3

THE ROLE OF ECONOMIC POLICIES INTERNATIONALLY IN THE FACE OF THE PANDEMIC

3.1 The main economic policy objectives in the current crisis

A swift and decisive economic policy response is required to mitigate the short-term effects of the current health crisis and to ensure a strong recovery. The global disruption to supply and demand caused by COVID-19 and the confinement of the population has been partly counteracted by the broad-based response of the main economic policy levers. However, in some cases, both fiscal and monetary policy space is more limited than in the past. This is not only due to the legacy of the global financial crisis of 2008, but also to certain structural weaknesses which have had a bearing on economic growth worldwide in recent years and will continue to do so in the medium term.

The world economy is tackling this crisis from a weaker position than in previous episodes of recession. In recent years, global economic growth, relatively modest in historical terms, has essentially been underpinned by highly expansionary demand-side policies, against a setting in which the potential growth rate worldwide remained on a downward path. The main causes of this secular weakness include population ageing,[1] which notably affects advanced economies and some emerging economies;[2] low investment rates, particularly in advanced economies; and the slowdown in global productivity growth. During this period, world economic activity has also been affected by an increase in inequality in many countries and growing political polarisation, both of which influence the economic policy decision-making process. Apart from all the above challenges, which will continue in the medium term, before the onset of the COVID-19 crisis, the global economy faced other major, and relatively recent, challenges, such as climate change or the digitalisation of the economy. Both will require substantial adaptation by economic agents and important public policy measures, both at regulatory level and in terms of greater investment. Climate change, in particular, calls for a resolute multilateral response.

The strong fiscal and monetary policy response is taking place in a setting in which the available margin may be influenced, in some cases, by the pre-pandemic situation of high levels of public debt and low interest rates. At end-2019, the levels of debt of the main systemic economies were well above those posted in 2007, before the global financial crisis (see Chart 3.1.1). According

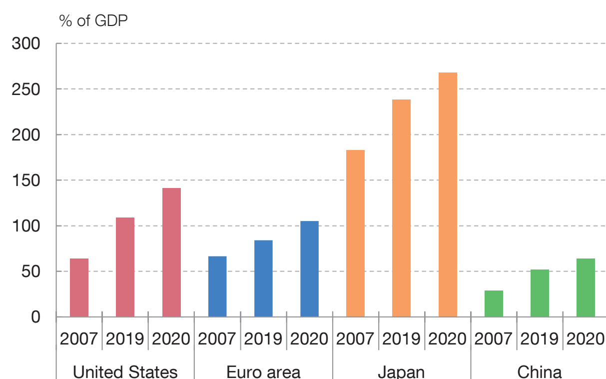
1 See Summers (2015) for a general discussion of *secular stagnation* and Jimeno et al. (2014) for an analysis of the consequences of these developments for European economies.

2 See Banco de España (2019b) for a detailed analysis of the situation in Spain, and Berganza et al. (2020) for an analysis focusing on Latin America.

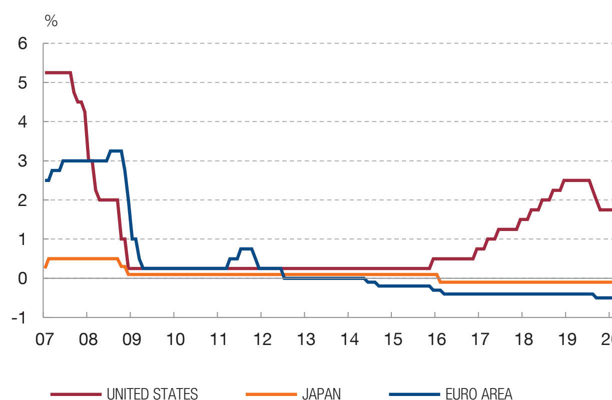
Chart 3.1
PUBLIC DEBT AND POLICY INTEREST RATES

The responsiveness of economic policies to the pandemic could be constrained by the high levels of public debt resulting from the financial crisis, and by the lack of monetary policy space. In 2019, the level of public debt of the main systemic economies was well above that posted in the years before the global financial crisis. In addition, according to IMF estimates, public-sector debt is expected to increase by 10 to 30 percentage points of GDP in 2020 in most world economies, as a result of the measures adopted to combat the pandemic.The policy interest rates of the main advanced economies were very close to their lower bound, in an environment of continued subdued inflation.

1 PUBLIC DEBT (a)



2 POLICY INTEREST RATES



SOURCES: IMF and Refinitiv.

a For 2020, the IMF projections (WEO June 2020) are used.

to the IMF,[3] in 2020, these levels are set to increase by 10 to 30 percentage points of GDP, mostly in advanced economies, as a result of the measures adopted to tackle the pandemic. This is also the case of emerging economies, particularly in Latin America. Moreover, in the latter region's economies, the external debt, mainly denominated in foreign currencies, has increased significantly since 2008, making them more vulnerable to a decline in external financing and to capital outflows. The fact that they have accumulated more international reserves than in the previous crisis only partially mitigates the problem. Before the outbreak of the health crisis, interest rates in the main advanced economies were already very low (see Chart 3.1.2), in an environment of continued subdued inflation and declines in the natural interest rate.[4]

The economic policy response to this crisis, in monetary, fiscal and regulatory terms, has essentially focused on providing economic agents with liquidity, on avoiding a tightening of their financing conditions and on supporting their income. The central banks of the main economies have implemented a broad raft of expansionary measures, particularly to increase their balance sheets through asset purchase programmes and to provide liquidity to the financial sector, in an environment

3 See International Monetary Fund (2020a).

4 For a more detailed analysis of the natural interest rate, see Banco de España (2019a).

in which the traditional channel for lowering interest rates is constrained by the proximity of rates to their lower bound, that is, the level below which they cannot be cut to provide greater monetary stimulus (see Section 3.4). The macro- and micro-prudential authorities, and those responsible for implementing accounting standards, have eased certain regulatory requirements to boost lending to the private sector (see Section 3.5). As for fiscal policy, the response has been more uneven at the international level, which is possibly a reflection of the strength of each country's public finances. Countries have gradually adjusted the fiscal policy response as the consequences of the pandemic and confinement have become evident in their economies (see Section 3.2). In general, the purpose of these measures has been to support the income of households and businesses and to provide them with liquidity to meet their immediate payment commitments, while preserving favourable financing conditions for the different economic agents.

The global nature of the crisis especially calls for an internationally coordinated response to the pandemic. A well-managed health crisis at country-level is essential, but a rapid recovery from the economic crisis cannot be guaranteed if the pandemic continues to affect other regions and, as a result, global external demand. In an environment in which the fiscal and monetary policy space may at times be limited at the national level, full advantage must be taken of the capacity of multilateral institutions to coordinate economic policies and to channel financing flows to the countries hardest hit by the pandemic and with fewer resources to tackle it (see Section 3.3). In the case of developing economies, a greater flow of foreign currency liquidity should be provided through credit facilities, and steps should be taken to alleviate their debt burden. In advanced economies, maintaining a high level of cooperation when designing economic policies is particularly important for preventing unwanted effects, such as a new wave of heightened protectionist pressures. In the euro area, in particular, the supranational response by European institutions should play a key role, since the current crisis affects all its Member States and has not been caused by imbalances built up in previous periods (see Section 3.2). The pandemic and the measures adopted to respond to it may give rise to disruption in the regional value chains and in the free circulation of factors of production, and to new episodes of financial fragmentation. In this respect, the lessons learned from the handling of the European sovereign debt crisis of 2010-2012 should be applied, to avoid repeating the same mistakes and to take full advantage of the common support mechanisms available in a monetary union (see Section 5.4 in Chapter 5)

The crisis may exacerbate the weak system of global governance and economic relations, which had already been affected in recent years by the rise in protectionism, with potentially serious consequences for world trade and manufacturing. The increase in bilateral tariffs and restrictions to the exchange of technology between the United States and China led to heightened economic uncertainty and a slowdown in manufacturing and international trade worldwide

during much of 2018 and 2019.[5] Recent developments could exacerbate this situation both in the short term, given the disruptions observed to supply chains and the global shortage of some products at specific points in time during the first half of the year, and mainly in the long term, if they lead to the excessive renationalisation of certain production chains or to major changes in their geographical diversification (see Section 5.2 of Chapter 5).

3.2 The fiscal policy response

To address the health emergency, virtually all countries have adopted fiscal policy measures to fund the increase in health spending and to support the income of economic agents.[6] The stimulus plans approved in different countries tend to share some common features. On the expenditure side, the measures include increases in health spending and other actions to support the income of those households and businesses most affected by the pandemic. These measures notably include shoring up the existing partial unemployment arrangements and sick leave in countries with strong automatic stabilisers, as is the case of Europe. Countries where the automatic stabilisers provide less coverage have mostly opted for direct cash transfers to households. Additionally, some governments have approved subsidies for businesses affected by the pandemic. On the income side, the vast majority of countries have approved moratoria on tax payments and social security contributions. Lastly, governments have introduced liquidity support measures for businesses, with the launch of sizeable State guarantee schemes, particularly in euro area countries.

The budgetary plans approved by the main non-euro area economies generally provide for a discretionary fiscal impulse that is greater than that of euro area countries, partly as a result of the less important role of automatic stabilisers outside the euro area (see Table 3.1). Such measures notably include subsidies to businesses to cover the costs arising from employee sick leave, in the United Kingdom, and from employees taking childcare leave, in Japan and South Korea. Meanwhile, China has brought forward unemployment benefits, by means of a single initial payment, and in Brazil, financial assistance is fundamentally aimed at supporting the income of the most vulnerable households. In addition, some countries (including China, Japan, South Korea, United Kingdom and Chile) have announced tax and social-contribution payment moratoria for businesses in the hardest-hit industries, with some, such as United Kingdom and China, having also approved broad-based fiscal stimulus measures. The cost of the fiscal measures announced at the cut-off date of this Report varies across countries, between 3.2% and 12.2% of GDP (see Chart 3.2).

5 See Caldara et al (2020) and Albrizio et al. (2020).

6 For more details about this section, see Cuadro-Sáez et al. (2020).

Table 3.1

FISCAL POLICY MEASURES IN NON EUROPEAN COUNTRIES (a)

