent the contribution (in percentage points) from each of the factors included in the model to the change in growth-at-risk between December 2019 and March 2020 and between March and June 2020. The results distinguish between countries that have eased macroprudential measures in response to the pandemic (MPI=1) and those that have not (MPI=0). Positive (negative) values represent a positive (negative) contribution to growth-at-risk. The diamonds represent the change in median growth-at-risk in each group of countries. For details of the methodology used, see J. E. Galán (2020) "The benefits are at the tail: uncovering the impact of macroprudential policy on growth-at-risk", Working Paper No 2007, Banco de España.

11.4. POLICY DISCUSSION

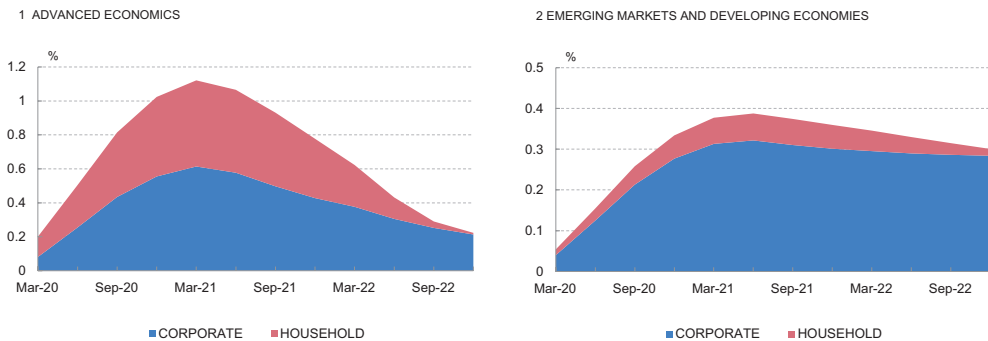
11.4.1. BROAD IMPLICATIONS

As noted above, the nature and characteristics of the Covid-19 crisis are different from the last financial crisis. In our view, the Covid-19 has brought three broad implications for policy.

First, the coronavirus has made the world stand still to some extent. But that has not been the case for risks. In particular, credit risk is expected to accumulate following the economic downturn caused by the pandemic. In light of this, banks should be ready to

promptly recognise in their balance sheets and income statements possible deteriorations in the quality of their credit portfolios, even when these risks will take some time to materialise. In line with EBA’s suggestions, banks should carefully assess their customers’ repayment capacity, adequately classify them and, based on this analysis, allocate and distribute provisions in advance (**Chart 7**).

CHART 7. PROJECTED PROVISIONS IN ADVANCED AND DEVELOPING ECONOMIES (A)



SOURCES: Fitch Connect, S&P Global Market Intelligence and IMF staff estimates.

a These graphs are included in the IMF Global Financial Stability Report, October 2020, box 4.1. They show a forward-looking simulation of the evolution of loan loss provisions (as a share of total loans) in the baseline scenario of the IMF World Economic Outlook and the share of them explained by corporate and household risk.

Second, policy-makers and banks will have to deal with significant inter-temporal trade-offs (ie: costs and benefits across time) that largely depend on the duration and severity of the pandemic. These factors are also contingent to external developments such as the scientific progress to find a vaccine against the virus. As a result, the pandemic generates a range of possible recovery scenarios (eg: L, U, W) that should be integrated into decision-making processes. In addition, it should be noted that the likelihood of alternative scenarios are not neutral to the range and intensity of the economic policies being deployed. Some of the practical challenges in this context are clear when deciding on the right timing for using capital buffers (first short-term challenge in the next sub-section).

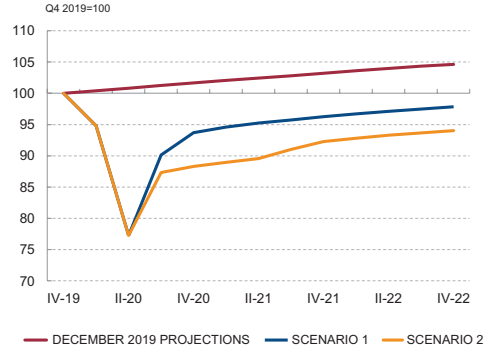
Although subject to a high level of uncertainty, the initially expected length of the shock is increasing and is having an unprecedented economic impact. For example, In Spain, GDP fell by 18.5% in Q2 this year, following a 5.2% decrease in Q1 with respect previous quarter. Estimates of the economic impacts for alternative scenarios illustrate the severity of the shock that can be anticipated at this time (**Chart 8**).

CHART 8: SPANISH GDP CHANGES IN LAST FINANCIAL CRISIS AND PROJECTED GDP IMPACT FROM COVID-19

1 GDP YEAR-ON-YEAR RATE OF CHANGE (Chained volume index)



2 GDP PROJECTIONS (Chained volume index)



SOURCE: *Bancode España*.

Third, the mix and type of policy actions should be able to adapt to the characteristics of the Covid-19 crisis and its phases. Since the source of the shock was not the financial system, there was a larger scope for policy measures outside the financial system to act as the first line of defence against the shock. The initial response was bold and system-wide. However, at present, more and better information is becoming available on the impact of the crisis across sectors. This can help guide more selective policy actions, also avoiding the proliferation of zombie companies. In any case, exit strategies for the support policies in place should be gradual and conditional on real economy developments. A too early withdrawal appears to be more costly than to maintain the policies somewhat longer than initially envisaged.

Further to these implications, there are specific trade-offs involved in the design of the policy measures in the context of the pandemic. One of them stems from the fact that while the Covid-19 is affecting countries globally, its effects and timing are not necessarily homogenous among countries. This creates a trade-off for the design of regulatory and supervisory treatments at the international level. Treatments should strive to achieve a minimum level of consistency to ensure a level playing field and avoid unintended fragmentation, but at the same time they should remain mindful of national specificities.

This type of cross-border spillovers can be especially intense in a situation as the current one, since an important part of the policy responses pivots on countries' fiscal capacity, which can be quite heterogeneous. Consequently, an attempt should be made to avoid that differences in the level of public support provided to the private sector turn into gains for some countries at the expense of others.

Drawing on the implications just described, we identify in what follows three challenges for the near term and set out some initial lessons for the future.

11.4.2. SHORT-TERM CHALLENGES

11.4.2.1. To ensure that buffers remain usable when mostly needed:

Buffers were thought to be usable by banks on a going-concern basis if needed, inasmuch as they were conceived as a response to limitations identified in the ‘hard minimum’ capital requirements.³⁴ In the Covid-19 crisis, the timing for using the buffers largely depends on the expected shape of the recovery scenarios. This shapes the benefits of using the buffers today (mainly to sustain lending) against the costs of having less resources to face later stages of the recession-recovery process (mainly to address possible erosions of capital). As expectations on the short and medium term scenarios change as we get further into the crisis, the decision on when using the buffers requires regular revisions based on updated information and projections.³⁵

Buffers usability also depends on banks’ capacity and willingness to use their buffers.³⁶ Banks may still be reluctant to use their buffers if the underlying binding constraint is not the regulatory requirement, but rather if investors or other market participants are the actual constraining factors. For instance, an investor in a given bank may be willing to avoid that the bank gets close to the point where automatic restrictions to earnings distributions are triggered, or she may simply consider that solvency levels in the system are too low. Further, banks may be worried about possible stigma effects associated to using the buffers and being the first in showing lower capital ratios as a result.

Measures that authorities can take to lessen these effects, incentivise or facilitate buffers usability, include the deactivation of releasable buffers (as the CCyB for example, see **Chart 9**), making public announcements (to coordinate banks’ and markets’ expect-

³⁴ Before the post-crisis reforms, capital requirements were mostly perceived as a binary concept with cliff-edges between two states: banks complying with the minimum capital requirements (normal supervisory actions and surveillance), and banks breaching the minimum (triggering more severe supervisory actions). As a consequence, during the last crisis some banks sharply deleveraged their balance sheets in order not to breach the minimum capital requirement (what would trigger severe intervention by supervisors), and some banks decided to cut credit but to continue making capital distributions (to avoid unsettling investors). In response, the design of the new buffers sought to strengthen banks’ loss absorbing capacity on a going-concern basis and, simultaneously, to prevent in an automatic manner imprudent distributions of capital. These two objectives – to help absorb losses and to prevent imprudent depletion of capital – were embedded in the design of the capital buffers and the Maximum Distributable Amount (MDA) restrictions (the MDA is the share of bank’s earnings that may be distributed when buffers are used, while the remaining share should be retained to replenish the buffers). However, these two objectives can be conflicting in practice.

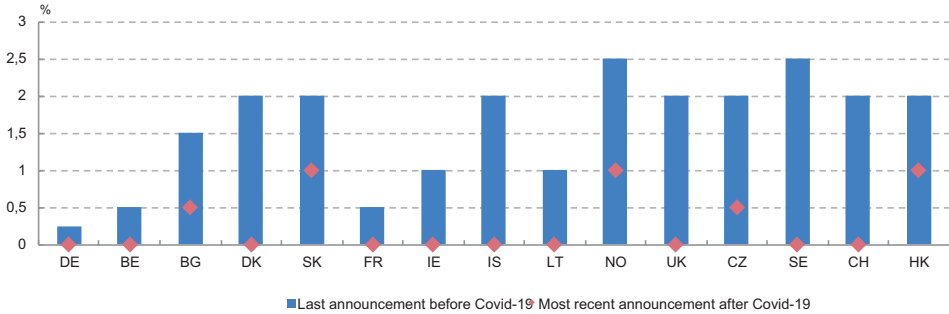
³⁵ In relation to this discussion, Lewrick, Schmieder, Sobrun and Takáts (2020) provides a tentative assessment of how much capital the global banking sector could free up in order to support lending, taking into account possible Covid-19-induced losses.

³⁶ Drehmann, Farag, Tarashev and Tsatsaronis (2020)

tations), and/or other more specific policy options (eg: take actions in relation to the pay-out constraints applicable to banks when using their buffers).

CHART 9. COUNTERCYCLICAL BUFFER CHANGES IN EUROPEAN COUNTRIES

1 COUNTERCYCLICAL BUFFER NATIONAL MEASURES



SOURCE: own elaboration (based on public information as of 15 July 2020).

In this regard, several international bodies and authorities have made public announcements encouraging buffers usability (some of which were commented in Section 2) and provided guidance clarifying that the buffers restoration is expected to be gradual, taking into account economic and credit factors, with sufficient time for banks to replenish their buffers once the crisis recedes.³⁷

From a broader perspective, the issues just mentioned call for a comprehensive strategy to modulate actions over a medium-term horizon, even when some key decisions should be taken in a much shorter time frame. To this end, further to stress-tests and sensitivity analyses, general equilibrium approaches can provide complementary information by considering fiscal and monetary constraints in addition to the cost and benefits analysis of financial stability measures.

11.4.2.2. To avoid cliff-effects when unwinding support policy measures:

Abrupt winding down of support policy measures put in place during the first phase of the Covid-19 pandemic can create cliff-effects for the financial sector and the economy. Such effects can take the form of pointed deteriorations in households and corporates repayment capacity, leading to sharp increases in banks' credit losses along with abrupt reclassifications in their loan portfolios. In parallel, it can also affect agents' confidence, dragging consumption and investment down, with falling or highly volatile assets

³⁷ See for example the public messages on buffers usability from the BCBS commented in section 2, the ECB's FAQs on supervisory measures in reaction to the coronavirus (ECB 2020b), and the Bank of England's Q&A on the use of liquidity and capital buffers (Bank of England (2020).

prices leading to increasing risk premia and higher market risks for banks. These effects altogether may entail a sharp tightening in overall financial conditions, bringing on what is commonly known as a ‘credit crunch’, and creating a self-reinforcing feedback loop with the initial decline in economic activity.³⁸

As a result, exit strategies for the policies in place should be carefully designed, bearing in mind those viable corporates in the more affected economic sectors, and also the most vulnerable households. Moreover, to the best possible extent, exit strategies should offer advanced guidance to relevant stakeholders along the different phases of the Covid-19 crisis.

11.4.2.3. To identify and tackle channels of heightened risk transmission from the economy to the financial sector in a context of high uncertainty:

As mentioned before, the evolution of the pandemic and the resulting recession/recovery scenarios are subject to a high level of uncertainty. Although policy actions from governments, central banks and regulatory bodies have helped to absorb the initial impact of the Covid-19 shock, especially avoiding large contractions in credit, there is a clear need to avoid that an exogenous shock as the Covid-19 may snowball into a banking crisis in the event that the more severe economic scenarios finally materialise. Stress from the financial sector would add to and amplify the effects from the initial economic shock making the crisis deeper and longer.