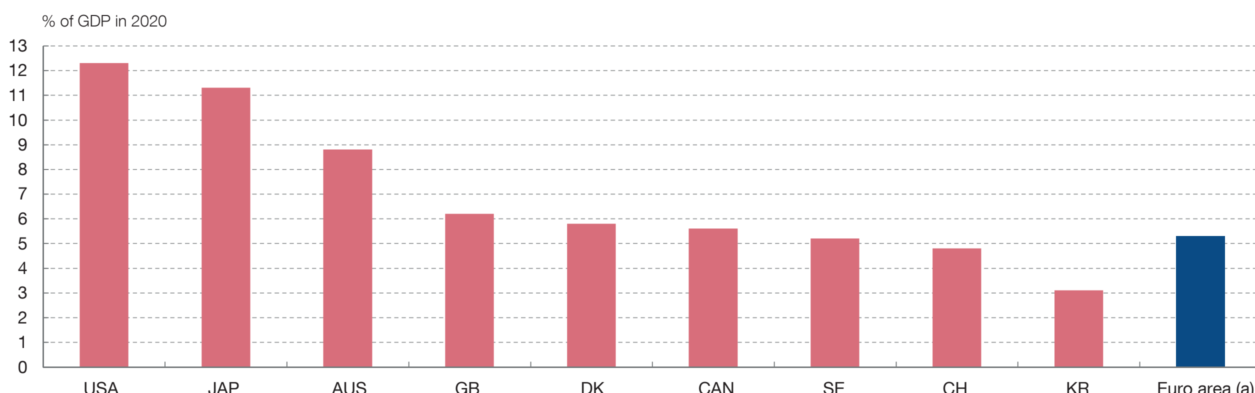
Country	Deferral or suspension of taxes	Support for households	Subsidisation of labour costs, unemployment and support for businesses	Liquidity provision to firms through loans	Aggregate demand
United States	Deferral of tax payments for individuals and businesses, including social security contributions Increase in deductions on personal income tax and on interest payments and losses on corporate income tax Deduction for preserving employment (50% of wages paid up to a maximum of $10,000 per employee) Temporary suspension of aviation taxes	Students exempt from paying interest on federal loans Food stamps and broader Medicare coverage Cash payments to individuals ($1,200) and $500 per dependent child, with gradual phase-out based on income (up to $99,000 per year) Loans to consumers	Remunerated sick leave for workers in quarantine; tax relief to SMEs for sick employees Increase to a maximum of $600 per week in provision for unemployment and duration extended by 13 weeks	Interest-free, unsecured loans to SMEs, which could become subsidies depending on the % of staff retained Loans to non-financial corporations and those hardest-hit such as airlines and strategic companies	Transfers to finance extraordinary spending of state and local governments
China	Exemption from VAT Exemption (reduction) from tax on new (used) cars Reduction of taxes and rates ($70 bn) and deferral of income tax payments for the self-employed and small businesses	Moratoria on student loan repayments and broader social benefits Temporary subsidies on prices doubled between March and June Deferral of social security contributions	Exemption/reduction of social security contributions and social housing pool Reduction in commercial premises rentals and electricity price Subsidies for companies to expand productive capacity	Refinancing and extension of credit to SMEs and companies affected. Support for companies in the form of bond purchases and guidelines to commercial banks to increase loans to microfirms and small businesses	General fiscal stimulus package Expansion of renewal projects in rural communities Job creation in education and healthcare sectors
Japan	Deferral for one year of social contribution payments and corporate income tax of businesses affected by the crisis	Increase in monthly subsidy per child for low-income households, if their income has been reduced as a result of the crisis Payment of $930 to all citizens 100% coverage of salary (maximum of 15,000 yen) and subsidies of 330,000 yen per month to employees dismissed by SMEs without compensation between April and September	Subsidies for businesses that retain workers on the payroll (9/10 of the cost of workers who take leave to SMEs and 3/4 to large corporations) $18 bn in subsidies to owners of SMEs who experience a significant fall in billing $18 bn in financial assistance for rental payments if monthly sales fell by more than 50%	Interest-free, unsecured loans granted through public and private financial institutions ($586 bn)	$107 bn for future contingencies
South Korea	9 months' deferral for corporate income tax, VAT and personal income tax 1 year's deferral for customs and wealth tax VAT cut for small businesses Tax deductions for property owners who reduce rent for small businesses	$2.8 bn in vouchers, family allowances and preserving employment 30% social security deduction for low-income households Up to $820 to 14 million households in the lowest 70% of wealth distribution ($7.4 bn) $4 bn for social safety nets	30% social security deduction for small businesses $1.2 bn in subsidies to self-employed and temporary workers who are not eligible for unemployment Subsidies for firms to cover sick leave and to SMEs for payment of wages and rentals $9 bn to stabilise employment	Total of $50 bn in loans to SMEs, consumers and businesses $16 bn to buy corporate bonds and commercial paper Extension of due dates for payment of debt and interest Additional fund of $33 bn to provide financial assistance to strategic sectors	Investment plan 2020-2025 worth $61 bn *(Korean New Deal)* Creation of 550,000 public-sector jobs
Australia	6-month deferral of loan payments for firms with loans of less than AU$ 10 million 4-month deferral on tax payments for firms	AU$ 750 payment to low-income social security taxpayers Double-up of job seeker payment (AU$ 550, every two weeks) The government will cover 50% of income in the childcare sector	100% payment of taxes withheld by firm from staff (maximum AU$ 100,000 and minimum of AU$ 20,000 if no withholding made) Payment every two weeks (AU$ $1,500) for 6 months to retain workers (SMEs will be eligible if their income is reduced by 30% and large corporations, by 50%)	Programme comprising guarantees of 50% of the loan for AU$ 40 billion Measures approved for greater deductions for asset purchases and depreciation	
Canada	Deferral of tax payments (CA$ 39 bn)	Transfers to low-income individuals Payment of CA$ 1,400 for up to 4 months to those who have lost income. Expansion of social policies and support to different groups	Subsidisation of sick leave for those not meeting requirements (i.e. the self-employed) Wage subsidy of up to 75% for up to 6 months Assistance to landlords who reduce or cancel rent for commercial premises	CA$ 48 bn in loans to businesses through the Business Credit Availability Program Loans to large corporations (minimum revenues of CA$ 217 million per year) to cover short-term expenses	

SOURCES: Banco de España, drawing on national sources.

a Solely includes numbers announced by governments. Generally, these figures do not include higher spending on unemployment insurance.

Chart 3.2
MAGNITUDE OF THE BUDGETARY MEASURES APPROVED IN DEVELOPED ECONOMIES IN RESPONSE TO THE PANDEMIC

Virtually all countries have adopted fiscal policy measures to finance the increase in health spending and to mitigate the effects of the pandemic on the economy. The differences in the size of the automatic stabilisers make international comparison difficult. However, the fiscal plans approved by the advanced economies outside the euro area countries generally provide for a discretionary fiscal impulse that is greater than that of euro area countries.



SOURCE: IMF (WEO June 2020).

a Data for the euro area reflects a weighted average of the budgetary measures of the following countries: France, Germany, Italy, Spain, Belgium, Netherlands and Finland.

DOWNLOAD

The US fiscal policy package is particularly significant in quantitative terms, and is essentially based on direct financial assistance to households, businesses and state and local governments. It is estimated that the measures adopted by the US federal government will have a total budgetary cost of more than 12% of GDP,[7] although funds equivalent to 14.7% of GDP will be mobilised once the guarantees to monetary authority transactions are added. With respect to businesses, funding has been provided for loans and subsidies to SMEs, and the Treasury's Exchange Stabilization Fund has been expanded to grant loans to the most affected large corporations. Additionally, all businesses are granted a six-month extension for corporate income tax payments. SMEs also obtain tax relief for the costs arising from sick leave. In addition, a Paycheck Protection Program has been created, based on providing incentives to businesses, mainly SMEs. It aims to provide $670 billion (3.1% of GDP) of guaranteed loans to small and medium-sized enterprises, so that they can keep their workers on the payroll during the interruptions caused by the pandemic. These loans will be partially or fully forgiven, provided that businesses retain their employees and do not significantly change their employment conditions. The fiscal package for households includes a transfer of $1,200 per person, plus $500 per dependent child. Unemployment benefits are also increased, their duration extended, and the

7 See the Congressional Budget Office's (CBO) assessments of *H.R. 748, CARES Act, Public Law 116-136* and *H.R. 266, Paycheck Protection Program and Health Care Enhancement Act*.

eligibility requirements eased. Furthermore, a three-month extension is granted for personal income tax payments. Lastly, the package mobilises funds equivalent to 1.4% of GDP to fund extraordinary health spending related to the pandemic at state and local level. These measures complement and add to those taken by the Federal Reserve to support liquidity, described below.

In euro area countries, national authorities have approved significant fiscal policy packages, albeit heterogeneous in scope (see Table 3.2). These packages are very similar as regards the main measures adopted. First, the partial unemployment systems have been strengthened in most countries, easing or expanding the existing arrangements. In addition, the debt burden of firms has been alleviated, through the suspension or deferral of taxes. Second, liquidity support schemes for firms have been approved, varying in size depending on the country. Worth noting is the case of Germany, where a mechanism has been established to provide liquidity to businesses in the form of loans with favourable conditions, new credit facilities and public guarantees, and a bail-out fund for large corporations has been set up, which may include both the acquisition of holdings in the capital of companies experiencing financial difficulties and additional guarantees for corporate debt.[8] France has adopted additional measures to support various industries, such as tourism, aviation and aerospace, through loans, guarantees and the possibility of bailing out businesses via recapitalisations or even nationalisation. Third, measures to support households and the self-employed have been approved. In Italy, these measures notably include the suspension for up to 18 months of mortgage payments on first homes, the creation of emergency income for low-income households excluded from other financial assistance, the five-month suspension of redundancy procedures initiated since 23 February, €600 of compensation for self-employed workers, various work-life balance measures and a "holiday voucher" for low-income households, to be used in Italian tourist establishments until the end of the year. In Germany, the government has extended basic income assistance, which grants minimum subsistence benefits subject to certain requirements, to working-age individuals whose income level is deemed insufficient, including assistance for rental expenses, Lastly, the German government has also adopted specific measures aimed at boosting the recovery of consumption and investment, through a temporary cut to VAT (from 19% to 16% from July to year-end) and the creation of a programme to invest in green and digital technologies.

At European supranational level, several EU instruments have been mobilised to support the measures adopted by national governments. In terms of legislation, the European Commission (EC) approved the easing of restrictions on State aid to accommodate the above-mentioned guarantee schemes. Furthermore,

---

8 Although State guarantee programmes are a common feature of the main European economies, at present, national schemes have been implemented at different speeds across the various countries. In May, the guarantees extended in Germany and Italy were equivalent to 3% and 8%, respectively, of their national guarantee programmes. In the same month, the guarantees approved in France amounted to 27% of the total scheme, a figure which stood at 60% in the case of Spain

Table 3.2
FISCAL POLICY MEASURES IN EUROPEAN COUNTRIES (a)

Country	Deferral or suspension of taxes	Support for households	Subsidisation of labour costs, unemployment and support for businesses	Liquidity provision to businesses through credit	Aggregate demand
Spain	6-month moratorium for tax debts of SMEs and the self-employed, up to a maximum of €30,000 per tax Adjustment to payment of corporate income tax Reduction of VAT Extension until 20 May for SMEs and the self-employed to declare income	Moratorium on mortgage payments for low-income workers and the self-employed Benefits for the self-employed and domestic service workers whose employment is suspended Extension of temporary contracts at universities Furthermore, albeit not directly linked to the current health crisis, a minimum living income was approved on a permanent basis	Exemption from payment for temporary layoffs or short-time working schemes, extension of unemployment benefit to more groups, greater protection for unemployed seasonal workers Reduction in contributions of agricultural employees	State guarantees of €100 billion for non-financial corporations' loans and additional guarantee facility of €2 billion for exporters	
Italy	Deferral of most March, April and May taxes until September for businesses and the self-employed that experienced losses of more than 33% or particularly hard hit industries and regions Abolition of regional tax on the self-employed and businesses with turnover of less than €250 million	Guarantees for moratoria on mortgages, leave for care responsibilities and fund for low-income workers Emergency income for low- income households, work-life balance measures and food aid	Unemployment subsidy for firms affected, of up to 13 weeks, extension to industries not covered and suspension of social security contributions Reduction of SMEs' fixed costs for 3 months Direct aid proportional to losses of SMEs and microfirms Dismissals suspended for 5 months Direct subsidies of €1,000 in May for the self-employed with reduction in income of more than 33% and €600 for the self-employed	Guarantees for moratoria on loan repayments reinforcement of guarantee fund for SMEs and "SACE" State guarantee (up to a total of €450 billion); large corporation recapitalisation fund	New fund for any type of short-term investment
Germany	Temporary deferral of taxes for businesses VAT reductions: from 19% to 16% and 7% to 5% (reduced rate) Reduction of electricity taxes Social security contributions limited to 40%	€10 billion for additional recipients of HARTZ IV (basic income) Greater protection for tenants and households unable to pay utility bills Financial assistance for low-income and single-parent households, €300 lower for all households	Easing of requirements for businesses to apply for *Kurzarbeit* (reduced working hours) and increase in amounts receivable by employees A total of €75 billion earmarked for direct assistance for businesses affected to cover fixed costs Unemployment benefit extended for 3 months (for the over 50s gradual increase of up to 2 years) €50 billion of support for green and digital companies	"Unlimited" liquidity through KfW (could reach €820 billion) Creation of bail-out fund for large corporations: €400 billion in guarantees; €100 billion for recapitalisations; €100 billion for KfW loan	2021-2024 investment plan of €12 billion and investment plan of €25 billion for municipalities, €55 billion in reserve
France	Temporary deferral of taxes for businesses Refund of tax credits accelerated	Enlargement of social rights and extension of unemployment benefit Postponement of unemployment insurance reform	Reinforcement of partial unemployment system Payment of social insurance deferred Creation of Solidarity Fund for microfirms and the self-employed Deferral of lease and utility payments €4 billion for start-ups	State guarantee programme for businesses of any size through Bpifrance totalling €300 billion	
Portugal	Temporary deferral of taxes for businesses	Work-life balance measures: 2/3 of salary for childcare leave	Suspension of businesses' social security contributions and temporary unemployment benefit of 2/3 of salary	Liquidity through State guarantees and a €3.7 billion credit line	
Netherlands	Deferral of taxes for businesses and the self-employed Reduction in interest rate on public loans	Coverage of 30% of pension contributions	Subsidies of up to 90% of salaries if employment is maintained €4,000 for businesses affected The self-employed may receive social assistance benefits for 7 months	Credit and guarantees of 50% for SMEs of up to €1.5 billion	
Austria	Temporary deferral of income tax, corporate income tax and businesses' and individuals' social security contributions	The State pays 1/3 of the salaries of individuals who have had to look after children due to the closure of childcare facilities and schools	Direct assistance to industries such as tourism and shorter working hours The State pays salaries (90% for salaries of up to €1,700; 95% of salaries under €2,685 and 80% for salaries which do not exceed €5,370)	€9 billion in credit guarantees €15 billion emergency fund	€4 billion in direct emergency assistance
Denmark	€22 billion in temporary deferral of corporate income tax and VAT for businesses (€5.4 billion for SMEs)	The State pays 75% of salaries and businesses pay 25% Extension of unemployment benefits and sick leave (€1.3 billion)	Assistance for payment of salaries due to temporary discontinuation of activity Subsidies of 75% of losses of the self-employed for 3 months (€1.3 billion) Subsidies of fixed costs of SMEs with lost turnover of more than 40% (€5.4 billion)	State guarantees and a €13 billion credit line	
United Kingdom	Stamp Duty Tax relief, delay in payment of VAT and income tax for the self-employed and professionals Application of zero rating to certain e-publications brought forward	Improvement in social welfare measures (income subsidies and rent support) Increase in benefits for the most disadvantaged	Extension of sick pay to include quarantine to be met by the government in full for up to 14 days Payment of 80% of the salary and contributions of companies which have furloughed workers (£9 billion) £25,000 for retailers, healthcare firms and leisure industry and £10,000 for small businesses £10 billion to pay 80% of profits of the self-employed in the last 3 months (maximum of £2,500) £1.2 billion support for start-ups	State guarantees (British Business Bank) and access to credit for businesses	General fiscal stimulus package

SOURCE: Banco de España, drawing on national sources.

a Only includes numbers announced by governments. In general, these figures do not include the increased expenditure on unemployment insurance.

Figure 3.1
THE SUPRANATIONAL RESPONSE TO THE CORONAVIRUS

EUROPEAN RESPONSE: BUDGET, EUROPEAN STABILITY MECHANISM (ESM)
AND EUROPEAN INVESTMENT BANK (EIB)

EUROPEAN COMMISSION

CRII (a)	NEXT GENERATION EU	SURE (a)
Immediate mobilisation of cohesion funds €37 bn	Supplementary temporary budget, which includes a Recovery and Resilience Facility to finance reforms and investments over 4 years Transfers: €427 bn Loans: €250 bn	Temporary loan instrument to protect employment, guaranteed by the MSs (a) €100 bn

FINANCING MOBILISED THROUGH THE EIB GROUP (b)		ESM
Liquidity funds, purchase of securities and guarantees €25 bn	Solvency Support Instrument: guarantees, loans and capital to European firms (c) €31 bn	Precautionary credit line to fund direct and indirect health spending related to the pandemic amounting to 2% of each country's GDP €240 bn

TOTAL EU + ESM + EIB FUNDS: €1,100 bn (7.9% EU GDP)

SOURCES: Banco de España, based on EU sources. The lightly-shaded parts are measures proposed by the Commission as part of Next Generation EU, pending approval.

a CRII stands for Coronavirus Response Investment Initiative, SURE refers to Support to mitigate Unemployment Risks in an Emergency and MSs stands for Member States.
b The EIB has two programmes, to mobilise up to €240 bn.
c The Solvency Support Instrument forms part of the proposals put forward under Next Generation EU.

Member States are allowed to use the flexibility clause in the face of exceptional circumstances contained in the Stability and Growth Pact, which would enable them to temporarily deviate from the paths for the deficit, expenditure and public debt which would be set, under normal circumstances, by the framework of the fiscal rules. From an operational standpoint, the EC approved several measures which envisage using the EU budget (see Figure 3.1). These include the Corona Response Investment Initiative (CRII) which can immediately mobilise €37 billion of existing and yet unallocated cohesion funds to finance pandemic-related expenses. If needed, this amount could be increased by a further €29 billion. Similarly, the EC proposed a reinsurance mechanism for national unemployment insurance (SURE), structured through loans to Member States to cover the costs of temporary lay-off schemes, these loans being conditional upon preserving employment. Total funding available under SURE amounts to €100 billion which will be distributed based on the expenditure incurred by these short-time work schemes, while respecting a combined ceiling of €60 billion for the three countries which request most funds.

The proposal with the greatest capacity to boost the European economy is the recovery plan for Europe (Next Generation EU).[9] This initiative, which was proposed by the European Commission at the end of May and has yet to be approved, would be based on a supplementary budget of €750 billion for the European Union within the 2021-2027 multiannual financial framework.[10] These funds would be financed with long-term debt repayable as from 2028 through new European taxes, such as digital or environmental taxes. The funds would be earmarked for financing investment and reforms in Member States to boost growth and compliance with shared EU objectives, and a combination of transfers, loans and guarantees for different EU programmes would be used. The distribution scheme would favour countries whose economies were hardest hit by the COVID-19 crisis, such as Spain or Italy.

In addition to the European Commission's measures, funding has been mobilised by the European Investment Bank (EIB) and by the European Stability Mechanism (ESM). As an immediate response to this crisis, the EIB set up a new €25 billion Pan-European Guarantee Fund which could guarantee up to €200 billion of financing for businesses, and a support plan to ease the liquidity strains of SMEs and mid-caps (with the purpose of mobilising up to a further €40 billion of financing). Governments of euro area countries established a special ESM credit line (Pandemic Crisis Support) based on existing preventive tools which may grant total financing of up to €240 billion. Exceptionally, the Member States agreed that the only requirement for accessing this credit, which has a ceiling of 2% of each State's GDP, is a commitment to use the financing to cover the direct and indirect costs of medical care owing to the health crisis.

It is estimated that the pandemic will trigger a substantial increase in the government deficit of the main advanced economies. The International Monetary Fund anticipates that, due to the effect of these discretionary measures and the automatic stabilisers, the health crisis will cause the government deficit of euro area countries to surge by 11.1 pp of GDP in 2020[11,12]. By comparison, a larger increase is expected in the US government deficit, whose budget balance will drop by 17.5 pp relative to the previous year. The increase in the UK government deficit is calculated to be similar to that projected for the euro area (10.6 pp of GDP).

3.3 The multilateral response

The depth of this crisis and the limited national policy leeway in many regions require stronger international coordination in times of fragile multilateralism. Strictly from a healthcare perspective, the advantages of international cooperation

9 See the European Commission's Recovery plan for Europe.

10 For thoughts on the design of a European Recovery Fund, see Arce et al. (2020).

11 The impact of State guarantees is not included in these fiscal projections. The final impact of these guarantees will hinge, among other factors, on the pace at which loans with State guarantees are granted and their default rates. For more information, see Cuadro-Sáez et al. (2020).

12 See International Monetary Fund (2020b).

in attempting to halt the spread of the disease or the emergence of new outbreaks are clear in a crisis of this kind. In particular, in the case of the poorest countries, with very weak health and social protection systems, the absence of a decisive multilateral response could have dramatic consequences. In the economic and financial field, the standstill in activity in numerous sectors, the ensuing slowdown in trade between countries and the abrupt changes in financial flows (see Section 2.2 in Chapter 2) also underscore the importance of multilateral fora for providing a global response to the pandemic. In this connection, the strength of the world economic recovery in the medium term will depend on the response to the crisis being global, coordinated and adaptable over time, as fresh action is required.[13] In 2008 the global financial crisis revived the G20 and macroeconomic policy coordination, and strengthened international financial regulation and its institutional architecture. These elements constitute a significant, albeit insufficient, basis for a global response to the current crisis.

The main multilateral fora started to analyse possible responses to the crisis from early March. In particular, the G7 reaffirmed its commitment to coordinate the economic stimuli and the health and border control measures necessary to contain the pandemic, mitigate its impact and contribute to economic recovery. For its part, the G20 endorsed an extensive Action Plan[14] which combines health measures – committing to compliance with international rules, transparent information and to providing institutions such as the World Health Organisation (WHO) with the resources needed[15] – with a coordinated global economic and financial response. It also allows for the application of exemptions (regarding export restrictions on medical and food supplies) from the rules of the World Trade Organisation (WTO), only if necessary. This plan aimed to mitigate the disruptions in the global medical equipment supply chains, in view of the lack of strategic stocks and production capacity at national level that became evident at the height of the pandemic. Also, in response to the IMF and the World Bank's call to action, the G20 countries, together with the Paris Club, resolved to address requests for a moratorium until end-2020 on debt payments from low-income countries hit hardest by the pandemic.[16] The G20 has also called on multilateral development banks, provided they maintain their credit ratings, and on private creditors to participate in this initiative through the Institute of International Finance (IIF). The aim is to allow countries with fewer resources to have greater fiscal space in the short term to tackle the pandemic. That said, based on the decisions taken since the onset of the pandemic, it appears that the highest level political stimulus for the multilateral

---

13 See, for example, Kohlscheen et al. (2020), who highlight the magnitude of the possible spillover effects between the major global economies as a result of the COVID-19 health crisis and illustrate the risk of unilateral macroeconomic policies. By focusing on the pandemic's direct effects on the domestic economy, these policies fail to internalise its indirect effects derived from international spillovers.

14 See *G20 Finance Ministers and Central Bank Governors Meeting*.

15 Except for the United States, which announced its withdrawal from the WHO at the end of May.

16 Countries eligible for International Development Agency (IDA) assistance and those defined as least developed countries by the United Nations may avail themselves of this moratorium.

response has been weaker than that provided during the global financial crisis in 2008.

The main multilateral development banks are playing a significant role in this crisis (see Table 3.3)**.** From the start of the pandemic, these institutions have fostered a series of emergency measures in line with their mandates and fields of action. Their financial support to emerging and low-income countries up to the cut-off date of this Report amounts to over $200 billion and includes investment programmes in the health sector in coordination with the competent international organisations.[17] Among other actions, they also provide support to the most vulnerable countries through safety nets and transfer programmes, emergency assistance using budget or sectoral channels in line with the IMF programmes and liquidity facilities for the private sector.