In this context, stress-tests and sensitivity analyses are useful tools to assess the effects that the materialisation of economic risks posed by the Covid-19 may have on banks’ balance sheets – for example, falls in GDP driving deterioration of banks’ credit and market risk exposures, thereby eroding banks’ solvency positions.³⁹ Banks, supported by this and other possible analyses, are expected to promptly identify and recognise in advance assets that are likely to become impaired in order to be able to appropriately distribute losses across time, facilitating their smooth absorption.

In this context, the analysis of the overall resilience of the banking sector under a broad range of scenarios can assist policy makers and supervisors in three aspects. First, to guide the sequencing of policies across the successive stages of the crisis – eg: for moving from ‘bridge’ policy actions (ie: those aimed to cushion the initial impact of the pandemic on households’ and firms’ liquidity) to policies more focused on preventing solvency risks. Second, to identify individual bank situations that may warrant specific supervisory actions – eg: more in depth reviews. And third, to help guide exit strategies

³⁸ Fragilities from the non-bank financial activities and its interconnections with the banking system may also contribute to larger-scale effects on financial stability.

³⁹ In a nutshell, stress-tests are more demanding exercises that analyse the resilience of the system or individual institutions to alternative economic scenarios taking into account a broad range of factors and variables, while also including feedback loops between banks and the non-financial sector. Sensitivity analyses, in contrast, are more narrow focused exercises, analysing the effects of shocks to specific factors and variables.

– eg: assess the right timing and circumstances under which maintain, extend or wind down policy support measures.

In the EU, the ECB published in late July the results of its sensitivity analysis on the impact of the Covid-19 shock on 86 euro area banks over a three-year horizon.⁴⁰ Its results suggested that the euro area banking sector at the whole would be able to withstand the Covid-19 shock, although the reduction in banks' capital under the most adverse macroeconomic scenarios would be significant.

Were the likelihood of more adverse scenarios increase, a more intense monitoring and surveillance of risks to financial stability should naturally be expected. But, in the EU, to avoid increasing strains on sovereigns and an eventual re-emergence of the nexus with the financial sector, the response can only be addressed at that European level. Potential policy actions in this scenario comprise the direct support to non-financial corporates (including deleveraging mechanisms), the recapitalisation of banks, and the development of asset management companies to absorb NPLs, among possible others. All these measures have well known costs and benefits, and are more adequate for certain circumstances. Thus, their selection should be grounded on solidly founded impact analysis. In any case, a common deposit guarantee scheme to complete the EU Banking Union should be created as soon as possible.

11.4.3. INITIAL LESSONS FOR THE FUTURE

- **Explore making more buffers releasable and risk-varying:** The Covid-19 crisis has re-emphasized the importance of having releasable buffers as the CCyB in the policy toolkit. Releasable buffers are particularly useful to deal with shocks of diverse severity and duration (features which can differ substantially from those of normal credit and business cycles), existing limitations and trade-offs in the usability of static buffers (including those stemming from automatic restrictions on earning distributions), and can also serve as a fast-adjusting policy tool. In relation to the first point, the accumulation of higher buffers in advance would be desirable. Regarding the latter one, a rapid deactivation by authorities can work as a strong signal to market participants on the need to sustain the flow of credit to the economy.

In addition, the experience with the Covid-19 shock suggests that buffers may need to react not only to endogenous systemic risks – such as those from excessive credit growth – but also to exogenous ones that may affect credit. In the CCyB case, this means that the buffer could be accumulated even if its benchmark guiding indicator (the Credit-to-GDP gap) is below zero.⁴¹ Other indicators, not necessarily directly

⁴⁰ ECB (2020c).

⁴¹ The decisional framework for the activation and release of the CCyB follows what is known as a 'constrained' or 'guided discretion' approach. This framework comprises a common standardised quantitative indicator to be used as a benchmark (the Credit-to-GDP gap) and a set of principles to guide judgement when taking buffer decisions. The Credit-to-GDP gap is mapped

linked to credit or financial variables, could help guide the activation/deactivation of the buffer. The possibility of extraordinary measures, such as those ones adopted during this crisis, could also be conceived if some thresholds are exceeded. An underlying motivation for this operationalisation is that of trying to address the typical rules vs. discretion trade-off in policy making and produce something similar to an automatic stabiliser for the financial sector.

Giving that some of these issues are also relevant for liquidity risks – for example, stigma effects when banks use their liquidity reserves – the possibility of operationalising releasable risk-varying liquidity buffers could also be explored.⁴²

- **Assess the adequacy of introducing certain simplifications to the capital framework and, eventually, consider giving higher weight to the usability objective in the design of the buffers:** there is a risk that ex-ante supposedly ‘usable’ buffers become ex-post ‘hard minimum’ requirements in practice. This would render the buffers useless for absorbing losses on a going-concern basis and will lead to some of the same problems observed during the last financial crisis. Namely, that banks may need to suddenly cut credit to the economy to avoid getting close to a ‘trigger point’. The only difference would be that this trigger point is higher now than in the past because it is the sum of microprudential capital requirements plus macroprudential buffers.

To prevent this and strengthen buffers usability, the adequacy of introducing possible tailored and targeted adjustments to the design of the buffers could be further assessed in light of the experience gained during the Covid-19 crisis.

- **Maintain an active and coordinated communication strategy to complement the regulatory and supervisory actions being taken:** regular communication between authorities and stakeholders, including in the form of guidance, technical reports, public statements and speeches, have shown to be fundamental to help guide expectations and boost policy effectiveness.

Public communication should however recognise the prevailing uncertainty regarding future macroeconomic developments in a context as the current one. For example, the difference between scenarios and estimates should be made clear-cut when explaining results from stress-tests and sensitivity analyses.

Policy communication in the Covid-19 context may also require to strengthen the level of coordination at the international and regional levels. For example, differences in the timing and effects of the pandemic across countries and regions, cross-border spillovers, and commonalities in some of the tools used to guide policy decisions (for

into a CCyB buffer rate (ie: the ‘benchmark buffer rate’) by means of a simple rule built around a lower and upper threshold of gap values. The CCyB activates when the gap is above 2 percentage points, point from where the CCyB starts increasing linearly until reaching its 2.5% maximum when the gap is at 10 percentage points. For a detailed description of the CCyB and its operationalisation in Spain, see Castro, Estrada and Martínez (2014, 2016).

⁴² Chapter 5 in the ESRB’s handbook on the operationalisation of macroprudential instruments in the banking sector (ESRB, 2018) describes some alternatives for the design of time-varying liquidity instruments grounded on the LCR and the NSFR.

example, stress tests and sensitivity analyses) may justify additional coordination efforts among authorities at the moment of presenting their analysis or explaining the policies to be adopted.

- **Get prepared to assess, in due time, the effectiveness of the reforms in place and the policies adopted during the Covid-19 pandemic:** the Covid-19 is testing the performance of the reforms adopted after the last financial crisis. In addition, it has motivated a broad range of additional policy measures to protect the economy and the financial system. Some early work in preparation, as data collections and informal interchanges of experiences in international fora could pave the road to more thorough analyses once the crisis is over. Ultimately, this analysis should serve as a basis to orientate potential policy developments as part of the post-pandemic regulatory and supervisory agenda.

All this should complement the analysis of structural changes going on in the financial system and other relevant issues under scrutiny such as the implications of new financial technologies and climate change.

11.5. FINAL THOUGHTS

The post-financial crisis reforms to the Basel framework implemented thus far have shown their effectiveness in helping to withstand the effects from the first phase of the Covid-19 crisis. They have also been an important factor explaining some of the structural changes observed in the banking system that have rendered it more resilient and better prepared to address such effects.

This evidence suggests the importance of duly implementing the second wave of revisions that completes the post-financial crisis reforms to Basel III. Of course, a deferral in their implementation as the one agreed by the BCBS in March is both sensible and necessary to help institutions focus on their financial intermediation activity. But this should not be seen as an opportunity to water down the agreements achieved.

There are also other broad lessons to be learned from the ongoing Covid-19 crisis. Among them, a salient one is that the banking system should be made more robust to exogenous shocks and not just to endogenous risks arising within the financial system. On this regard, authorities should stand ready to react and take extraordinary measures in the event that the magnitude of a shock exceeds what can naturally be anticipated or if most severe scenarios finally materialise.

In turn, the banking system should get prepared for a post-Covid environment that will likely be characterised by ‘lower for longer’ interest rates and an increasing activity of bigtechs in financial intermediation. The first issue suggests that banks should continue making efforts to improve profitability. This could be done by reducing costs – including by means of consolidations in the sector to reduce possible over-capacity. But this could also be done by investing in a more efficient use of customers’ information in order to get maximum advantage from certain business areas without incurring in excessive risk taking (for example, loans to SMEs, consumer loans, and loans to innovative activities).

The second issue – bigtechs activity – implies that regulatory authorities in general will probably need to be more proactive in the future. This seems justified by the increasing odds of new types of endogenous risks and by the need to close any regulatory gap between bigtechs and regulated banks, thus contributing to a level playing field and avoiding excessive regulatory burden. This should not be seen as mean to discourage the financial intermediation activity by bigtechs, particularly as it may bring benefits for consumers, but rather as a way to ensure that competition is exercised under similar conditions. Proportional regulatory approaches may also be expected, tailoring requirements if justified and with more intense scrutiny and regulation if entities or activities become increasingly systemic.

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12. HOW STRONG AND LIQUID BANKS HELPED THE FEDERAL RESERVE PREVENT A FINANCIAL CRISIS THIS SPRING¹

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12.1. ABSTRACT

Between mid-February and the end of March, the financial system was hit with a staggering blow. By several measures, the shock was at least as bad as that caused by Lehman's failure in September 2008. However, this shock did not cause a financial crisis. It is widely and correctly recognized that the reversal owed importantly to the rapid and massive response of the Federal Reserve, but it also owed to the strength of the banking sector going into the crisis. In this paper we discuss the role of the Federal Reserve in helping prevent a financial crisis and analyze the contribution of the banking sector as a source of strength during this particular period of stress.

Keywords: federal reserve, banking system, financial stability, banking regulation, Covid-19 pandemic.

JEL-codes: G01, G21, G28, E02, E58

¹ This paper is the sole responsibility of its authors. It is based on a previous paper: "Strong and Liquid Banks Helped Prevent a Financial Crisis This Spring" published on June 16, 2020. The views expressed in this paper are those of the author(s) and do not necessarily reflect the position of the Bank Policy Institute or its membership, and are not intended to be, and should not be construed as, legal advice of any kind.

12.2. INTRODUCTION

But I think as I sit here right today in the middle of May, the banking system is really a source of strength and a source of credit in the economy. And that's important.

Vice Chair Richard Clarida

Between mid-February and the end of March, the financial system was hit with a staggering blow. By several measures (see Table 1), the shock was at least as bad as that caused by Lehman's failure in September 2008. The reaction in financial markets to Covid-19 is not surprising. In a few short weeks, as the inevitability of the pandemic became clear, the economic outlook went from strong to abysmal.

Table 1: Comparison of Shocks to Financial System

Maximum adverse shock	4-weeks after Lehman collapse	Covid-19 (Feb. 19 to Mar. 23)
S&P 500	-28%	-34%
High yield bond spreads (bps)	+647	+636
U.S. banks bond spreads (bps)	+186	+287

What is surprising is that the pandemic shock did not cause a financial crisis. Instead, while the initial shock to the financial system made measures of financial crisis intensity flash red, those measures quickly reverted to yellow or even green. The Systemic Risk Indicator of the Cleveland Fed and the Financial Stress Index of the St. Louis Fed, for example, both rose to high levels in mid-March but had returned to near-normal levels by mid-April. It is widely and correctly recognized that the reversal owed importantly to the rapid and massive response of the Federal Reserve, but it also owed to the strength of the banking sector going into the crisis.