Within the framework of the global financial safety net, the IMF has swiftly deployed a broad battery of measures. The measures adopted by the IMF include most notably increasing access to emergency facilities with no conditionality[18] and creating a new liquidity line designed to assist emerging countries with sound fundamentals and moderate funding needs. The Regional Financing Arrangements (RFAs)[19] have confirmed their willingness to cooperate with the IMF, share information and co-finance possible programmes. Against the backdrop of the "Team Europe" strategy supporting partner countries in combating the pandemic, a macro-financial assistance (MFA)[20] package totalling €3 billion in assistance to ten countries[21] will be combined with the IMF's emergency financing. The main central banks have been quick to reactivate, and even expand, the swap lines with systemic emerging economies which were so useful during the global financial crisis. In addition, the Federal Reserve (Fed) has established a repo facility to exchange US Treasury securities for US dollars (see Section 3.4). The fact that not all emerging countries have access to these facilities or are covered by an RFA provides a greater opportunity for the IMF's new liquidity line, since it allows these countries to deal with the liquidity tensions and capital outflows they have experienced since the onset of the crisis (see Section 2.2 in Chapter 2).

Despite the deployment of these multilateral actions, the magnitude and nature of this crisis evidence the need to analyse in depth the multilateral institutional structure and to step up international cooperation. Specifically,

---

17 Excluding the EIB, which also provides assistance to developed countries.

18 To cover the greater demand for concessional, including emergency, assistance, the Fund has initiated a round of fund-raising for the Poverty Reduction and Growth Trust (PRGT).

19 The main RFAs are the Chiang Mai Initiative Multilateralised (CMIM) in Asia and the European Stability Mechanism (ESM) in Europe. For further information on these bodies and their cooperation with the IMF, see European Central Bank (2018).

20 Through the MFA, the EU provides loans or grants to third-country partners as a supplement to an IMF adjustment programme. MFA is available for candidate countries, potential candidate countries, EU neighbours and, exceptionally, other countries politically, economically and geographically close to the EU.

21 See Decision of the European Parliament and of the Council on providing macro-financial assistance to enlargement and neighbourhood partners in the context of the COVID-19 pandemic, of 18 May 2020.

Table 3.3

RESPONSE OF THE MAIN MULTILATERAL DEVELOPMENT BANKS TO COVID-19

Institution	Measures	Main eligible countries	Duration
World Bank	Financial package of $160 billion including $50 billion in concessional assistance and grants through the International Development Association (IDA) This financial package includes an emergency assistance line of $14 billion, comprising $8 billion from the International Finance Corporation (IFC) and $6 billion from the International Development Association (IDA) and the International Bank for Reconstruction and Development (IBRD)	Developing and low-income countries that are World Bank members To date the World Bank is providing assistance to 100 countries, mainly in Africa and Asia, within the framework of COVID-19	15 months with possible extension
Asian Development Bank (ADB)	Announcement of measures amounting to $20 billion, including $2.5 billion in concessional lending and grants and $2 billion for the private sector	Asian countries that are ADB members To date the countries which have received COVID-19-related assistance are: Mongolia, Bangladesh, Sri Lanka, Kyrgyz Republic, Bhutan, India, Philippines, Nepal, Laos, Indonesia, Georgia and Pakistan	15 months with possible extension
African Development Bank (AfDB)	(1) A *Rapid Response Facility* amounting to $10 billion, including: $5.5 billion for sovereign operations for all AFDB member countries; $3.1 billion in concessional financial assistance to countries under the framework of the African Development Fund (AFD); and $1.4 billion in non-concessional assistance to the private sector (2) Issuance of $3 billion "*Fight COVID-19*" Social Bond, issued in the international markets	African countries that are AfDB members	Unspecified
Inter-American Development Bank (IDB)	$12 billion allocated to: reprogramming the existing portfolio of healthcare projects to address the COVID-19 crisis; an additional $3.2 billion for the loan programme initially stipulated for 2020; and $5 billion for the private sector through IDP Invest	Latin American countries that are IDB members To date, the countries that have received COVID-19-related assistance from IDB are: Argentina, Dominican Republic, Panama, Honduras, Ecuador, Paraguay, Uruguay and El Salvador	9 months
Islamic Development Bank (IsDB)	Approval of the *Respond, Restore, Restart* programme, with an allocation of $2.3 billion, including emergency grants, credit facilities for SMEs, sovereign loans and political risk insurance	Countries that are members of the Organisation of Islamic Cooperation (Muslim-majority countries)	Short term: 6/9 months Medium/long term: 18/24 months
Asian Infrastructure Investment Bank (AIIB)	(1) Creation of COVID-19 *Crisis Recovery Facility* (CRF) amounting to $10 billion in the form of healthcare support, liquidity, and budgetary and fiscal support in coordination with other Multilateral Development Banks. Includes a concessional window (2) Approval of a sovereign-backed loan to China of $355 million for the healthcare sector	Asian countries To date the countries that have received COVID-19-related assistance are India, China, Mongolia, Indonesia, Pakistan, Philippines, Bangladesh and Turkey	Unspecified
European Investment Bank (EIB)	*Response for European Union (EU) countries:* (1) €40 billion to support the needs of SMEs through guarantees backed up by the EU budget (2) Special assistance to the healthcare sector via redistribution of framework loans not entered into/not signed and loans of €5 billion already earmarked for the healthcare sector (3) Creation of a €25 billion Guarantee Fund to mobilise €200 billion in bank credit to firms *Response for non-EU countries:* €5.2 billion for the healthcare sector and the private sector (this funding is part of the Team Europe programme)	EU and non-EU countries: Africa, EU neighbouring countries, Western Balkans, Asia and Latin America To date the countries which have requested assistance related to COVID-19 are Spain, Italy, Western Balkans, Egypt, Montenegro and Morocco	Unspecified
European Bank for Reconstruction and Development (EBRD)	*Solidarity Package* of €4 billion for clients with imminent working capital and liquidity needs, with a possible expansion to €21 billion during 2020/2021	38 emerging countries mainly in Europe (not EU), Central Asia and southern and eastern Mediterranean countries	During 2020 and 2021
New Development Bank (NDB)	(1) Issuance of a 3-year *Coronavirus Combating Bond* in the China interbank bond market amounting to $1 billion to finance the emergency assistance programme for China (2) Creation of an *Emergency Assistance Facility* to provide $10 billion to finance expenditure in combating COVID-19 and boost economic recovery	BRICS (Brazil, Russia, India, China and South Africa) To date, China and India have received assistance	Unspecified

SOURCE: Banco de España, drawing on information from the different Multilateral Development Banks.

a greater political stimulus, coordinated at the highest level, to foster a global healthcare management strategy was lacking in the early stages of the global spread of the pandemic. This was evidenced, for instance, in the shortages which arose in the global medical equipment supply chains at the height of the pandemic. Just as major crises in the past profoundly transformed international cooperation – the Great Depression led to the creation of the Bretton Woods institutions and the global financial crisis redrew the map of international financial institutions[22] and fostered coordinated action among countries – the size of this pandemic and its severe global economic impact should bolster a richer multilateral institutional structure and lay the foundations for sounder international cooperation. In particular, it is time to reflect on how to improve the role of these instruments in managing global crises, such as the current one, and in the early containment of their effects. This would also help to better address other challenges, such as climate change, which the world economy and society at large should begin to deal with in the short term. Nevertheless, it is not easy to make progress in this direction given the fragility of multilateralism in the current circumstances, as it is threatened by growing tensions in US-China relations, and this could lead to a reactivation of protectionist positions. In this setting, the EU should play a leading role in achieving a reinforced and inclusive multilateralism and an area of operation governed by international rules.

3.4 The monetary policy response

3.4.1 Actions taken by the main central banks

The monetary authorities of the main advanced and emerging economies have reacted swiftly and decisively to the COVID-19 crisis. First, most central banks have reduced their key policy rates to all-time lows and, second, many have simultaneously used unconventional instruments which were, in many cases, created to address the 2008 financial crisis. The US Federal Reserve (Fed) lowered its key policy rates by 150 bp to between 0% and 0.25%. It also reactivated the quantitative expansion of its balance sheet through unlimited purchases of government bonds and mortgage-backed securities (see Chart 3.3.1) and introduced measures supporting liquidity in the markets to facilitate their functioning, including some relating to the availability of dollar liquidity in international markets and new credit facilities to promote financing for small and medium-sized enterprises, households and sub-central governments. The US monetary authority is also encouraging, through regulatory changes, the modification of the loans of customers affected by the pandemic and the extension of new credit to solvent customers. The US Treasury has supported the Fed in many of these programmes by providing guarantees for its operations and, especially, by contributing capital to joint financial

22 See Garrido et al. (2016).

Table 3.4
MONETARY POLICY MEASURES ADOPTED TO COMBAT THE IMPACT OF COVID-19

Country	Cut in policy rate (to % level)	Asset purchases	Maximum amount established	Credit support	Amount	Backed by the Treasury (%)
Euro area		Purchases of government and private-sector bonds (including commercial paper) with reinvestment of principal (increase in Asset Purchase Programme, APP) and new Pandemic Emergency Purchase Programme (PEPP)	€120 billion (APP) +€1,350 billion (PEPP)	Additional longer-term refinancing operations (LTRO) until June (average deposit facility rate) Subsequently, TLTRO III under more favourable conditions, and pandemic emergency longer-term refinancing operations (PELTROs, 25 bp below the average interest rate on the main refinancing operations)	—	—
				Easing of capital and liquidity requirements for banks	—	—
				Easing of collateral criteria	—	—
United States	–150 bp (0%-0.25%)	Unlimited purchases of Treasury bonds and mortgage-backed securities Reinvestment of the principal of the agency debt and mortgage-backed securities		Reduces discount window cost (to 0.25%) and lengthens maturity of operations up to 90 days	—	—
				Encourages the use of liquidity and capital buffers to support credit	—	—
				Reduces reserve requirement to 0% as from 26 March	—	—
				Encourages the use of intraday credit	—	—
				Primary Market Corporate Credit Facility (PMCCF) for purchases of corporate bonds in the primary market	$500 billion	10
				Secondary Market Corporate Credit Facility (SMCCF) for purchases of corporate bonds in the secondary market	$250 billion	10
				Commercial Paper Funding Facility (CPFF)	$10 billion	—
				Term Asset-Backed Securities Loan Facility (TALF) to provide credit to households	$100 billion	10
				Municipal Liquidity Facility (MLF) to purchase local and state government debt	$500 billion	7
				Paycheck Protection Program Liquidity Facility (PPPLF) to provide term financing backed by PPP loans	$670 billion	100
				Main Street Lending Program to provide funding for SMEs not covered by the other facilities	$600 billion	12.5

SOURCE: Banco de España.

vehicles expressly created to implement such programmes. Among the major central banks, the Bank of England has also cut its key policy rate by 65 bp to 0.1% since March, while the Bank of Japan maintained it at -0.1%. The two institutions have expanded their sovereign and corporate bond purchase programmes, established measures to support credit and market liquidity, and participate in the agreement to re-establish swap lines with the Fed to provide dollars at international level. Other advanced economies such as Canada, Sweden, South Korea and Australia, have taken similar measures (see a summary of the measures adopted by central banks in Table 3.4).