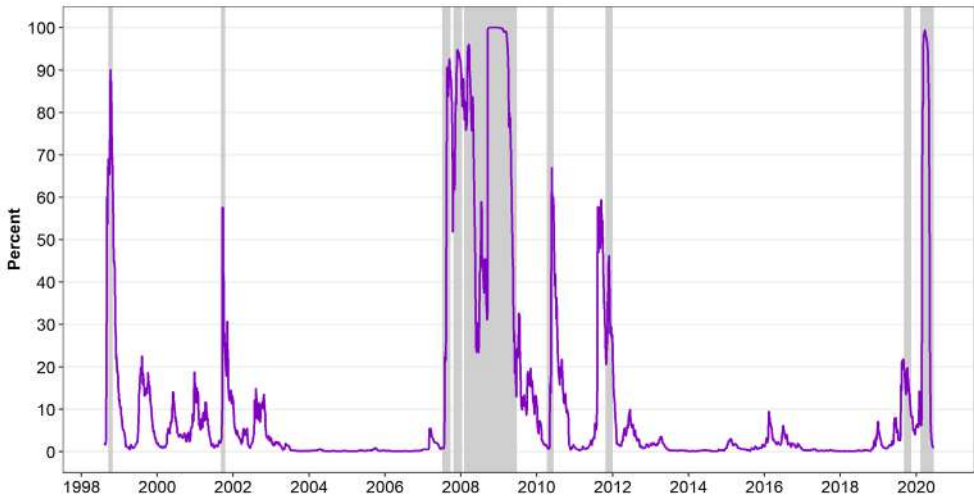
This paper discusses and assesses: (i) the impact of the Federal Reserve's actions to prevent a financial crisis; (ii) and the role of the banking system as a source of strength.

12.2.1 FINANCIAL STRESS INDEX WARRANTED AN EMERGENCY INTERVENTION BY THE FED.

The financial stress index we report is designed to determine the probability that a situation warrants emergency intervention by the Federal Reserve judging by past situations where the Fed intervened. The index uses a model introduced in Nelson and Perli (2005). The approach is similar to those used for models of whether the economy is in

recession such as Chauvet, M. and J. Piger (2008) and Chauvet (1998).² In a nutshell, following Carlson et al. (2012) and Nelson and Freedman (2020), we calculate the average level, volatility, and correlation of a dozen standard measures of financial stress such as implied volatilities, risk spreads, and off-the-run spreads and use those three variables to fit a logit model for Fed emergency intervention. Details on the model and the data are provided in the appendix. The result is shown in Exhibit 1.

Exhibit 1: Probability that financial conditions are consistent with Fed emergency intervention



Note: Shaded bars indicate historical periods of financial stress.

As can be seen, the model places nearly a 100 percent probability that financial conditions after the coronavirus crisis first hit were consistent with those associated with past instances of Fed emergency intervention. The only period when the index registered such high levels of stress was after Lehman failed in 2008, although the period of the past financial crisis before the Lehman failures and the episode around the Russian default and LTCM bailout in 1998 were nearly as high.

The striking difference between the Lehman and current episode is that the index remained elevated for nearly 6 months after Lehman but fell sharply within a few weeks after the coronavirus shock. As of June 12, the index assesses an approximately 1 percent probability that current conditions are consistent with emergency Fed intervention. In

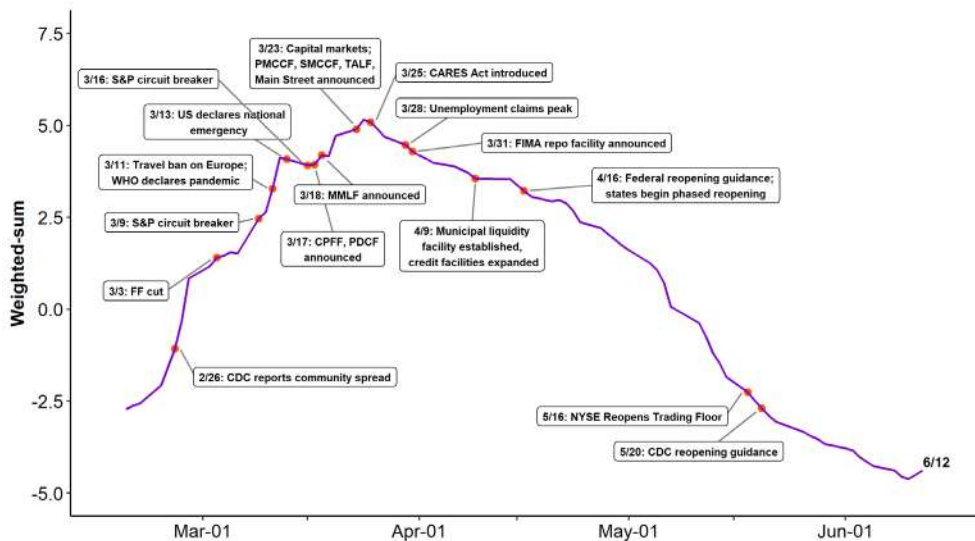
² Chauvet, M. and J. Piger (2008), “A Comparison of the Real-Time Performance of Business Cycle Dating Methods,” *Journal of Business and Economic Statistics*, 26, 42-49, and Chauvet (1998), “An Econometric Characterization of Business Cycle Dynamics with Factor Structure and Regime Switching,” *International Economic Review*, 39(4), 969-96.

the following sections we look into the potential reasons for such a significant decrease in our measure of financial stress index.

12.3. FEDERAL RESERVE ACTIONS

No doubt, the Fed’s quick and massive response to the severe market dislocation in mid-March helped prevent a larger conflagration. In Exhibit 2 below, we plot the weighted-sum value of the financial conditions index over the Covid-19 stress period to illustrate the market’s response to Fed actions. It is worth highlighting that the main drivers of big increases in the index were news about the pandemic, not news about Fed actions or the condition of financial institutions. Indeed, markets reacted negatively when the Fed cut rates to zero on March 3rd. However, Fed and legislative actions undoubtedly helped diffuse the crisis: namely, the Fed’s sweeping announcements on March 23rd and the introduction of the CARES Act in the House of Representatives on March 25th induced a sustained decline in the index. With no indications of a pernicious dynamic through the financial system, optimistic news about the virus and state re-openings enabled further declines in the index. In the end, this is a health and macroeconomic crisis, and thanks to swift action by the Federal Reserve and the strength of the banking sector going into the crisis, was stopped short of becoming a financial crisis (see Table B in the Appendix for a detailed chronography of policy interventions).

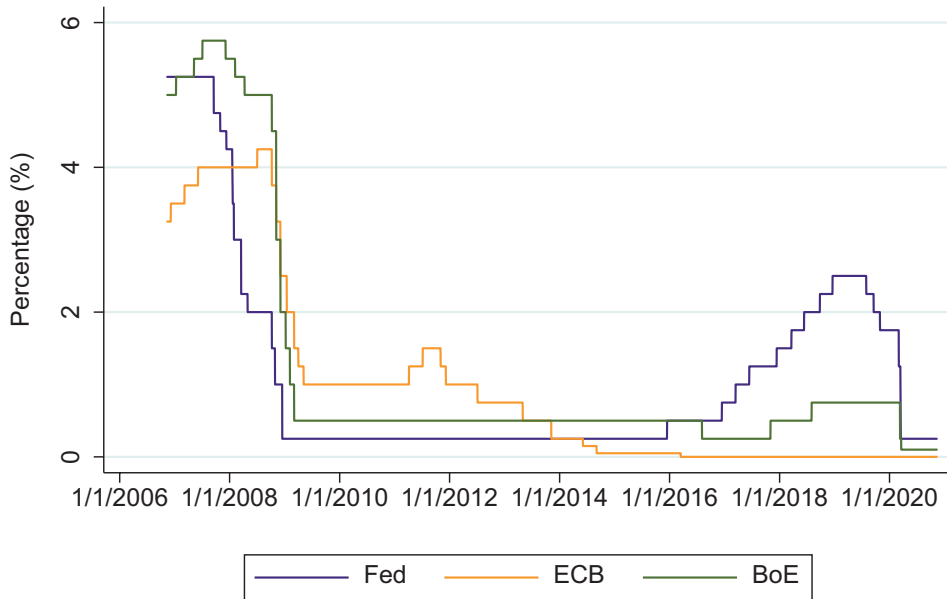
Exhibit 2: Evolution of financial stress index through Covid period.



12.3.1. FEDERAL RESERVE HAD ROOM FOR MONETARY POLICY
 ACCOMMODATION

At the onset of the Covid-19 pandemic, the upper end of the target range of the federal funds rate stood at 1.75 percent, having reached its post-GFC peak of 2.5 percent in December 2019. In comparison, the ECB’s main refinancing operations rate stood at the zero-lower bound and the Bank of England’s official bank rate was 0.75 percent (see Exhibit 3). In a series of swift policy decisions spanning two-weeks, the Fed lowered its target by 1.25 percentage points, including an emergency cut of 1 percentage point on March 15th, reaching 0-0.25 percent. In addition, the FOMC statement clarified that “The Committee expects to maintain this target range until it is confident that the economy has weathered recent events and is on track to achieve its maximum employment and price stability goals.”³

Exhibit 3: Monetary policy: Key Central Bank interest rates



Source: Bloomberg.

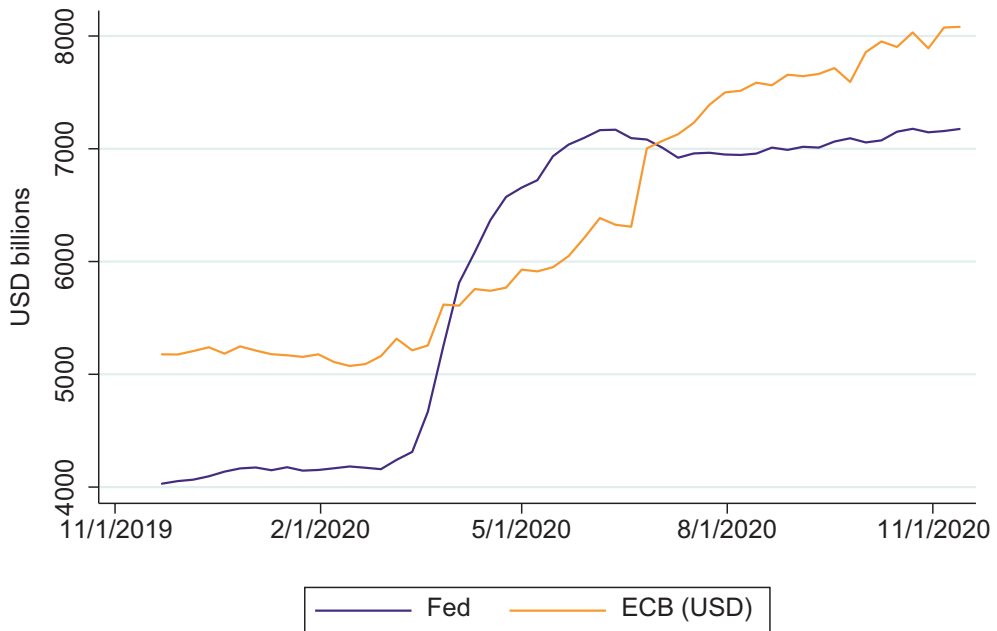
Note: ECB refers to ECB main refinancing operations rate. Fed represents the upper end of the target range for the federal funds rate. BoE stands for the Bank of England’s official bank rate.

³ <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.htm>

12.3.2. SWIFT ASSET PURCHASE PROGRAMS BY THE MAIN CENTRAL BANKS

Perhaps most importantly among those actions, in just three weeks beginning on March 15, the Federal Reserve bought \$1 trillion in Treasury securities (Exhibit 4).⁴ The purchases were a response to a severe oversupply of securities as many leveraged investors sought to sell their holdings simultaneously, overwhelming the balance sheet space on the books of broker-dealers (see Duffie (2020)).

Exhibit 4: Non-Conventional monetary policy: Central Bank balance sheets



Source: Bloomberg.

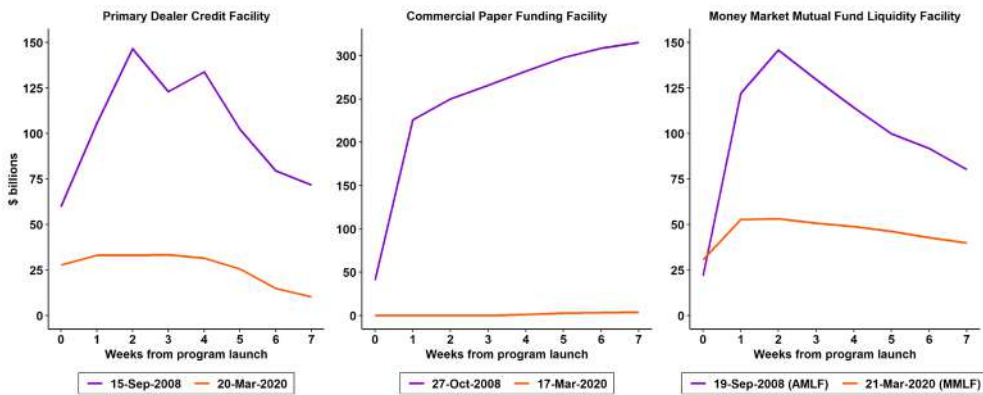
Note: ECB refers to total size of ECB Balance Sheet in USD. Fed refers to total size of consolidated Federal Reserve Balance Sheet.

⁴ More broadly, between March 11 and May 6 the Fed purchased \$1¾ trillion in Treasury and Agency mortgage-backed securities.

12.3.2.1. Fed Emergency Facilities have remained mostly unused

In addition, the Federal Reserve eased terms on the discount window and central bank swap lines and, between March 17 and April 9, announced nine credit facilities. The three facilities that began operations quickly and reportedly helped ease conditions the most were the Primary Dealer Credit Facility, the Money Market Mutual Fund Liquidity Facility (MMLF) and the Commercial Paper Funding Facility (CPFF). All three facilities are direct copies of facilities opened in the wake of the Lehman failure – the PDCF, the AMLF, and the CPFF. The initial uptake of all three has been much lower this time around, though, as indicated by the orange lines in Exhibit 4 below.

Exhibit 4: Fed emergency facilities in 2008 and 2020



Thus, while the Fed responded quickly and forcefully, the conditions did not, in the end, require much emergency lending, in part because simply opening the programs helped calm financial markets. In contrast, while Fed stood up the AMLF and CPFF quickly in 2008 as well, and the PDCF had been opened several months before, the financial turmoil persisted, and the programs lent hundreds of billions of dollars. For a complete comparison of Fed emergency facilities used in the present Covid19-related crisis and at the time of the Global Financial Crisis (GFC) see Table 2 below.

Table 2: A Comparison of Fed emergency facilities

Name	Date of Announcement	Description	Legal Authority	Authorized size	Peak outstanding	GFC variant
Primary credit/ Discount window	March 15, 2020 (program already existed, terms changed)	The Fed extends primary credit to financially sound depository institutions (commercial banks, thrifts, and credit unions), accepting nearly all DI assets as collateral including loans. The Fed cut the spread of the primary credit rate above the top of the FOMC's target range for the fed funds rate from 50 bp to 0 and extended the permissible initial maturity from overnight to 90 days, prepayable and renewable by the borrower.	Section 10B (regular lending authority)	N/A	\$130 billion on April 1, 2020	Primary credit/ Discount window
U.S. dollar liquidity swap lines	March 15, 2020 (program already existed, terms changed)	Under the swap lines, the Fed provides the foreign central bank dollars at the prevailing exchange rate, and the funds are swapped back at the same exchange rate at a future date. The Fed cut the interest it charges the central banks from 50 bp to 25 bp over OIS and the foreign central banks began offering loans with maturities of 84-day in addition to current offers with one-week maturities. Over subsequent months, the Fed expanded the number of central bank counterparties significantly	Section 14 (authority for regular open market operations)	N/A	\$449 billion on May 27, 2020	
Primary Dealer Credit Facility (PDCF)	March 17, 2020	Under the PDCF, the New York Fed extends loans with maturities up to 90 days to primary dealers. Eligible collateral includes Treasury, Agency, a range of investment-grade private securities, and equities. The loans are made at the primary credit rate	Section 13(3) (emergency lending)	N/A	\$33 billion on April 15, 2020	PDCF

Name	Date of Announcement	Description	Legal Authority	Authorized size	Peak outstanding	GFC variant
Commercial Paper Funding Facility (CPFF)	March 17, 2020	Under the CPFF, the New York Fed lends to a special purpose vehicle capitalized by an equity investment from Treasury (not CARES Act funds). The SPV purchases newly issued A1/P1 commercial paper or, on a one time basis, A2/P2 paper that was recently downgraded, from a U.S. entity.	Section 13(3) (emergency lending)	N/A	\$13 billion on June 8, 2020	CPFF
Money Market Mutual Fund Liquidity Facility (MMLF)	March 18, 2020	Under the MMLF the Federal Reserve Bank of Boston lends to depository institutions, bank holding companies, or U.S. branches of foreign banks on a nonrecourse basis with no haircut against Treasury securities or top-rated commercial paper, municipal debt, and VRDNs purchased from a money market mutual fund.	Section 13(3) (emergency lending)	N/A	\$53 billion on April 8, 2020	Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility (AMLF)
Primary Market Corporate Credit Facility (PMCCF)	March 23, 2020	Under the PMCCF, the New York Fed lends to a special purpose vehicle capitalized by an equity investment from Treasury (CARES Act funds). The SPV purchases newly issued corporate bonds and syndicated loans from U.S. issuers that either are investment grade or were downgraded from investment grade to no lower than BB-/Ba3.	Section 13(3) (emergency lending) and CARES Act	\$750 billion when combined with SMCCF	The facility is operational but has not closed any transactions as of November 30th 2020 ²⁵	N/A

⁵ <https://www.federalreserve.gov/monetarypolicy/files/pdcf-mmlf-cpff-pmccf-smccf-talf-mlf-ppplf-msnlf-mself-msplf-nonlf-noelf-12-11-20.pdf#page=3>

Name	Date of Announcement	Description	Legal Authority	Authorized size	Peak outstanding	GFC variant
Secondary Market Corporate Credit Facility (SMCCF)	March 23, 2020	Under the SMCCF, the New York Fed lends to a special purpose vehicle capitalized by an equity investment from Treasury (CARES Act funds). The SPV purchases on the secondary market corporate bonds of U.S. companies that either are investment grade or were downgraded from investment grade to no lower than BB-/Ba3 and ETFs backed by corporate bonds.	Section 13(3) (emergency lending) and CARES Act	\$750 billion when combined with PMCCF	\$46 billion on December 9, 2020	N/A
Term Asset-Backed Securities Loan Facility (TALF)	March 23, 2020	Under the TALF, the New York Fed will lend 3-year loans on a non-recourse basis to holders of certain AAA-rated ABS backed by newly and recently originated consumer and small business loans and to holders of existing CMBS. The Treasury provides credit protection.	Section 13(3) (emergency lending) and CARES Act	\$100 billion	\$13 billion on December 9, 2020	TALF
Foreign and International Monetary Authorities (FIMA) Repo Facility	March 31, 2020	The FIMA Repo Facility allows central banks and other international monetary authorities with accounts to borrow on an overnight basis from the New York Fed in the form of a Treasury repo at 25 bp over the IOR rate, rolled over as needed.	Section 14 (authority for regular open market operations)	N/A	N/A	N/A
Paycheck Protection Program Liquidity Facility (PPPLF)	April 9, 2020	Under the PPPLF, several different reserve banks lend to institutions eligible to originate PPP loans at 35 basis points on a nonrecourse basis for the full amount of the PPP loan. The PPPLF loan maturity matches the maturity of the PPP loan collateral	Section 13(3) (emergency lending)	N/A	\$70 billion on July 29, 2020	N/A

Name	Date of Announcement	Description	Legal Authority	Authorized size	Peak outstanding	GFC variant
Main Street Lending Program	April 9, 2020	Under the five facilities ultimately established under the Main Street Lending Program, the Fed lends to an SPV capitalized by the Treasury. The SPV purchases 90 or 95 percent of new loans by participating depository institutions to small and medium sized businesses and nonprofits.	Section 13(3) (emergency lending) and CARES Act	\$600 billion	\$45 billion on December 9, 2020	N/A
Municipal Liquidity Facility (MLF)	April 9, 2020	Under the MLF, the New York Fed lends to a special purpose vehicle capitalized by an equity investment from Treasury (CARES Act funds). The SPV purchases newly issued notes with maturities of 3-years or less directly from U.S. states and medium or larger counties and cities. In general, the issuers must be investment grade or recently downgraded to no lower than BB-/Ba3.	Section 13(3) (emergency lending) and CARES Act	\$500 billion	\$17 billion as of December, 2 2020	N/A

12.4. REGULATORY RELIEF

Federal banking agencies have proposed a series of measures to facilitate credit intermediation through regulatory relief in a number of fronts. In this section we briefly summarize the main actions:

12.4.1. CAPITAL:

- Federal regulatory agencies issued changes to the supplementary leverage ratio (SLR)⁶, temporarily allowing depository institutions to exclude U.S. Treasuries and reserve balances (deposits at the Fed). Banking agencies passed a similar exclusion at the commercial bank level. A bank making use of the exclusion must request approval from its primary federal regulator before making capital distributions.

⁶ Supplementary Leverage Ratio required large bank holding companies to hold a minimum of 3 percent of common equity capital with respect to non-risk weighted total assets.

- Agencies' capital rules were modified to neutralize the regulatory capital effects of participating in the Paycheck Protection Program facility. No credit or market risk and a zero percent risk weight have been assigned to PPP loans pledged to the facility.
- A revised definition of eligible retained income to make any automatic limitation on capital distributions under the Agencies' capital rules more gradual facilitating the use of firms' capital buffers.

12.4.2. LIQUIDITY:

- To further support banks in times of distress and especially to preserve the well-functioning of the flow of credit to businesses and households, the Fed proposed to neutralize the impact on the Liquidity Coverage Ratio (LCR) stemming from non-recourse borrowing from certain Fed facilities like the Money Market Mutual Fund Liquidity Facility and the Paycheck Protection Program Liquidity Facility.
- In addition, the Fed cut banks' reserve requirements to zero. The cut in reserve requirements resulted in a dollar-for-dollar increase in the "High Quality Liquid Assets" (HQLA) bank assets that are eligible to satisfy the Liquidity Coverage Ratio (LCR) because required reserves are excluded from HQLA.

12.4.3. CECL (CURRENT EXPECTED CREDIT LOSS)

- Further actions were taken to grant capital relief as the agencies issued a statement delaying for up to two years the impact of estimated cumulative regulatory capital effects of CECL accounting and de facto providing an optional extension in addition to the three-year transition period that was already in place

12.4.4. CARES ACT LOAN FORBEARANCE PROGRAM

- Under the CARES Act a forbearance program for federally backed mortgage loans was signed protecting borrowers from negative credit reporting due to loan modifications stemming from Covid-19 national emergency and allows banks the option to temporarily suspend triggering troubled debt restructuring (TDR) from modifications in loan terms arising under the CARES Act Covid-19 exceptions.

12.4.5. RESTRICTIONS ON BANK PAYOUTS EXTENDED UNTIL THE END OF THE YEAR

- In a statement published on June 25, the Federal Reserve announced capital payout restrictions on large banks (over USD\$ 100bn in assets). Measures included an outright ban on share-repurchases and a cap on dividend payments to the amount paid in the second quarter of 2020. The Fed further restricted dividends to a maximum of the average net income over the past four quarters. This restriction was extended to fourth quarter capital distributions in a statement published in mid-September. Uncertainty remains as to whether this restriction will continue into 2021.

12.5. STRESS TESTING TAILORED TO COVID-19 PANDEMIC

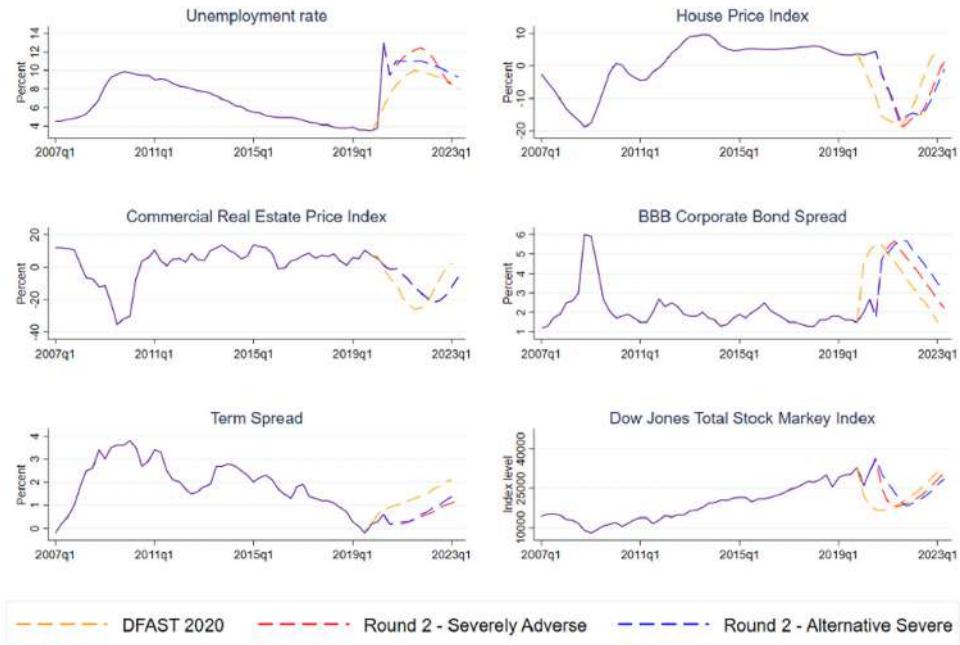
The Federal Reserve released results for its 2020 stress tests that included additional sensitivity analysis around the potential impact of Covid-19. Results for full stress tests designed pre-pandemic showed that all large banks would remain strongly capitalized⁷.