The central banks of emerging economies have resorted to policy interest rate cuts across the board. As a result of these decisions, these rates have been

Table 3.4
MONETARY POLICY MEASURES ADOPTED TO COMBAT THE IMPACT OF COVID-19 (cont'd)

Country	Cut in policy rate (to % level)	Asset purchases	Maximum amount established	Credit support	Amount	Backed by the Treasury (%)
Japan		Maximum annual purchases of ETFs doubled	¥6 trillion additional (Annual total: ¥12 trillion)	New lending facility maturing at up to one year for financial institutions (0% interest, corporate and household debt as collateral)	The maximum would be reached if all corporate and household debt were used as collateral (¥25 trillion in April 2020)	—
		Maximum annual purchases of J-REITs doubled	¥90 billion additional (Annual total: ¥180 billion)	Increase in limit for corporate bonds in bank balance sheets, which may mature in up to 5 years (formerly 3)	Purchases of up to ¥7.5 trillion up to March 2021 (Maximum in the balance sheet: ¥10.5 trillion)	—
				Incresase in limit for commercial paper in bank balance sheets	Purchases of up to ¥7.5 trillion up to March 2021 (Maximum in the balance sheet: ¥9.5 trillion)	—
		Increase in purchases of government bonds	Indefinite	New lending facility (0% interest, maturing at up to one year and interest-free, unsecured loans granted through the measures put in place by the Government)	The maximum would be reached if all eligible loans were used as collateral (¥30 trillion)	—
United Kingdom	–65 bp (0.1%)	Increase in purchases of sovereign and corporate bonds	+ £200 billion increase (+ £10 billion corporates, + £190 billion government bonds) (Total: £645 billion)	TFSME: financing facility for SMEs, over 12 months, at a rate close to the policy rate	£100 billion (BoE estimations)	0
				CCFF: State guarantees on loans to firms affected, via purchases of commercial paper (through the BoE)	Unlimited in principle, first phase for £330 billion, to be combined with the British Business Bank's CBILS, CLBILS and BBLS programmes	100
China	MLF (1 year): –30 bp (2.95%) Reverse repos: 7 days: –30 bp (2.20%) 14 days: –10 bp (2.55%) Preferential loans: 1 year –30 bp (3.85%); 5 years –15 bp (4.65%)	—	—	Refinancing facility for firms hit by the pandemic	¥300 billion	—
				Refinancing/rediscounting facility for lending to SMEs	¥900 billion	—
				Expansion of financing and rediscounting share for small and medium-sized banks	¥1,000 billion	—
				Issuance of financial institutions' bonds to increase credit granted to SMEs	¥300 billion	—

SOURCE: Banco de España.

Table 3.4
MONETARY POLICY MEASURES ADOPTED TO COMBAT THE IMPACT OF COVID-19 (cont'd)

Country	Liquidity measures on domestic markets	Amount	Backed by the Treasury (%)	Currency swaps/Provision of liquidity to other central banks	Amount
Euro area				Coordinated with other central banks	Bulgaria and Hungary (€2 billion), Romania (€4.5 billion) and Denmark (€12 billion) No limit specified by the Federal Reserve
United States	1-month repos	$500 billion	—	Coordinated with other central banks	For Australia, Brazil, South Korea, Mexico, Singapore and Sweden ($60 billion) For Denmark, Norway and New Zealand ($30 billion)
	3-month repos	$500 billion	—		
	Increase in supply of overnight repos	+$400 billion (Total: $500 billion)	—		
	Increase in supply of 15-day repos	+$25 billion (Total: $45 billion)	—		
	Primary Dealer Credit Facility	—	—		
	Money Market Mutual Fund Liquidity Facility (MMLF)	—	$10 billion		
Japan	Ad hoc operation in March to inject liquidity through repos	¥500 billion		Coordinated with other central banks	—
	Other operations: securities sale repo, government bond loans for use in transactions of liquidity provision in dollars, etc.	—			
United Kingdom	*Contingent Term Repo Facility* (CTRF) to increase liquidity in monetary markets	—	—	Coordinated with other central banks	—
	Temporary extension of the *Ways and Means Facility* (W&M) Treasury credit facility at BoE				
China	Cuts in reserve ratio: — Segmented (equivalent to –35 bp on the aggregate, currently 10%). — For SMEs (100 bp, currently 7%)	—	—	—	—
	Liquidity provision: reverse repos for value of $174 billion and $71 billion	—	—		
	Decrease in remuneration of excess reserves from 0.72% to 0.35%)	—	—		

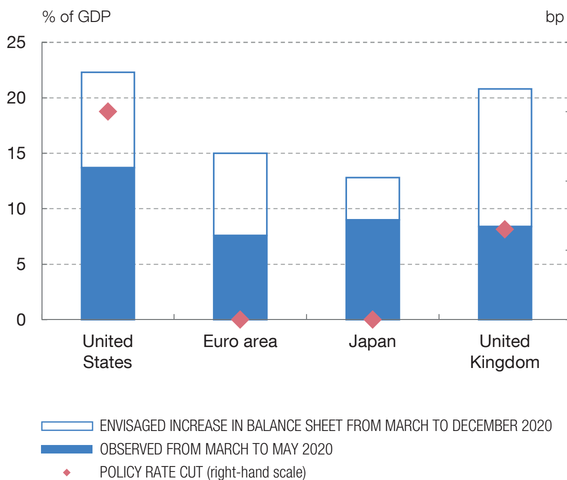
SOURCE: Banco de España.

reduced to all-time lows in certain cases and, in real terms, have moved into negative territory (see Chart 3.3.2). In contrast with other episodes in the past, this expansionary monetary policy was implemented in an environment of notable currency depreciation, which was only partially mitigated through foreign exchange intervention. Additionally, certain central banks (for instance, those of Brazil, Chile,

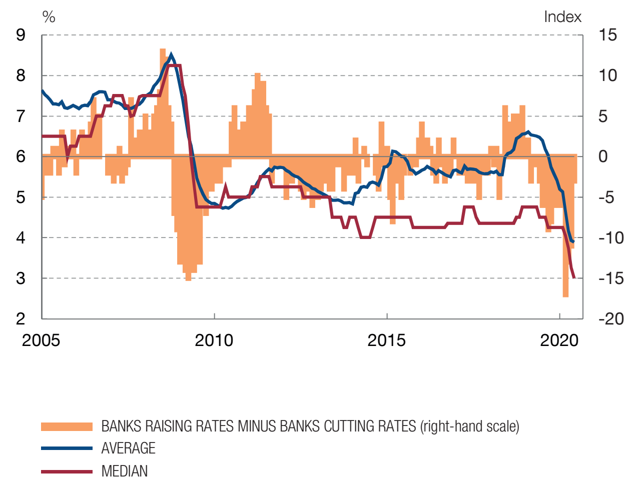
Chart 3.3
MEASURES ADOPTED BY THE MAIN CENTRAL BANKS

The monetary authorities of the main advanced and emerging economies have reacted swiftly by reducing key policy rates to all-time lows and using unconventional instruments.

1 INTEREST RATE CUTS AND MONETARY EXPANSION IN ADVANCED ECONOMIES (a)



2 POLICY INTEREST RATES IN EMERGING ECONOMIES



SOURCES: Central banks and Banco de España calculations based on reports of Reuters, JP Morgan, Goldman Sachs, Morgan Stanley, Bank of America, Capital Economics and Barclays Capital.

a "Envisaged increase in balance sheet from March to December 2020" is calculated based on projections made by analysts for the total balance sheet size in December 2020. "Observed from March to May 2020" refers to the change in the total balance sheet size from 28 February to 29 May 2020, expressed as percentage points of 2019 GDP. The policy rate cuts refer to the those made between 28 February and 29 May 2020.

Colombia, Hungary, India and South Africa) have put into place, or plan to do so, asset purchase programmes similar to those implemented by the central banks of the advanced economies. Also, the central banks of the emerging economies have, in general, adopted measures to support credit and provide liquidity to the domestic financial markets.

3.4.2 Actions taken by the ECB

In view of the COVID-19 health crisis, on 12 March the ECB adopted a comprehensive package of expansionary monetary policy measures to help preserve the smooth provision of credit to the real economy. First, the ECB undertook to carry out additional net asset purchases under its asset purchase programme (APP) of €120 billion until the end of 2020. Second, it decided to conduct additional longer-term refinancing operations (LTROs) to provide immediate liquidity on favourable terms for banks until June 2020, the date of the second targeted longer-term refinancing operation (TLTRO III) scheduled this

year.[23] Third, to support bank lending to the agents most affected by the spread of COVID-19, particularly to small and medium-sized enterprises, the ECB resolved to apply considerably more favourable conditions between June 2020 and June 2021 to all TLTRO III outstanding during that period.[24] In parallel, the European Single Supervisory Mechanism decided to allow banks to temporarily use their capital and liquidity buffers to help them to continue to fulfil their role in financing the real economy (see Section 3.5).

On 18 March 2020 the ECB announced a new Pandemic Emergency Purchase Programme (PEPP), which was expanded by the Governing Council on 4 June, to counter the serious risks to the monetary policy transmission mechanism and to the outlook for the euro area posed by the pandemic. This temporary asset purchase programme of private and public sector securities was launched with an initial envelope of €750 billion until end-2020. Subsequently, on 4 June 2020 it was increased to €1,350 billion until at least the end of June 2021 and it was announced that the maturing principal payments from securities purchased under the PEPP will be reinvested at least until the end of 2022. Purchases will be conducted in a flexible manner and fluctuations in their distribution will be allowed over time, among jurisdictions and across asset classes. However, the allocation of public sector bonds purchases across jurisdictions will continue to be guided by the capital key, without prejudice to the aforementioned flexible application of the programme in the short term. The extraordinary Governing Council meeting of 18 March also resolved to include non-financial commercial paper in the range of eligible assets under the corporate sector purchase programme (CSPP). The PEPP, together with the new purchases under the APP will increase the portfolio of the Eurosystem's securities purchase programmes to around €4.4 trillion in June 2021 (see Chart 3.4.1).

In April the ECB also adopted a package of temporary collateral easing measures in the Eurosystem. The main purpose of these measures is to expand the capacity of banks to access the Eurosystem's refinancing operations and to support bank lending to businesses and households (see Box 3.2 for further details). Additionally, at its meeting on 30 April, the ECB announced new pandemic emergency longer-term refinancing operations (PELTROs) to provide liquidity support to the financial system.[25]

---

23 The rate in these new LTROs will be fixed at the average of the deposit facility rate (DFR) (currently -0.50%) over the life of the respective operation and they will be conducted with full allotment.

24 The terms and conditions of TLTRO III were further improved at the ECB meeting on 30 April. Following this recalibration, the maximum rate applicable from June 2020 to June 2020 is 50 bp below the average rate on the main refinancing operations (MRO) at long term, currently at 0%. For institutions maintaining their levels of lending, the interest rate will be 50 bp below the average DFR. Also, for these operations, the limit for requesting funds per institution was increased to 50% of their eligible loans.

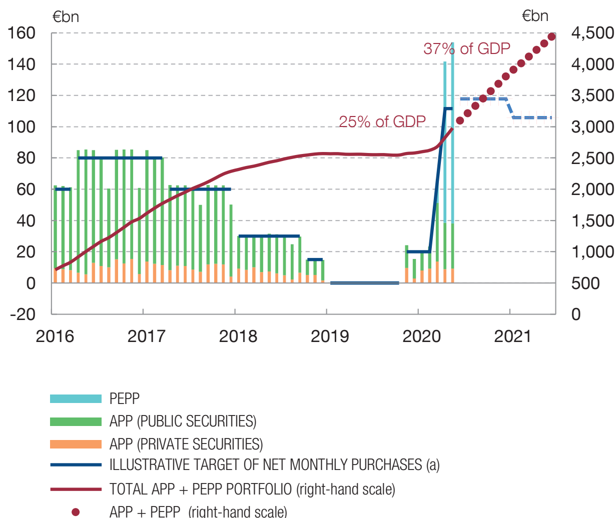
25 Specifically, seven operations will be carried out, commencing in May, with staggered maturities in 2021 Q3. These operations will be conducted as fixed rate tender procedures with full allotment. The interest rate will be 25 bp below the average MRO rate over the life of each PELTRO.

Chart 3.4

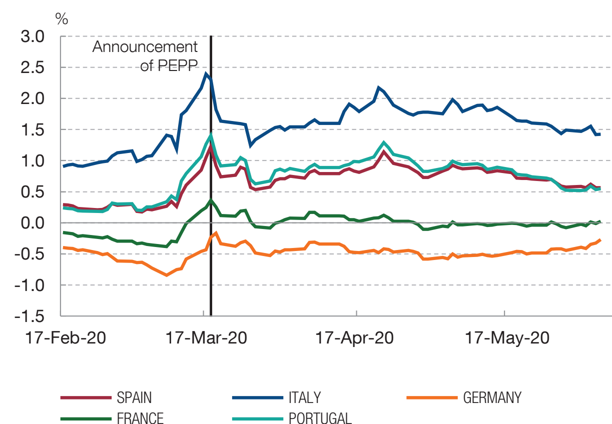
THE ECB ADOPTED A COMPREHENSIVE PACKAGE OF EXPANSIONARY MONETARY POLICY MEASURES

The ECB adopted a comprehensive package of measures to help preserve the smooth provision of credit to the real economy and to counter the risks to the monetary policy transmission mechanism posed by the outbreak of coronavirus. These measures include programmes to provide liquidity (LTROs, TLTRO-III and PELTROs) and to purchase assets (APP and PEPP).

1 ASSET PURCHASE PROGRAMME (APP)



2 INTEREST RATES ON TEN-YEAR SOVEREIGN BONDS



SOURCES: ECB and Thomson Reuters Datastream.

a The monthly net purchase target as from June 2020 (broken blue line) includes, in addition to the €20 billion per month approved last year, monthly net purchases of €120 billion under the APP (approved on 12 March) and €1,350 billion under the PEPP (approved 18 March and extended and increased on 4 June). These purchases will be made until June 2021, assuming, for illustrative purposes, that they will be distributed uniformly until June 2021 (in practice they may be distributed flexibly over time). Based on the total purchases announced, the asset volume under the APP and PEPP in the Eurosystem's balance sheet as at June 2021 will reach 37% of the euro area's GDP in 2019.

In short, the ECB has, in general, reacted substantially more forcefully than it did in the wake of the 2008 financial crisis. As discussed previously, the ECB's main measures focused on its asset purchase programmes (APP and PEPP) and on its longer-term refinancing operations (LTRO, TLTRO III and PELTRO). As a result of these measures, the size of the Eurosystem's balance sheet is expected to expand by around €2 trillion during 2020,[26] considerably more than the increase of just over €0.5 trillion following the ECB's initial response to the crisis that began in 2008. On that occasion the European monetary authority's reaction centred mainly on reducing its policy interest rates and on establishing fixed rate full allotment (FRFA) tender procedures in refinancing operations since October 2008 with the aim of providing financial institutions in the euro area with sufficient liquidity.

The measures recently deployed by the ECB appear to be considerably effective and, in particular, the announcement of the PEPP substantially eased financial conditions in the euro area. On the one hand, European banks seem to

26 According to a Reuters survey of financial sector professionals, mostly banks, conducted in May 2020.

be using the liquidity offered by the Eurosystem to provide credit to the real economy. This is suggested by the euro area Bank Lending Survey (BLS) of April 2020, where 74% of the banks surveyed indicate that they expect to use the liquidity provided by TLTRO III to grant loans to households and firms over the next six months. Noteworthy in this connection is that the fourth TLTRO III tender operation, held on 18 June, received demand for €1.3 trillion, a far higher figure than that of the three previous tenders (a maximum volume of €115 billion was recorded in the March 2020 tender procedure). On the other, the announcement of the PEPP significantly eased financial conditions in the euro area. Such easing prompted a strong fall in sovereign debt yields (see Chart 3.4.2), but also affected other financial indicators, as illustrated in Box 3.3, which uses an event-study methodology.

The easing of financial conditions prompted by the PEPP was partially reversed in April owing to the progressive worsening of the euro area's economic prospects, only to improve over the course of May and June, in part possibly as a result of the extension of the PEPP. Following the lows posted at end-March after the PEPP was announced, sovereign debt yields and spreads rose again, and at end-April stood at levels close to the highs recorded before it was announced. However, announcements of new stimulus measures by national and supranational authorities, as well as the extension of the PEPP in early June, led to another decline in sovereign debt spreads to levels which, at the cut-off date of this Report, continue, nonetheless, to be somewhat higher than their pre-crisis levels. In any event, these dynamics evidence the importance of accompanying the high level of monetary stimulus provided by the ECB with a broad fiscal policy response within the euro area. This response should incorporate common investment and financing instruments, in line with the European Commission's recent proposal, particularly in a setting in which the fiscal space available in certain countries is relatively limited, as shown in Box 3.4).

3.5 The response of the financial authorities

The measures adopted in the realm of banking supervision to mitigate the effects of COVID-19 have been extended to other areas. These measures cover, among others, macroprudential, microprudential and accounting decisions. Their common purpose is that, in the current adverse environment, the financial system continues to provide the financing needed by households and businesses so that they can cope with the (in many cases expected to be essentially temporary) fall in their income.

As for macroprudential policy, numerous countries have released the countercyclical capital buffer (CCyB). The CCyB, which had been activated by many European economies in the past, generally as a result of excess credit growth, has now been released and set at 0%.[27] In Spain the CCyB stood at 0%, given the

27 See Banco de España (2020).

absence of alerts to warrant its activation. Following the outbreak of COVID-19, it is anticipated that this instrument will not be activated over a prolonged period, at least until the main economic and financial effects arising from the current crisis have receded. Accordingly, an important lesson of the current shock is that capital requirements which can be released during macro-financial crisis situations need to account for a higher proportion of the total requirements requested from banks, and they need to adapt to cyclical economic developments to a greater degree than in the past. Indeed, building up a higher level of these cyclical capital requirements would provide banks with more room at this time, not only to cushion the fluctuations in the financial cycle, but also to deal with the impact of shocks such as the current one, which has not arisen from within the financial system itself.

Furthermore, banks will be allowed to operate temporarily under lower regulatory capital and liquidity requirements than usual. Although Spain had not activated the CCyB, Spanish banks did build up other buffers and capital requirements over the last few years, precisely with the aim of using them to absorb losses in the face of scenarios where risks materialise, such as that generated by COVID-19. In this respect, the ECB and the Basel Committee on Banking Supervision (BCBS) have boosted the use of capital and liquidity buffers which can be drawn down by credit institutions, as well as the timely use of the flexibility afforded by prudential regulations to adapt to the new situation. Additionally, the Single Resolution Board (SRB) also clarified how it will supervise, in the current environment, compliance with MREL (minimum requirements for own funds and eligible liabilities). These requirements, which were designed to absorb losses in case of resolution, will be supervised so that they do not constrain banks' ability to use capital buffers which have been released or made more flexible by the authorities.[28]

In the microprudential realm, financial authorities promoted measures on operational, prudential and regulatory flexibility to support the correct functioning of the banking system and to make it easier for the flow of credit to be maintained. Supervisory processes were adapted to adjust the operational resources committed by institutions so that such resources can be used to contribute to business continuity. In this respect, the European Banking Authority (EBA) decided to postpone the biannual stress tests until 2021. Nevertheless, this institution published a sensitivity analysis to assess the impact of COVID-19 based on the information collected in the 2018 stress test exercise.[29] Additionally, the EBA published its 2020 transparency exercise with data on 127 European banks, which includes details of their financial position in December 2019.[30] The ECB's Banking Supervision requested banks to include the pandemic risk in their

28 This situation would arise in cases where capital buffers need to be recorded for the calculation of MREL, which would effectively prevent using them to absorb losses if the SRB does not adopt mitigating measures.

29 See *Thematic note - Preliminary analysis of impact of COVID-19 on EU banks – May 2020. EBA/REP/2020/17*.

30 See *2020 EU-wide transparency exercise*.

contingency plans and to review their business continuity plans. Likewise, deadlines were extended for compliance with the corrective measures required in on-site inspections and completed internal model reviews, and flexible application of the ECB guidance on non-performing assets was permitted.

On 28 April, the European Commission presented a raft of measures to encourage banks to make full use of the flexibility included in the EU's prudential and accounting framework and to introduce a series of adjustments to the regulation applicable to facilitating bank loans to households and businesses. This set of measures included an interpretative communication on the application of the accounting and prudential frameworks – a "quick fix" – to the Capital Requirements Regulation (CRR) which was approved by the Council and the Parliament in June and has already come into force. Among other measures, this amendment to the CRR delays by one year the entry into force of the leverage ratio buffer requirements for global systemically important institutions introduced by CRR2, at the same time as it brings forward the application dates of certain measures agreed in 2019 in the CRR review (including supporting factors for SMEs and infrastructure projects, as well as changes to the prudential treatment of software assets which is being finalised by the EBA). Additionally, changes are introduced to the transitional arrangements for provisioning under IFRS 9 in the prudential framework (in line with the changes agreed recently by the Basel Committee) and other further adjustments are made to the framework which allow credit institutions to reduce capital requirements. These changes include favourable treatment of publicly guaranteed loans under the NPL prudential backstop, adjustments to the possibility of excluding central bank reserves from the leverage ratio, the possibility of overlooking forecasting errors in market risk models during 2020 and 2021, along with favourable prudential treatment for a transitional period of euro-denominated sovereign debt issued by non-euro area countries.

As for accounting, financial authorities adopted measures to avoid an excessively procyclical and mechanical behaviour of provisions which could trigger a contractionary effect on the supply of bank lending to the real economy. The measures focus on clarifying the correct interpretation of accounting rules for calculating the credit risk impairment of financial assets. Specifically, these measures attempt to better differentiate between temporary and permanent credit risk impairment and to take into account the value of guarantees granted by the State. This should limit the growth rate of impairment allowances and moderate their negative impact on profitability. Nevertheless, the supervisory guidelines also consider that the measures adopted in this area should not hamper the measurement of actual impairment and the recording of reasonable provisions for credit risk, and should provide banks with the necessary incentives to maintain adequate standards. The authorities' goals also include a temporary reduction in the amount of accounting information required in order to free up additional operational resources.

Financial authorities recommended the temporary suspension of dividend payments and prudence in employee bonuses, in order to channel income towards shoring up banks' solvency. In March 2020, the ECB[31] and the EBA[32] recommended that banks refrain from paying out dividends for 2019 and 2020, at least until 1 October 2020, and from buying back shares to remunerate shareholders. The Banco de España extended these recommendations to the Spanish banks which it supervises.[33] The CNMV and the Registrars Association of Spain issued a joint statement to indicate how banks, which have approved a dividend and wish to make changes, should proceed.[34] All Spanish significant institutions which could legally suspend or defer the dividend paid out of income for 2019 followed the ECB's recommendation.

The measures adopted by the sectoral supervisors were supplemented and strengthened by a set of macroprudential recommendations of the European Systemic Risk Board (ESRB).[35] First, the ESRB recommended that restrictions on dividend distribution cover the EU's financial system in its entirety and extended them until, at least, 1 January 2021. Additionally, the ERSB issued recommendations on variable remuneration[36] and a recommendation on monitoring, both nationally and EU-wide, the financial stability implications of the measures to support the economy introduced by Member States in response to the COVID-19 crisis.[37] Furthermore, the ESRB published a recommendation, addressed to the European Securities and Markets Authority (ESMA) to coordinate with national competent authorities a supervisory exercise to assess the preparedness of investment funds with significant exposures to corporate debt and real estate in the face of possible pressure on future redemptions.[38] Lastly, the ESRB issued a recommendation with actions targeting the mitigation of potential liquidity risks and of procyclical effects linked to variation margin requirements in securities settlement by central counterparties.[39]

31 See European Central Bank press release of 27 March 2020.

32 See EBA Statement on dividends distribution, share buybacks and variable remuneration of 31 March 2020.

33 See Banco de España press release of 27 March 2020.

34 See Joint statement issued by the Registrars Association of Spain and the Spanish National Securities Market Commission in relation to annual accounts and the proposed distribution of profit of corporate entities in the context of the health crisis resulting from COVID-19 of 26 March 2020.