Bank resiliency was tested using three scenarios designed to capture the potential impact of Covid-19: a V-shaped recovery; a more persistent economic impact and slower U-shaped recovery; and a double-dip recession or W-shaped path. In aggregate, loan losses would potentially range from \$560 billion to \$700 billion implying an aggregate capital ratio decline from 12.0 percent to between 9.5 percent and 7.7 percent. Under the more severe scenarios, most firms would remain well capitalized, but several would approach minimum capital requirements. It is important to highlight that the Fed's sensitivity analysis did not incorporate the potential effects of government stimulus payments or expanded unemployment insurance. Following the publication of these results, the Fed restricted bank payout as explained in the section below.

Moreover, the Federal Reserve urged banks to re-evaluate their long-term capital plans and announced a second round of stress tests in 2020. Two new scenarios were published on September 17, 2020. Our analysis indicates that both stress tests scenarios are tougher than the severely adverse scenario used in the June 2020 exercise (Covas 2020). In the Exhibit 5 below, we plot the main macroeconomic variables under the June 2020 exercise and the upcoming Round 2 scenarios. It is worth highlighting that while the unemployment rate is already elevated for the new round of stress tests, instead of using the 13 percent unemployment rate in the second quarter as the jumping-off point from which the deterioration in the unemployment rate starts, both stress scenarios use the third-quarter baseline forecast for the unemployment rate at 9½ percent. Another important difference between Round 1 and 2 is that the yield curve is flatter in the second stress tests, which creates more headwinds for bank profitability.

⁷ <https://www.federalreserve.gov/newsevents/pressreleases/bcreg20200625c.htm>

Exhibit 5: Stress Test. Scenario and Comparison



12.6. ROLE OF BANKS

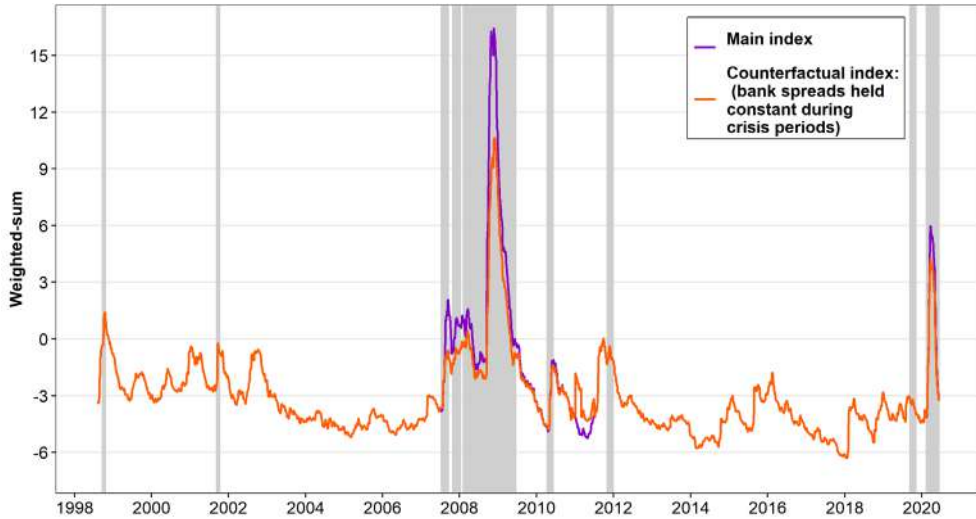
A critical difference between the Global Financial Crisis and the Covid-19 pandemic is that in 2007-09, banks contributed to the disarray in financial markets and the broader economy, whereas now they are part of the solution. Leading up to the 2007-09 crisis, banks were weakly capitalized, held a relatively small quantity of liquid assets, and were exposed to losses from private mortgage-backed securities and other structured products that were at the heart of the financial rot. Since the past financial crisis, much has been done to heal the banking sector and make it safer and more resilient. For example, according to the data provided in the Fed’s May 2020 Supervision and Regulation report⁸, large banks have doubled their capital ratios and quadrupled their liquidity holdings. Moreover, banks are rigorously tested each year for their ability to withstand a massive downgrade of the economic outlook such as the one we are experiencing today.

To compare banks’ contribution to financial market stress during the two periods, we provide a counterfactual representation of the financial stress index discussed above. In Exhibit 6, we plot the main index along with its counterfactual that holds bank credit

⁸ <https://www.federalreserve.gov/publications/files/202005-supervision-and-regulation-report.pdf>

spreads constant throughout the 2007-09 and coronavirus episodes.⁹ Note that the main index shown is computationally equivalent to that in Exhibit 1, but to improve viewability, we do not convert the index into probabilities.¹⁰

Exhibit 6: Continuous financial stress index and counterfactual scenario



Note: Shaded bars indicate historical periods of financial stress.

As can be seen, approximately 42 percent of the sharp increase in the index that followed the Lehman collapse reflected a widening of bank credit spreads. In contrast, increases in bank credit spreads contributed only 17 percent of the jump in the index during the Covid period.

To understand the important role of banks in stemming the crisis, consider this description of the early stages of the past financial crisis from Borio and Nelson (2008):

The turmoil was triggered by a sharp and disorderly repricing of credit risk, with the US subprime mortgage market at its epicentre. Given the leverage built up in the system and the opaqueness of valuations of new structured products and of their distribution within the system, the repricing led to, and was exacerbated by, an evaporation of liquidity in many markets, including in the interbank market. As the strains spread, banks became very concerned with the liquidity and capital implications of potential large-scale

⁹ The two bank-credit spread measures are the 3-month LIBOR – 3-month Treasury yield spread, and the Bloomberg-Barclays investment-grade bank index. In the counterfactual version, we hold each series constant from the end of June 2007 to the end of December 2010, and from the end of January 2020 to the present.

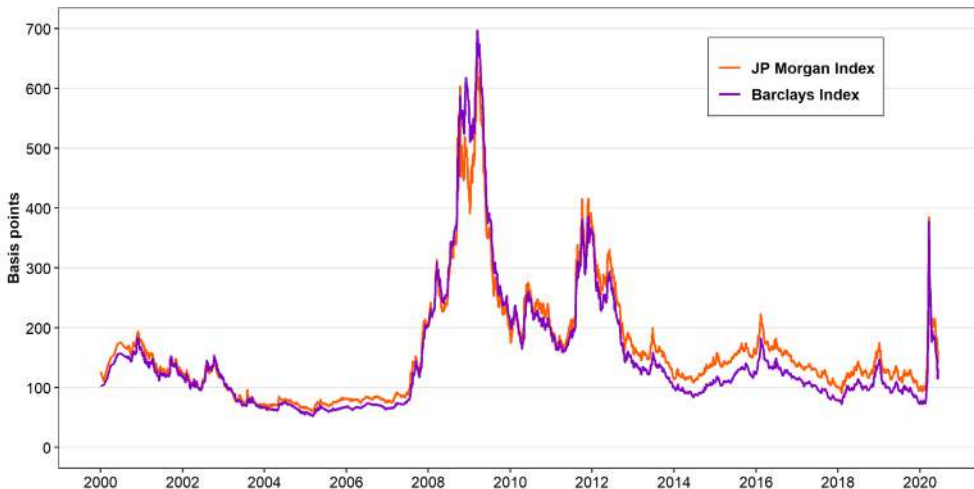
¹⁰ As explained in Carlson et al. (2012), the three summary indicators of financial stress are first mapped into an index that they call the “weighted-sum” before being translated into probability of Fed emergency intervention. Exhibit 3 uses the weighted-sum representation.

involuntary reintermediation and distrusted their counterparties. The reintermediation was primarily associated with banks' backup credit lines for securitised vehicles and with the inability to dispose of assets intended to be sold off, in line with the originate and-distribute model. In August, tensions were thus transmitted to the heart of the financial system – the interbank market, both in the United States and in a number of other mature markets. (pp. 37-8)

In March 2020, just as in August 2007, banks were again hit by massive draws on lines of credit, but this time the consequences were much different. Between February 12, 2020 and April 1, bank loans increased a bit over \$700 billion, in large part because banks were funding draws on lines of credit as businesses, large and small, sought to stockpile cash. By contrast, Fed lending peaked at about \$130 billion at the beginning of April.¹¹ Banks and broker-dealers were the first responders on the scene in this crisis, not the arsonists. But despite these massive draws, banks faced no material liquidity challenges, and counterparty concerns remained largely subdued.

In Exhibit 7, we plot two comparable measures of bank credit risk from JP Morgan and Barclays. Both series measure the banking sector investment-grade corporate bond spreads over comparable Treasury yields. The JP Morgan and Barclays indices recently peaked at 385 basis points on March 20, and 378 basis points on March 23, respectively, only two-thirds of the levels recorded in the past financial crisis and similar to levels observed during the European Banking Crisis. Moreover, both indices fell below 200 basis points by mid-April, below levels that had generally prevailed from 2008 to 2013.

Exhibit 7: Measures of bank credit risk



Note: Both series measure the investment-grade banking sector corporate bond spread over comparable Treasury yields.

Sources: (1) JP Morgan Markets U.S. Liquid Index - Banking Sector.
 (2) Bloomberg Barclays Invest. Grade: Banking Total Return Index - U.S. Banks.

¹¹ Federal Reserve statistical releases H.4.1. and H.8.

When banks are concerned about whether counterparties will repay their loans, and about their own ability to fund themselves, they stop lending to each other at term or entirely. In that way, a liquidity shock becomes a liquidity crisis. In March 2020, there was a profound liquidity shock, but with no counterparty or own liquidity concerns to amplify it; therefore, it quickly subsided. As noted in the Fed's June 2020 Monetary Policy Report to Congress:

Funding markets proved less fragile than during the 2007–09 episode in the face of the Covid-19 outbreak and the associated financial market turmoil. The subdued reliance of large bank holding companies on short-term funding and their robust holdings of high-quality liquid assets have prevented any considerable stress in the banking sector.

12.7. FINAL THOUGHTS AND LESSONS LEARNT.

The Covid-19 pandemic was a staggering blow to the financial system. In essence, it was the first real test to the post Global Financial Crisis regulatory framework. As countries around the world went through serious lockdowns and their economies were set on pause, the fear of a sudden stop within the financial system was real. No doubt, the Fed's quick and massive response to the severe market dislocation in mid-March helped prevent a larger conflagration, but as expressed in the Federal Reserve Stability reports in May and November, so did a well-capitalized and liquid financial system.

We are, of course, not out of the woods yet. While employment and the economy have partially recovered, and vaccines are being distributed, the country is in the grips of the worse-yet wave of the pandemic and it is unclear if there will be further Federal aid. Loan losses may rise, but the impact of those losses on banks' capital positions could be modest because banks have built up such sizeable loan loss reserves. Thus far, as reflected in the quote from Fed Vice Chair Clarida at the top of this paper, banks are a source of strength and credit for the economy. And that's important.

12.8. APPENDIX

We follow the financial stress events and model used by Carlson, Lewis, and Nelson (2012) and developed in Nelson and Perli (2005). Financial stress episodes are defined events in which U.S. policymakers (mostly Federal Reserve) intervened in response to deteriorating financial market conditions. As in those previous papers, we fit those occurrences using a logistic regression using various market measures of risk, uncertainty, and liquidity. As explained below, we adjust the variables used in the model slightly and identify additional instances where the Fed intervened.

Methodology

The building blocks of the model are thirteen financial series, taken at a daily frequency, that in turn capture market measures of risk spreads, investor uncertainty, and liquidity premia. These series are listed in table A. The variables are standardized, converted to a 5-day moving average, and consolidated into three sub-indices:

1. *Levels*: the average levels of the series
2. *Volatility*: the average volatility of the series, calculated as the sum of squared changes over an 8-week moving average
3. *Co-movement*: the co-movement of the daily changes of the series, calculated as the percent of total variation that can be explained by a single common factor over a 26-week moving average

These sub-indices comprise the explanatory variables in the logistic regression.

The dependent variable consists of a binary variable that is set equal to one on the four weeks before and after the announcement of government (primarily Fed) interventions designed specifically to protect financial market functioning. A complete list of identified stress events is provided in Table B.

Changes from Carlson, Lewis, and Nelson (2012)

We updated the analysis slightly relative to Carlson et al. First, we added additional episodes of government intervention. In addition to the interventions in response to the Covid-19 crisis we added the reopening of the central bank swap lines on November 30, 2011, in response to pressures stemming from the European banking crisis, and the expansion of Fed asset purchases and repo lending announced on October 3, 2019, in response to volatility in repo markets.

Second, we added two measures of financial stress: The root-mean-squared-error (RSME) of the Treasury yield curve fitting error, and, more importantly, the average corporate bond spread to comparable Treasury yields for investment-grade U.S. banks. RMSE has become a standard measure of financial stress. Bank risk spreads improve the fit of the model and help us to assess the role of banks during the Covid-19 financial shock. We dropped the series on certificate of deposit spreads for which we do not have data.

Table A: Underlying data series

- Liquidity
 - On-the-run liquidity premium for the 2-year Treasury
 - On-the-run liquidity premium for the 10-year Treasury
 - Root-mean-squared-error of the Treasury yield curve fitting error
 - Federal funds target – yield on the two-year Treasury
- Risk Spreads
 - Yield spread between AA-rated corporate bonds (ICE BofA AA US Corporate Index) and 10-year Treasury securities
 - Yield spread between BBB-rated corporate bonds (ICE BofA BBB US Corporate Index) and 10-year Treasury securities
 - Yield spread between high-yield corporate bonds (ICE BofA US High Yield Index) and 10-year Treasury securities
 - Spread between the 3-month LIBOR and the 3-month Treasury rate
 - Corporate bond spread to comparable Treasury yields for investment-grade U.S. banks (Bloomberg-Barclays investment-grade bank index)

- o (12-month ahead earnings/S&P 500 earnings) – yield on 10-year Treasury (a measure of the equity premium for stocks)
- Investor Uncertainty
 - o Implied volatility on 3-month swaptions
 - o Implied volatility on 10-year swaptions
 - o S&P100 implied volatility (VXO)

Table B: Policy Intervention Events

Date	Intervention Event
September 23, 1998	Federal Reserve coordinates purchase of LTCM by consortium of 14 firms
September 11, 2001	Federal Reserve responds to liquidity shortages caused by the physical limitations of 9/11 (note: we do not identify the 4-weeks leading up to 9/11 as a stress period)
August 10, 2007	Federal Reserve adds \$38 billion in reserves and issues a statement reaffirming its commitment to provide liquidity
August 17, 2007	Federal Reserve reduces primary credit spread by 50 basis points and allows 30-day term financing
August 21, 2007	Federal Reserve reduces minimum fee rate for SOMA securities lending
November 26, 2007	Federal Reserve eases terms on SOMA lending
December 12, 2007	Federal Reserve announces creation of the TAF
March 7, 2008	Federal Reserve announces it is expanding the size of the next two TAF auctions
March 11, 2008	Federal Reserve announces the creation of the TSLF
March 14, 2008	Federal Reserve lends to Bear Stearns
March 16, 2008	Federal Reserve facilitates purchase of Bear Stearns by JPMC and creates PDCF
May 2, 2008	Federal Reserve increases the size of TAF auctions
July 13, 2008	Federal Reserve authorizes the FRBNY to lend to Fannie and Freddie should lending prove necessary
July 30, 2008	Federal Reserve extends term lending on TAF to 84 days
September 7, 2008	Treasury places Fannie and Freddie into conservatorship & provides liquidity backstops for GSEs
September 15, 2008	Federal Reserve expands PDCF eligible assets & conducts two open market operations
September 16, 2008	Federal Reserve extends line of credit to AIG
September 19, 2008	Federal Reserve announces AMLF & Treasury guaranties MMMFs
September 28, 2008	FDIC announces assistance for Wachovia merger & Federal Reserve increase size of TAF
October 6, 2008	Federal Reserve further expands size of TAF
October 7, 2008	Federal Reserve announces creation of the CPFF
October 8, 2008	Federal Reserve decreases fees on SOMA lending

Date	Intervention Event
October 14, 2008	Treasury announces \$250 billion for preferred stock purchases & FDIC announces TLGP
October 21, 2008	Federal Reserve announces the creation of the MMIFF
November 23, 2008	Federal Reserve, Treasury and FDIC agree to provide Citigroup a package of guarantees, liquidity access, and capital
November 25, 2008	Federal Reserve announces the TALF
December 30, 2008	Treasury announces the purchase of preferred stock in GMAC
January 7, 2009	Federal Reserve expands set of institutions eligible to borrow under the MMIFF
January 16, 2009	Treasury, FDIC and Federal Reserve provide BofA with a rescue package
January 30, 2009	Federal Reserve liberalizes rules related to AMLF
February 25, 2009	Federal Reserve, OCC, FDIC, and OTS announce details of the Capital Assistance Program
March 23, 2009	Treasury announces the details of the public-partnership investment plan
May 1, 2009	Federal Reserve announces the inclusion of the CMBS in the TALF
May 7, 2009	Bank stress test results and capital-raising requirements for SCAP firms officially announced
May 19, 2009	Federal Reserve further expands collateral eligible under the TALF
May 11, 2010	Federal Reserve agrees with foreign central banks to reestablish temporary dollar swap facilities
November 30, 2011	Federal Reserve authorizes reopening of central bank swap lines
October 11, 2019	Expansion of the Fed's balance sheet in reaction to repo market volatility
March 15, 2020	Federal Reserve announces quantitative easing and enhancements to discount window borrowing and swap lines
March 17, 2020	Federal Reserve announces Commercial Paper Funding Facility (CPFF) and Primary Dealer Credit Facility (PDCF)
March 18, 2020	Federal Reserve announces Money Market Mutual Fund Liquidity Facility (MMLF)
March 23, 2020	Federal Reserve directs Open Market Desk to purchase Treasuries and agency MBS. Announces Corporate Credit Facilities (PMCCF, SMCCF), and Term Asset-backed Liquidity Facility (TALF). Expands MMLF and CPFF. Announces plans to establish Main Street Lending Program
March 31, 2020	Federal Reserve announces FIMA repo facility
April 9, 2020	Federal Reserve establishes Municipal Liquidity Facility (MLF) and Paycheck Protection Program Liquidity Facility (PPPLF). Expands size and scope of PMCCF, SMCCF, and TALF
April 27, 2020	Federal Reserve expands scope and duration of the MLF
April 30, 2020	Federal Reserve expands access to PPPLF
May 5, 2020	Federal banking agencies modify LCR rule to support MMLF and PPPLF
May 15, 2020	Temporary change to SLR rule
June 3, 2020	Federal Reserve Expands Number and Type of Entities Eligible for MLF



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13. BANKING SUPERVISION AFTER THE PANDEMIC

FERNANDO RESTOY¹

13.1. INTRODUCTION

The pandemic's impact has been extreme in many respects. First, the scale of this health crisis is almost unprecedented. Second, the resulting lockdowns and mobility restrictions have created the sharpest fall-off in economic activity and employment in decades. Finally, the worldwide policy response has probably been the boldest and the most synchronised ever.

Regarding policy, the fiscal and monetary authorities have not only adopted a largely expansionary stance but some have also used instruments that were rarely employed in the past. The massive provision by fiscal authorities of loan-loss guarantees to all types of borrower is an example. In monetary policy, the expansion of asset purchase programmes and, in some jurisdictions, the increase in central banks' exposure to non-financial corporate risk are actions that were previously unthinkable.

No less remarkable has been the response from regulators. Possibly for the first time, they have explicitly assumed a macro-stabilisation role. Indeed, their actions have been openly geared towards maintaining credit flows to firms and households, to soften the pandemic's impact on economic activity and job creation. With a suite of regulatory relief measures, they have adopted a macroprudential approach along the lines drawn up in the post-crisis reforms. Interestingly, these measures are aimed not at containing

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The views expressed are my own and not necessarily the views of the BIS or Basel-based standard setting bodies.

excessive credit growth but, on the contrary, at aligning prudential policy with the need to keep up financing for the real economy.

In this, the authorities had to face difficult trade-offs, as the macro and micro dimensions of prudential policies may well clash with each other. Those challenges could compound any structural vulnerabilities of the financial sector – such as those related to low profitability and new sources of risks – that the pandemic may have exacerbated. In Europe, the Single Supervisory Mechanism (SSM) will need to bear in mind the excess capacity of the industry, and the consequent need to promote an orderly consolidation, when deciding on how best react to the stress generated by the pandemic on supervised institutions.

This article reviews the key challenges for prudential authorities after the pandemic. Section 2 focuses on supervisory issues. In particular, it asks how the pandemic shock, combined with structural developments, has affected supervisory priorities for the short and medium term. Section 3 deals with the regulatory framework and identifies elements that regulators may want to reconsider. Finally, Section 4 concludes.

13.2. ON SUPERVISORY CHALLENGES

13.2.1. ACTIONS UNDERTAKEN

Regulators and supervisors have taken bold action to reduce incentives for banks to retrench on their willingness to provide credit to the private sector. Their aim is to prevent uncoordinated responses by banks that could lead to a credit contraction, thus amplifying the harm done by the pandemic to the real economy. These measures complement those taken by other public authorities, notably the adoption of borrower support measures, including public guarantees and payment deferrals (of interest and/or principal) on outstanding loans.

Table 1 shows measures undertaken in major economies short after the pandemic's outbreak.

Table 1 Selected policy measures

Jurisdiction	Government guarantees	Capital requirements	Asset classification	Expected loss provisioning	Dividends and other payouts
Australia	Yes	Encouragement to use buffers	New guidance	-	Expectation to limit
Canada	Yes	Lower Domestic Stability Buffer, Encouragement to use buffers	New guidance	New guidance, Introduction of transitional arrangements	Expectation to halt increases

Jurisdiction	Government guarantees	Capital requirements	Asset classification	Expected loss provisioning	Dividends and other payouts
EU/SSM	Yes (*)	Release CCyB, Encouragement to use buffers	New guidance	New guidance	Expectation to halt
Japan	Yes	Encouragement to use buffers	Adjust risk weights of certain loans	-	-
United Kingdom	Yes	Release CCyB, Encouragement to use buffers	New guidance	New guidance	Expectation to halt
United States	Yes	Encouragement to use buffers, Adjust supplementary leverage ratio	New guidance, Definition of restructured debt	Optional suspension, Extension of transitional arrangements	Expectation of prudent decisions, Smoothing of automatic restrictions

(*) conditions vary across member countries.

Source: Borio and Restoy (2020).

Those actions cover key elements of the prudential framework, including capital requirements, asset classification and measurement, capital distribution and the supervisory strategy. More concretely:

- On capital, supervisors have set the countercyclical capital buffer (CCyB) at zero or at a low level, changed the calculation of the leverage ratio to make it less binding and encouraged banks to use buffers to keep up the credit supply.
- On asset classification, they have issued guidance providing flexibility for the consideration of exposures as impaired, non-performing or forborne when they benefit from public guarantees or payment deferrals.
- On asset measurement, banks have been asked to apply a pragmatic approach for the calculation of expected losses. Moreover, the impact of the new expected-credit-loss accounting standard on bank solvency has been mitigated by temporarily suspending the application of the standard or by sterilising its effect on regulatory capital.
- On capital distribution, authorities have asked banks to limit or suspend dividends, share buyback programmes and other payouts.
- Finally, supervisors have alleviated banks' operational burdens by postponing information requests and resource-consuming exercises such as horizontal reviews and stress tests.

13.2.2. THE CHALLENGING SUPERVISORY ENVIRONMENT

The measures taken by supervisory authorities, when combined with supportive fiscal and monetary policy, should undoubtedly mitigate the pandemic's impact on economic

and financial stability. Yet, these actions will need to be followed up by effective supervision of individual financial institutions.

This task will face three substantial challenges from the business and supervisory environment:

First, and most importantly, substantially riskier business conditions for banks, which affect nearly all sources of risk (credit, market, liquidity, counterparty, operational etc). While many of these risks have not yet materialised, thanks partly to government-provided support, they may yet have a future impact on bank balance sheets.