35 See ESRB press releases of 14 May 2020 and 8 June 2020.

36 See Recommendation ESRB/2020/7.

37 See Recommendation ESRB/2020/8.

38 See Recommendation ESRB/2020/4.

39 See Recommendation ESRB/2020/6.

REFERENCES

Arce, Ó., I. Kataryniuk, P. Marín and J. Pérez (2020). "Thoughts on the design of a European Recovery Fund", *Occasional Paper,* No 2014, Banco de España

Albrizio, S., A. Buesa, M. Roth and F. Viani (2020). "The real effects of trade uncertainty", Banco de España, mimeo.

Banco de España (2020). "Macroprudential measures adopted across Europe in response to the COVID-19 crisis", Box 3.1, *Financial Stability Report,* Spring 2020.

— (2019a). "Monetary policy design in the medium and long term", Chapter 3, Annual Report 2018.

— (2019b). "Economic consequences of demographic change", Chapter 4, *Annual Report* 2018.

Berganza, J.C., R. Campos, E. Martínez and J. Pérez (2020). "The end of the demographic dividend in Latin America: challenges for economic and social policies", Analytical Articles, *Economic Bulletin,* 1/2020, Banco de España.

Caldara, D., M. Iacoviello, P. Molligo, A. Prestipino and A. Raffo (2020). "The economic effects of trade policy uncertainty", *Journal of Monetary Economics,* January, Vol. 109 January, pp. 38-59.

Cuadro-Sáez, L., F. López-Vicente, S. Párraga and F. Viani (2020). "Medidas de política fiscal en respuesta a la crisis sanitaria en las principales economías del área del euro, EEUU y el Reino Unido", *Documentos Ocasionales,* Banco de España, forthcoming.

European Central Bank (2018). "Strengthening the Global Financial Safety Net. Moving relations between the IMF and Regional Financing Arrangements forward". *Occasional Paper,* No 207.

Garrido, I., P. Moreno and X. Serra (2016). "The new map of international financial institutions", *Economic Bulletin,* January, Banco de España.

International Monetary Fund (2020a) *Fiscal Monitor,* April.

— (2020b). *World Economic Outlook Update,* June 2020,

Jimeno, J.F., F. Smets and J. Yiangou (2014). "Secular stagnation: a view from the Eurozone", Chapter 13 in *Secular stagnation: facts, causes and cures* (Eds. C. Teulings and R. Baldwin), pp. 153-164, CEPR.

Kohlscheen, E., B. Mojon and D. Rees (2020). "The macroeconomic spillover effects of the pandemic on the global economy", *BIS Bulletin,* No 4.

Summers, L. (2015). "Demand Side Secular Stagnation", *The American Economic Review,* May, Vol. 105, No 5, pp. 60-65.

Box 3.1

THE IMF's FINANCIAL RESPONSE TO THE COVID-19 CRISIS

The IMF reacted swiftly and forcefully to the health emergency triggered by COVID-19, as well as to the crisis resulting from the confinement of a large part of the world population and from broad economic sectors having come to a global standstill. Its initial response was mainly geared towards the economies that were most vulnerable from a healthcare standpoint, but also towards the emerging economies that were potentially more affected by the capital outflows that took place in certain regions.

The support measures adopted by the IMF focused mainly on boosting emergency financial assistance on a temporary basis, as well as providing debt relief for the most vulnerable low-income countries and short-term liquidity through a new credit line.[1] At the cut-off date of this Report, the Fund had not yet decided whether to supplement these measures with a general allocation of its own currency, the special drawing rights (SDRs), distributed proportionally among all its members.

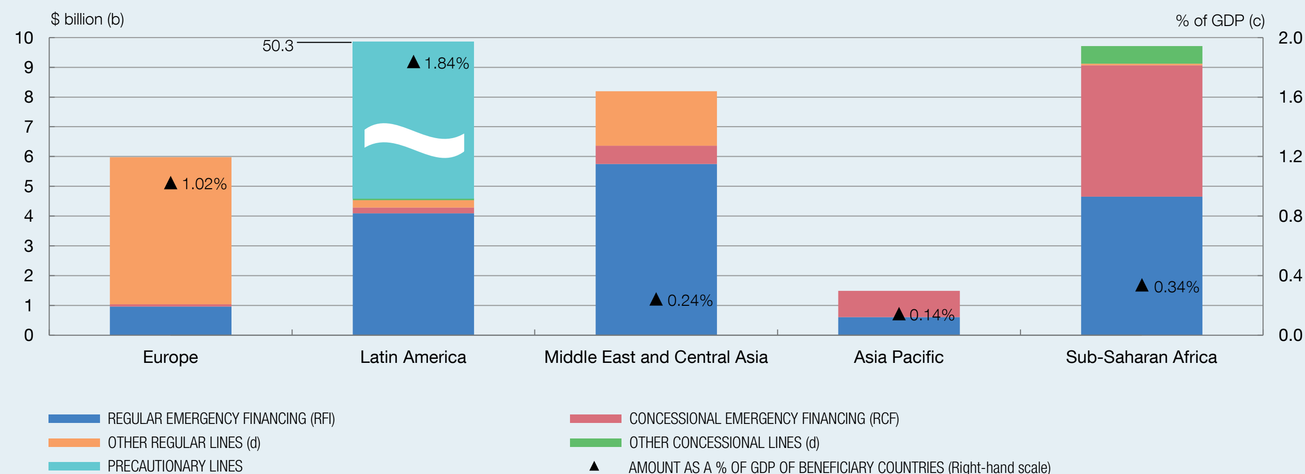
As regards emergency financial assistance, the IMF has approved raising the access limits to its emergency facilities, namely the Rapid Financing Instrument (RFI), available to all Fund members, and the Rapid Credit Facility (RCF), a concessional instrument limited to low-income countries only. Specifically, the annual access limit for the lines has been increased from 50% to 100% of the country quota in the IMF, and the cumulative limit from 100% to 150%, for an initial period of six months, which may be extended. Neither of these instruments requires the application of an economic programme nor compliance with conditionality.

To date the IMF has received requests for emergency financial assistance from around 100 mostly low-income countries and has approved aid amounting to nearly $70 billion, a figure which is expected to continue rising. Chart 1 shows all the financial – not only emergency – assistance, by region, granted by the IMF since the onset of the pandemic until the cut-off date of this Report.

As regards debt relief for the most vulnerable low-income countries, the IMF has adapted the Catastrophe Containment and Relief Trust (CCRT) to the new global pandemic scenario. The trust is supported by voluntary

Chart 1
IMF FINANCIAL ASSISTANCE APPROVED FROM THE ONSET OF THE PANDEMIC (a)

ABSOLUTE AND RELATIVE VOLUME OF FINANCIAL ASSISTANCE TO EACH REGION



SOURCE: Devised by authors based on IMF data.

a Including loans approved up to 10 June.
b Exchange rate as at 1 June.
c 2019 GDP according to WEO, April 2020.
d New loans and augmentation of access under previous lines.

1 See *Communiqué of the Forty First Meeting of the International Monetary and Financial Committee (IMFC),* 16 April 2020.

contributions from its members and aims to help the most vulnerable countries free up financial resources to channel them to strengthening their emergency health systems and assistance. The IMF has also green-lighted the immediate forgiveness of debt maturities in 25 out of the 33 countries covered by the CCRT, mostly in Sub-Saharan Africa, amounting to $215 million, over an initial six-month period ending in October. This period may be extended up to a maximum of two years, subject to the availability of trust resources. To this end, the IMF has opened a round of fund-raising to generate approximately $1 billion for the CCRT. In connection with concessional lending, the Fund has also launched a new round of fund-raising for loans and subsidies under the Poverty Reduction and Growth Trust (PRGT) of approximately $19 billion.[2] Lastly, in parallel with the CCRT reform, the IMF and the World Bank issued a joint statement to the G20 calling on official bilateral creditors to suspend debt payments from low-income countries that request a moratorium (see Section 3.2 of this Report).[3]

As regards the provision of short-term liquidity, the IMF has created a new credit line called Short-term Liquidity Line (SLL) to provide liquidity to (mainly emerging) economies with strong economic fundamentals, but subject to moderate balance of payments pressures.[4] The SLL sets the same access criteria as the precautionary Flexible Credit Line (FCL), financing for up to 145% of the country quota, a duration of one year (with indefinite renewals), revolving access and more favourable financial charges than the rest of the Fund's credit lines.[5] This instrument will contribute to enhancing the Fund's role in the global financial safety net, particularly insofar as it will be able to provide liquidity to economies outside the network of swap lines provided by the main central banks. The Fund's first estimates point to a potential demand for approximately $50 billion, although no request has been made at the date of this Report. The SLL will be reviewed in five years and, if not renewed, it will expire in seven.

An additional support measure for all IMF members is the possible issuance by the IMF of SDRs[6] amounting to $500 billion, which would be allocated to all the members on the basis of their shares in the IMF quotas. This is an option that has been repeatedly discussed in the Fund, and implemented during the global financial crisis, but which still lacks sufficient support for its approval. SDR issues aim to cover very high long-term global liquidity needs to supplement the aggregate volume of existing reserves. Countries opposing this measure argue that there is no structural lack of liquidity as envisaged by the Fund's Articles of Agreement in order to launch a new issue. They also highlight the scant use of the SDRs issued in 2009 in the wake of the global financial crisis, the fact that SDRs entail additional financing with no conditionality associated or that the SDR market is shallow and narrow. As they are allocated to IMF members on the basis of their quotas in the Fund, the bulk of the issues goes to advanced countries and emerging economies that generally already have fully convertible reserve assets. In the current setting, around 52% of the issue would be allocated to these countries and only 3.3% of the remaining 48% would be allocated to low-income countries. A solution to correct this asymmetry is that surplus SDR economies could voluntarily pledge these surpluses for the grant of IMF concessional loans. The outcome of the crisis and its effect on global liquidity will ultimately determine the decision of whether or not to issue SDRs over the next quarters.

The COVID-19 crisis has revived the public debate on the sufficiency of the IMF's resources. Its current lending capacity is around $1 trillion. Of this amount, 45% relates to membership quotas, 20% to funds from the New

2 Against this background, the Banco de España has pledged SDR 750 million (around $1 billion) to the PRGT managed by the IMF, to grant concessional loans to low-income countries.

3 See *Joint Statement World Bank Group and IMF—Call to Action on Debt of IDA Countries, 25 March 2020.*

4 See International Monetary Fund (2020). "IMF COVID-19 Response—A New Short-Term Liquidity Line to Enhance the Adequacy of the Global Financial Safety Net", Policy Paper No 20//025, April.

5 Other differences with respect to the SLL are that the FCL covers all types of external imbalances, has no access limit and may be in place for up to two years following an interim annual review. The IMF trusts that, in certain cases, the SLL may serve as an instrument to facilitate exiting a pre-existing FCL.

6 The IMF created the SDR in 1969 as an international reserve asset to supplement gold and US dollars. The SDR is neither strictly a currency nor a claim on the IMF, but rather a claim on currencies considered to be freely usable, as well as being the unit of account of the IMF and other international organisations. SDRs can only be held and used by IMF member countries, by the IMF itself and by certain prescribed organisations. The IMF allocates SDRs unconditionally. General SDR allocations are made in proportion to member countries' IMF quotas. The IMF reviews the long-term global liquidity situation at least every five years and, in this context, decides whether a new general allocation is to be made. General SDR allocations have only been made three times; in addition, there has been a special one-time allocation made for equitable reasons. The IMF's Articles of Agreement also allow for cancellation of SDRs, but this provision has never been used.