Second, regulatory measures to support credit flows to the real economy may complicate supervisory work. While fully warranted, they could make banks' financial health more difficult to assess. Indeed, most of the relief measures directly affect the computation of regulatory capital, risk-weighted assets and asset quality indicators. The latter may be particularly significant. The flexibility provided for the classification of assets as non-performing or forborne makes it challenging for supervisors to monitor the evolution of asset quality. The extreme case is in jurisdictions, particularly in emerging market economies, that have gone as far as freezing the classification status of all credit exposures prior to Covid-19 (IMF and World Bank (2020)). And most countries have suspended the application of the objective past-due criterion to identify non-performing exposures (NPEs) for all loans that benefit from payment deferrals.² The identification of NPEs will then have to rely exclusively on the more subjective *unlikely-to-pay criterion*, which is particularly difficult to assess at present, given the uncertain length of the health crisis and its impact on credit quality.

Finally, the pandemic makes it more difficult for supervisors to conduct on-site missions, and hence to assess a bank's risk profile. In most jurisdictions, supervision relies heavily on on-site inspections to complement the off-site analysis of regular supervisory reports. In some cases, examiners regularly work on a bank's premises to obtain the required information and maintain contact with key officers. Moreover, supervisory agencies have regular in-person contact with bank directors and occasionally participate in board meetings. All this interaction is affected by the pandemic, even if new technology has helped to underpin essential supervisory work.

In sum, a combination of higher risks, less informative prudential indicators and a heavy reliance on off-site reviews make supervisory work particularly challenging at present. Against that background, supervisors need to make difficult decisions on how best to address the vulnerabilities of institutions they see as more significantly exposed to the pandemic's effects.

13.2.3. Short-term supervisory priorities

The overall short-term objective for supervisors is to achieve the right balance between the macro and micro objectives of prudential regulation. This is a challenge because the policy response to the Covid-19 outbreak shows that the macro/microprudential divide is far from clear.

² This practice follows the Basel Committee guidance on the matter (BCBS (2020a)).

Arguably, the most relevant macroprudential instrument within the Basel III toolkit is the CCyB. Thus far, however, it has lacked the necessary firepower to address the potential impact of this unexpected shock to credit availability. As a consequence, authorities have had to rely on other, essentially microprudential, instruments, such as encouraging the use of supervisory buffers and of flexible criteria for asset classification and measurement. This matter will be discussed further in the next section.

There is no doubt that the focus on helping banks to continue funding the real economy was fully warranted. At the same time, there is a limit on what microprudential policies can do to support aggregate credit developments without jeopardising the safety and soundness of individual financial institutions. In particular, while supervisors have promoted the application of pragmatic criteria for asset classification and measurement, banks' practices should remain consistent with a sound evaluation of asset quality – on the basis of all available information – and with an adequate disclosure of their expected losses. Otherwise, corrective actions will be unduly delayed and market trust in reported data will be affected, generating instability risks.

The challenge, therefore, is to keep a supportive macroprudential policy stance that could help stabilise the economy while, at the same time, continuing to closely monitor individual financial institutions. Well designed stress tests could certainly help supervisors to assess the banking sector's capacity to absorb losses and continue providing credit. Yet the conduct of such exercises is particularly complex at present, given the uncertainty surrounding economic projections and the direction of public policy (Baudino (2020)). In any event, the reliability of the results hinges on the accuracy of accounting data and banks' asset classifications, which are the starting point for the simulations.

Finally, it would seem wise, as some regulators are already doing, to step up contingency planning for resolution. This could include reviewing the feasibility of resolution strategies, raising internal awareness of decision-making procedures, seeking ways to re-vamp capacity in case of need and identifying key external parties, such as valuers and legal advisors.

13.2.4. THE MEDIUM-TERM STRATEGY

While the above measures are necessary, they will not be sufficient to address the broader longer-term challenges faced by the banking sector worldwide. Moreover, to identify the right policy response in relation to vulnerable banks, it is worth noting that the pandemic shock compounds some structural developments in the financial industry.

In particular, short-term uncertainty exacerbates the stresses generated by technological disruption and persistently low profitability in some jurisdictions. Similarly, operational risks associated with remote working during lockdowns add to the trend of increasing reliance by banks on technology and third-party providers. Over the longer term, climate change and energy transition policies could further affect banks' financial strength.

Supervisors may therefore want to take this opportunity to accelerate their response to these structural vulnerabilities rather than focusing only on addressing the immediate impact of the pandemic on bank solvency.

The low profitability of banks in a number of jurisdictions reflects a variety of factors. First, persistently low interest rates compress banks' intermediation margins. Second, the fintech disruption threatens to erode banks' market shares in providing financial services such as payments, wealth management and even credit underwriting – in which they have traditionally been dominant. Finally, the post-Great Financial Crisis (GFC) reforms have put pressure on traditional bank business models, increasing compliance costs. As a consequence, low profitability appears to reflect excess capacity in the banking industry.

This is certainly the case in Europe, where all standard indicators point to overbanking (Restoy (2018)). Moreover, the European banking industry is characterised by a large proportion of institutions with little exposure to capital markets. As these institutions can operate with only limited market discipline, this factor tends to slow – if not obstruct – the required restructuring.

Overcapacity could trigger financial stability risk by preventing banks from generating sufficient capital resources internally or raising them externally. In these circumstances, supervisors should be entitled to adopt a proactive strategy to facilitate an orderly consolidation of the industry wherever this is needed (ECB (2020)). For that purpose, the business model sustainability analyses that several supervisory agencies regularly conduct represent a potentially effective tool for facilitating a more sustainable banking industry in terms of its size and structure.

On operational resilience, it is fortunate that the BCBS (BCBS (2020b)) is in the process of finalising guidance on the matter. This will constitute a good reference point for firms and supervisors as they respond to the challenges arising from banks' increased reliance on technology and third-party providers. More generally, some authorities are reviewing their framework for the monitoring of banks' operational resilience. The new approach adopts a more comprehensive understanding of that concept, going beyond the cyber-security focus of current frameworks. There is also more emphasis on incident recovery. Finally, the traditional focus on banks and insurance companies is replaced by a broader approach in establishing general requirements and guidance to be followed by all providers of financial services, including fintech firms (See European Commission (2020) and Bank of England et al (2020)).

Regarding climate change, no international consensus yet exists on how to embed these risks into regulatory and supervisory requirements. It seems logical to accept the principle that prudential regulation should not promote green finance as a way to fight climate change. Instead, this should be addressed by other policy instruments such as carbon taxation. Where such risks are not fully captured by the current framework, however, prudential regulation will need to be adjusted insofar as climate change will generate risks for the safety and soundness of financial institutions.

As a first step, the international community (see NGFS (2020)) has started developing useful references for banks to conduct their own self-evaluations on specific physical

and transition risks. Some regulators are already developing scenarios, taxonomies and assessment methodologies that should support that assessment. Yet, much work remains to be done in this area, not least to fill data gaps.

Finally, the crisis has strengthened the case for supervisors to embrace technology in order to keep up with the sector's digital transformation. Technology can also help to improve supervisory processes and to make them less-dependent on on-site reviews. The FSI has already undertaken a number of projects that analyse the potential of supotech applications with the aim of supporting capacity-building in this area (Broeders and Prenio (2018), di Castri et al (2019)).

It is worth stressing here that the primary objective is not to quickly develop sophisticated inhouse AI/ML algorithms and the like. More importantly, supervisors need to ensure the swift availability of sufficiently granular data – beyond that contained in regular supervisory reports – and to develop the capacity to process that data. This is essential if the new technologies are to generate sufficient value in terms of supervisory efficiency and effectiveness.

13.3. ON REGULATORY CHALLENGES

By stress testing the financial sector, the pandemic is helping to show how far the post-GFC regulatory framework is likely to achieve its objectives.

The first observation is that, as shown in the actual stress tests conducted in major economies, the financial system seems generally able to absorb the pandemic's impact even under the severe scenarios of a prolonged health crisis and economic contraction. This is largely thanks to the ample capital and liquidity buffers built up by financial institutions to comply with the Basel III reforms.

At the same time, the crisis has shown that other components of the post-crisis reforms may have had some unanticipated effects. For example, the expected credit loss provisioning standard was meant to reduce the procyclicality of banks' income by requiring them to anticipate loan loss provisions before actual delinquencies take place. The pandemic has shown that, when facing an unexpected common shock, accounting rules based on expected rather than incurred losses tend to force all banks to sharply increase their provisions more or less at the same time. This convergence of provisioning efforts across time and across entities may generate a destabilising procyclicality. This may explain why regulators – including accounting standard setters (IFRS (2020)) – have issued guidance for banks to apply the new standard in a pragmatic way and that, in some cases, have opted to postpone the compulsory application of the new accounting rules.

Another important area for reflection by regulators is the Basel III buffer system, and how well it works. In particular, it makes sense to reflect on whether buffers are contributing, as intended, to preserve minimum capital and mitigate the impact of the downturn on credit supply.

Table 2

	CAP REQUIREMENTS =					Sup Buffers (SB)
	P1	+ P2	+ SIB	+ CCoB	+ CCyB +	<ul style="list-style-type: none"> • P2G in BU • PRA-B in UK • STCB in US
Basel III	✓	✓	✓	✓	✓	✗
Microprudential	✓	✓	✗	✓	✗	✓
Usable in bad times	✗	In some cases	✗	✓	✓	✓
Releasable	✗	✗	✗	✗	✓	✗
Penalties/restrictions	✓	✓	✓	✓	✓	In some cases

Source: Author's compilation.

Table 2 illustrates the different layers of regulatory capital envisaged in the Basel framework. Pillar 1 (P1) establishes the minimum capital all banks have to hold. Pillar 2 (P2) includes capital add-ons to cover entity-specific risks not captured in Pillar 1. In addition, all banks must meet a combined buffer requirement composed of a homogeneous capital conservation buffer (CCoB), a systemic risk buffer (SIB) if they meet specific criteria, and a countercyclical capital buffer (CCyB) that can be imposed and released by macroprudential authorities in response to economic developments and, especially, credit growth (FSI (2019)).

Some of those buffers (CCoB and CCyB) are supposed to be used in bad-times, while others (P2 and SIB) should generally be met at all times. The use of these Basel III buffers may imply penalties or restrictions, such as limits on dividend payouts or on variable remuneration.

To judge how the buffer system is performing in the current crisis, it is necessary to acknowledge the wide variety of approaches followed in different jurisdictions to establish buffers above the minimum capital requirements. That heterogeneity arises in part from the different interpretations and calibrations of the Basel Pillar 2 (Duckwitz et al (2019)). In addition, as shown in Table 2, discrepancies have emerged from the differences in national or jurisdictional overlays (supervisory buffers (SB)) above the Basel III capital stack.

In jurisdictions such as the European banking union, the United Kingdom and the United States, supervisors expect banks to meet additional buffers (P2 Guidance, PRA buffer and the stress-test capital buffer, respectively), which are calculated as a function of the capital depletion that banks would suffer in an adverse scenario of different types of supervisory stress test. Those jurisdiction-specific buffers are set annually for each institution as part of the supervisory cycle and can be used – with or without pay-out restrictions – to absorb unexpected losses.

A key observation from Table 2 is that there was only one purely macroprudential instrument (the CCyB) that could be (and was) swiftly released following the pandemic's outbreak. But other, microprudential, instruments (such as the CCoB or supervisory

buffers) can also play a partially macroprudential role by allowing banks to absorb losses and still meet minimum capital requirements without the need to constrain credit.

It is too early to conclude whether any aspect of the current framework needs adjustment. So far, the buffer system is proving helpful in allowing banks to absorb losses and hence safeguard their minimum capital. Moreover, there is no firm evidence for any significant credit contraction that could be blamed on an imperfect functioning of the buffers' macro-stabilisation function.³

At the same time, some developments could merit continued monitoring and analysis. First, the CCyB was intended to address economic contractions caused by the unwinding of macro-financial imbalances such as excessive credit growth. Since, in the recent past, credit has not been growing rapidly, the CCyB was already set at zero or a very low level in most jurisdictions. Thus, very little firepower remained to deploy against a purely exogenous shock that was unrelated to credit developments.

Second, as the CCyB proved unable to deliver the stabilising power required, regulators had to rely mainly on microprudential instruments to meet a macroprudential objective (Carstens (2020)). Concrete actions varied across jurisdictions, although they often consisted in asking banks to make use of their microprudential buffers (such as the CCoB and SB). The result has not so far been entirely satisfactory, as banks have generally shown a reluctance to use their buffers.

This unwillingness may, of course, reflect the slightness of the impact (at least so far) of the pandemic on banks' solvency. That in turn may be due partly to the pandemic's limited impact on asset quality indicators, as payment deferrals and government guarantees are still working to shore up banks' asset values. However, several disincentives seem to exist that may make banks reluctant to make use of their buffers, even if they are facing significant capital pressure.

In particular, the use of the Basel III buffer depletion is subject to automatic remuneration restrictions for instruments qualifying as regulatory capital. Thus, banks may fear that the market price of those instruments will be undermined if they reduce their capital levels below the buffer thresholds. In addition, the binding constraint for regulatory capital is not necessarily the prudential requirement. Global systemically important banks (G-SIBs) are subject to loss-absorption requirements (ie the TLAC) aiming at facilitating their resolution in case of failure. Those requirements have not been modified following the pandemic's outbreak. Banks may therefore be unwilling to reduce their equity levels – by consuming their prudential buffers – if they still need that equity to meet TLAC requirements. In the European Union, that constraint can be particularly important, as all significant banks – not only the European G-SIBs – are subject to TLAC-type requirements (ie the MREL) and medium-sized banks heavily rely on common equity to satisfy them.

³ Lending surveys show a tightening of lending standards as of Q2/2020 in the EU (Euro Area Bank Lending Survey) and Q3/2020 in the US (Senior Loan Office Survey).

Moreover, uncertainty may linger as to the pandemic's length and severity, and the forbearance that supervisors will extend before insisting on a full restoration of pre-Covid capital levels, despite the assurance given by supervisors that they will give banks ample time to rebuild their depleted buffers.

More generally, the uncertain financial and economic environment makes markets sensitive to any development affecting the ability of banks to withstand adverse developments without replenishing their capital. In these conditions, investors may penalise any capital reductions below the regulatory references, even if this is supported by supervisory guidance.

This market stigma is likely to be particularly pronounced in jurisdictions, such as the European Union, where – as discussed in Section 2 – the profitability of financial institutions and their market valuations are depressed due to the sector's excess capacity. Low profits indicate that banks are finding it difficult to generate capital internally. Similarly, low price-to-book values indicate the heavy price that banks would have to pay to attract more equity capital. Available capital becomes particularly precious in these jurisdictions. This suggests that overbanking may affect not only market efficiency and, potentially, financial stability, but also banks' ability to use their capital to smooth out fluctuations in credit supply. This macroprudential argument further supports a proactive approach by authorities to facilitate an orderly consolidation.

In any event, this suggests that supervisors' willingness to accept a temporary use of the buffers to absorb losses may not suffice to keep the credit supply at adequate levels. These developments will need to be carefully examined by regulators and international standard-setting bodies to assess whether refinements of the current framework would be warranted.

In this regard, there could be several options for improving the current framework.

One conservative approach would be to work on the actual penalties faced by banks if they use buffers. In particular, it could be considered whether current constraints on the remuneration of holders of equity or other instruments – such as Additional Tier 1 (AT1) – have unintended effects when bank capital falls below specific thresholds. However, removing these restrictions may be inconsistent with the required loss-absorption nature of all instruments qualifying as regulatory capital. Moreover, as argued above, that strategy would not address the plurality of factors, including market stigma, that feed into banks' apparent unwillingness to make use of their capital buffers.

A more ambitious approach would be to establish a larger macroprudential buffer that could be released at discretion during bad times. Such a buffer would replace the current CCyB and would have a positive level in normal times in order to accommodate unexpected shocks such as a pandemic.⁴ This adjustment of the current framework would allow objectives and instruments to be more clearly aligned. The macroprudential buffer would be set exclusively on macroprudential policy grounds (eg to help keep up

⁴ This is the approach currently followed in the United Kingdom. Quarles (2019) and Hernández de Cos (2020) support further reflection on the merits of this approach.

an orderly provision of credit to the real economy) while the microprudential buffers (CCoB and SB) would be calibrated to meet purely microprudential objectives, ie to ensure that individual financial institutions have sufficient capital in all phases of the economic and financial cycle.

Arguably, that proposal could entail some transfer of powers from microprudential to macroprudential authorities. Moreover, for international banks, the host authorities would have more influence on capital requirements for the group, as they would set the macroprudential buffer for both domestic banks and subsidiaries of foreign banks.

Those political-economy considerations may become particularly significant in the European banking union. At present, the microprudential responsibility is effectively centralised in the ECB through the Single Supervisory Mechanism. At the same time, the macroprudential responsibilities remain largely decentralised, although the ECB can top up measures taken at the national level. The idea of moving resources in normal times from microprudential to macroprudential buffers, thus enhancing the role of macroprudential authorities in setting capital requirements, may need to be supported by a strengthening of the ECB's macroprudential policy role. Otherwise, additional challenges may emerge for an adequate coordination between the micro- and the macroprudential policy functions.

13.4. CONCLUDING REMARKS

That regulators have accepted an explicit macro-stabilisation role is to be welcomed. This builds directly on one of the main lessons from the GFC: authorities should aim not only to preserve the safety and soundness of individual financial institutions but also to keep credit flowing to the real economy through all phases of the cycle.

Yet the Covid-19 crisis has shown just how challenging that task is in practice. From a supervisory viewpoint, it is a challenge to keep up an effective oversight of banks and address pockets of vulnerability while maintaining a supportive macroprudential stance. This complexity increases when there is a need to encourage the industry and the supervisory function itself to adapt to new technologies and new sources of risk, such as climate change. In the European Union, the challenges go even further, as the authorities need to promote an orderly restructuring of an overbanked sector.

Certainly, adjustments in regulation – particularly to strengthen macroprudential frameworks – may help to address those challenges by providing authorities with more and better tools. Yet regulatory adjustments can only take place once sufficient evidence is on hand for the issues that need to be tackled, so that a thorough analysis can be performed.

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GLOSSARY

AGS	Annual Growth Survey
AIReF	Spain's independent fiscal authority
ALMPs	Active Labour Market Policies
AML/CFT	Anti-Money Laundering/Combating the Financing of Terrorism
AMLF	The Asset-Backed Commercial Paper Money Market Mutual Fund Liquidity Facility
AMR	Alert Mechanism Report
APP	Asset Purchase Programme
ASGS	Annual Sustainable Growth Strategy
AT	Additional Tier
BCBS	Basel Committee on Banking Supervision
BdE	Banco de España
BLS	Bank Lending Survey
BofA	Bank of America
BRRD	Bank Recovery and Resolution Directive
CAP	Common Agriculture Policy
CB	Central Bank
CBDC	Central Bank Digital Currencies
CCoB	Capital Conservation Buffer
CCyB	Countercyclical Capital Buffer
CDO	Collateralised debt obligation
CDP	Carbon Disclosure Project
CECL	Current Expected Credit Loss
CEF	Connecting Europe Facility
CMBS	Commercial mortgage-backed securities
COM	Communication from the Commission
CPFF	Commercial Paper Funding Facility
CR	Country Reports

CRR	Capital Requirement Regulation
CSPP	Corporate Sector Purchase Program
DBPs	Draft budgets plans
DGS	Deposit Guarantee Scheme
DGSD	Deposit Guarantee Scheme Directive
EA	Euro Area
EBA	European Banking Authority
EC	European Commission
ECB	European Central Bank
ECDPC	European Center for Disease Prevention and Control
EC-IPE	European Commission Investment Plan for Europe
ECL	Expected Credit Loss
EDF	European Defence Fund
EDIS	European Deposit Insurance Scheme
EDP	Excessive Deficit Procedure
EFB	The European Fiscal Board
EFSI	European Funds for Strategic Investments
EFSM	European Financial Stabilisation Mechanism
EIB	European Investment Bank
EIIP	European Infrastructure Investment Plan
EISF	European Investment Stabilisation Function
EMS	European Monetary System
EMU	European Monetary Union
EONIA	Euro OverNight Index Average
EP	European Parliament
EPF	European Peace Facility
EPPO	European Public Prosecutor's Office
ERDF	European Regional Development Fund
ESBies	European Senior Bonds
ESBR	European Systemic Risk Board
ESF+	European Social Fund Plus
ESFS	European System of Financial Supervision

ESM	European Stability Mechanism
ESMA	European Securities and Markets Authority
ETS	Emissions Trading System
EU	European Union
EUBS	European Unemployment Benefit Schemes
EUC	EU Council
FAQs	frequently asked questions
FDIC	Federal Deposit Insurance Corporation
FOLTF	Failing or likely to fail
FOMC's	Federal Open Market Committee
FRBNY	The Federal Reserve Bank of New York
FSB	Financial Stability Board
FSI	Financial Stability Institute
GCC	German Constitutional Court
GDP	Gross Domestic Product
GDPR	General Data Protection Regulation
GFC	Great Financial Crisis
GHG	Greenhouse gas
GNI	Gross National Income
GSEs	Government Supported Entities
G-SIBs	Global Systemically Important Banks
HCPI	Harmonised Consumer Price Index
HICP	Harmonised Index of Consumer Prices
HQLA	High-quality liquid assets
ICO	Instituto de Crédito Oficial
IDR	In-Depth Review
IFRS	International Financial Reporting Standards
IMF	International Monetary Fund
JER	Joint Employment Report
JTF	Just Transition Fund
JTM	Just Transition Mechanism
LABREF	The Labour Market Reforms Database

LCR	The Liquidity Coverage Ratio
LTCM	Long-Term Capital Management
LTROs	Long-Term Refinancing Operations (LTROs)
MDA	Maximum Distributable Amount
MERS	Middle East Respiratory Syndrome
MFF	Multiannual Financial Framework
MFI	Money Flow Index
MIP	Macroeconomic Imbalances Procedure
MLF	Municipal Liquidity Facility
MMIFF	The Money Market Investor Funding Facility
MMLF	Money Market Mutual Fund Liquidity Facility
MMT	Modern Monetary Theory
MREL	Minimum requirement for own funds and eligible liabilities
MRO	Main Refinancing Operations
MTO	Medium-Term Budget Objective
NCWO	No creditor worse off
NFCs	Non-Financial Corporations
NGEU	Next Generation European Union
NGFS	The Network of Central Banks and Supervisors for Greening the Financial System
NIR	Negative Interest Rates
NIS	Network and Information Systems Directive
NPEs	Non-performing exposures
NPLs	Non-performing loans
NRP	National Reform Programme
NSFR	The Net Funding Stable Ratio
NSP/NCP	National Stability /Convergence Programs
OLAF	The European Anti-Fraud Office
PD	Probability of default
PDCF	Primary Dealer Credit Facility
PELTROs	Pandemic Emergency Long-Term Refinancing Operations
PEPP	Pandemic Emergency Purchase Programme

PMCCF	Primary Market Corporate Credit Facility
PMI	Purchase Managers Index
PPPLF	Paycheck Protection Programme Liquidity Facility
PRA	Prudential Regulation Authority
PROA	Programas de Refuerzo, Orientación y Apoyo
QE	Quantitative easing
R&D	Research and Development
REACT-EU	Recovery Assistance for cohesion and the territories of Europe
RRF	Recovery and Resilience Facility
RRP	Recovery and Resilience Plans
RSME	Root-Mean-Squared-Error
RTSE	Regulatory treatment of sovereign exposures
RWAs	Risk-weighted assets
SARS	Severe acute respiratory syndrome
SB	Supervisory Buffers
SBBS	Sovereign bond-backed securities
SCAP	Security Content Automation Protocol
SGP	Stability and Growth Pact
SIB	Systemic risk buffer
SLR	Supplementary leverage ratio
SMCCF	Secondary Market Corporate Credit Facility
SME	Small and Medium-sized Enterprise
SPV	Special Purpose Vehicle
SRB	Single Resolution Board
SRF	Single Resolution Fund
SRM	Single Resolution Mechanism
SRMR	Single Resolution Mechanism Regulation
SSBs	Standard setting bodies
SSM	Single Supervisory Mechanism
SURE	Support to mitigate Unemployment Risks in an Emergency
TALF	Term Asset-Backed Securities Loan Facility
TCFD	Task Force on Climate-related Financial Disclosures

TDR	Troubled debt restructuring
TFEU	Treaty on the Functioning of the European Union
TLGP	Temporary Liquidity Guarantee Programme
TLTRO	Targeted Long-Term Refinancing Operations
TSLF	Term Securities Lending Facility
VAT	Value Added Tax

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