Box 3.1
THE IMF's FINANCIAL RESPONSE TO THE COVID-19 CRISIS (cont'd.)

Arrangements to Borrow (NAB) and 35% to bilateral borrowing agreements of the IMF with certain members. The NAB constitutes the second line of defence to satisfy the demand for IMF funding, after the quotas, and the bilateral agreements the third one. At the cut-off date of this Report, around 80% of the Fund's lending capacity was not committed and its liquidity, calculated for a one-year horizon, stood at $225 billion and was supported solely by the quotas. However, an increase in the demand for ordinary lending, in conjunction with the approval (and future disbursement) of SLL lines might require activating NAB and, subsidiarily, bilateral borrowing.

In principle, the IMF's current resources should be sufficient to satisfy the projected demand for loans. However, owing to the gravity of the crisis and the still high uncertainty on how it evolves over the next quarters, more extreme scenarios in which, additionally, a significant number of IMF member countries might be reluctant to increasing the Fund's resources cannot be ruled out. In this connection, it should be noted that a change in the composition of the IMF's external financing was scheduled for January 2021, with a doubling of the NAB and a retrenchment in bilateral loans to practically one half, which would leave its total size practically unchanged. However, part of IMF membership, particularly the more dynamic emerging economies, continue to claim a decisive quota increase, both to underpin the Fund's lending capacity and to correct their underrepresentation in the institution.

Box 3.2

EASING OF THE EUROSYSTEM'S COLLATERAL FRAMEWORK

In March and April this year, the Governing Council of the European Central Bank (ECB) adopted a broad package of measures to ensure liquidity and mitigate the tightening of financing conditions as a result of COVID-19. These measures include the expansion of asset purchases (additional envelope for the existing Asset Purchase Programme and launch of the Pandemic Emergency Purchase Programme), changes in liquidity-providing operations to credit institutions, and easing of collateral eligibility criteria for such operations (see Section 3.3). This box aims to review the latter aspect of the package in greater detail.

In the Eurosystem's monetary policy framework, liquidity-providing operations must be sufficiently collateralised by counterparties. National central banks (NCBs) accept as collateral marketable and non-marketable financial assets that comply with certain eligibility criteria and to which a valuation haircut is applied depending on the level of risk involved.

In April 2020, the Governing Council of the ECB adopted a set of temporary measures to ensure that any potential shortage of collateral caused by the pandemic does not reduce credit institutions' access to liquidity from their NCBs and, consequently, does not undermine the transmission of monetary policy or restrain the supply of credit to the economy. The economic crisis triggered by the COVID-19 pandemic may adversely affect both the value of assets used as collateral and their eligibility if their credit ratings are downgraded, thus excluding them from the set of assets that are eligible in such operations.

The measures adopted by the Governing Council of the ECB can be divided into three broad categories:

First, measures which apply immediately and uniformly to all NCBs. Specifically:

— The valuation haircuts applied to both marketable and non-marketable assets have been reduced by between 20% and 36%.

— Credit institutions have been allowed to use a larger volume of bank bonds as collateral. The limit for those of a single issuer or connected issuers has been increased from 2.5% of the total portfolio of pledged assets, to 10%.

— To mitigate the impact of possible rating downgrades resulting from this crisis, it has been decided that all the marketable assets of public or private issuers that were eligible on 7 April shall continue to be so, as long as their credit rating does not fall below the BB equivalent (CQS5, in the Eurosystem's taxonomy), except in the case of asset-backed securities, which will remain eligible provided that their rating does not drop below BB+ (CQS4).

The second set of measures focuses on the expansion of the so-called "additional credit claims frameworks" (ACCs). These frameworks give NCBs the possibility of enlarging the scope of eligible collateral in their jurisdictions by including bank loans that comply with certain requirements. The ACCs are proposed by NCBs and approved by the Governing Council of the ECB, thus ensuring a sufficient degree of uniformity across the different national frameworks. The measures that have been adopted by the Banco de España under its ACC framework can be summarised as follows:

— Acceptance of the government-guaranteed loans to corporates, SMEs and self-employed individuals under the Royal Decree-Laws approved in response to the COVID-19 pandemic.

— Introduction of a purely statistical system for the credit assessment of non-financial corporations, which will allow for an increase in the number of debtors assessed and the acceptance of loan portfolios (not only of individual loans).

— Acceptance of loans with a credit rating not lower than the equivalent of BB (CQS5).

Lastly, also in April, the Governing Council of the ECB approved another set of measures, the adoption of which is voluntary for NCBs. With respect to this category, the Banco de España has adopted the following measures under its collateral framework:

— It has removed the minimum threshold for the acceptance of loans, previously set at €25,000.

— It has decided to accept Greek sovereign debt as collateral, for which the ECB has granted a waiver of the minimum credit rating threshold (equivalent to investment-grade, CQS3).

It is not easy to quantify the aggregate impact of all these measures. First, because it will depend on the behaviour of the counterparties themselves, and second, because it

Box 3.2
EASING OF THE EUROSYSTEM'S COLLATERAL FRAMEWORK (cont'd.)

will also be influenced by external factors such as the assessment of credit rating agencies in light of the risks generated by COVID-19, which will be decisive for assessing the effects of the measures adopted.

In any event, the impact will foreseeably be quantitatively significant. For example, the expanded ACC framework in Spain includes as new collateral the loans guaranteed by the ICO facility of €100 billion provided by the Spanish Government to partly cover loans to non-financial corporations (see Section 4.3 in Chapter 4). At end-March 2020, credit institutions had pledged collateral amounting to €255 billion to the Banco de España. The potential inclusion of all these new loans as eligible assets would mean a substantial increase in the liquidity that institutions could borrow from the Banco de España.

The impact is also likely to be significant from a qualitative viewpoint. To a large extent, the expanded ACC framework in Spain has a direct effect on institutions' capacity to pledge at the Banco de España loans granted to productive sectors of the economy that are greatly exposed to the adverse economic impact of the pandemic, such as SMEs or self-employed individuals.

Box 3.3

IMPACT ANALYSIS OF THE ANNOUNCEMENT OF THE PANDEMIC EMERGENCY PURCHASE PROGRAMME (PEPP)

As discussed in the main text of this chapter, an essential part of the ECB's response to the COVID-19 crisis consisted of the implementation of large-scale financial asset purchases. Thus, in addition to increasing the volume of net purchases by €120 billion within the asset purchase programme (APP), the ECB will purchase €1,350 billion of public and private-sector securities under the new Pandemic Emergency Purchase Programme (PEPP) – the sum of the €750 billion committed when the PEPP was initially announced on 18 March and the €600 billion added at the recalibration adopted by the Governing Council of the ECB on 4 June. This box analyses the impact of both announcements on financial conditions in the euro area.

The event-study methodology, which uses the intraday data of several financial market indicators, is applied for this purpose. This technique identifies the immediate impact of the announcements of asset purchase programmes by central banks on financial asset prices. This impact is one of the main transmission channels of these programmes and is called the "stock effect" in the economic literature since it includes investors' expectations of future developments in the stock of financial assets held by the central bank. Event studies are usual in the assessment of the main central banks' asset purchase programmes.[1] As a note of caution, this methodology only partially assesses this type of programme's effects on financial markets given that it does not capture other effects of asset purchases, such as those produced by the flow of purchases when the latter take place ("flow effects"). Consequently, in principle, this approach undervalues the total impact of these programmes.

Event studies are based on the calculation of the variation in the financial indicators of interest in a narrow window of time around the event in question. This isolates the variation in such indicators that is attributable solely to the event analysed, and not to other factors (such as different economic or, in the current context, epidemiological news). Specifically, the ECB announced the PEPP in a press release published at 23:45 on 18 March after European capital markets had closed. Consequently, the variation is calculated in each indicator between the closing value on 18 March (for example, 17:30 in the case of stock market indices) and the first 30 minutes of the session on 19 March (09:30 for the stock markets).[2] On 4 June the increase in the PEPP was announced in the usual fashion, through a press release published at 13:45 and, therefore, the window between 13:30 and 14:15 is used so that it ends, once more, 30 minutes after the event.

Chart 1
STOCK MARKETS AND EXCHANGE RATES

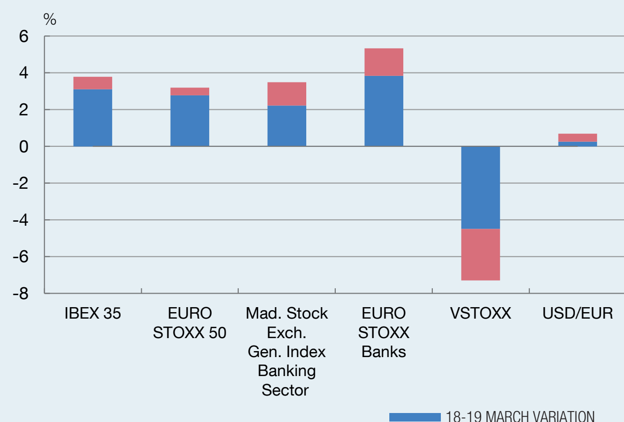
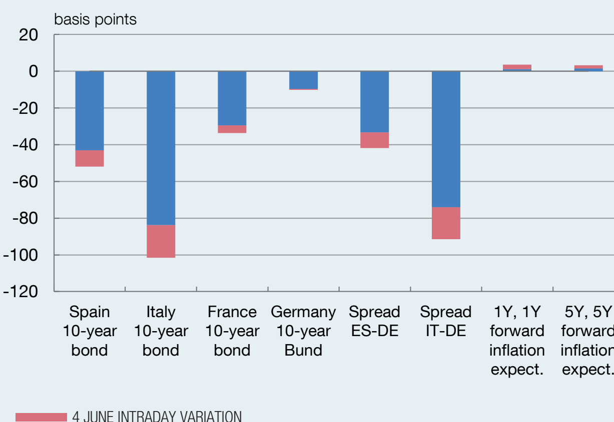


Chart 2
SOVEREIGN BONDS AND INFLATION EXPECTATIONS



18-19 MARCH VARIATION
4 JUNE INTRADAY VARIATION

SOURCE: Thomson Reuters.

1 For the case of the United States, see for example Gagnon, J., M. Raski, J. Remache and B. Sack (2011). "The Financial Market Effects of the Federal Reserve's Large-Scale Asset Purchases", *International Journal of Central Banking,* Vol. 7(1), pp. 3-43. For the case of the euro area, see Altavilla, C., G. Carboni, or R. Motto (2015). "Asset purchase programmes and financial markets: lessons from the euro area", *ECB Working Paper Series* No 1864. See also Banco de España (2016) "The effect of the ECB's monetary policies in the recent period", Chapter 3, *2015 Annual Report.*

2 The exception is the foreign exchange market which operates via a computerised trading system. In this case the exchange rate variation is calculated between 30 minutes before and after the announcement is made, namely between 23:15 on 18 March and 00:15 on 19 March.

Box 3.3

IMPACT ANALYSIS OF THE ANNOUNCEMENT OF THE PANDEMIC EMERGENCY PURCHASE PROGRAMME (PEPP) (cont'd.)

Charts 1 and 2 show the effect of the announcements of 18 March (blue bars) and of 4 June (red bars) on various stock market indicators, the euro/dollar exchange rate and ten-year sovereign bond yields and spreads, as well as on inflation expectations obtained from inflation swaps. The results indicate that the announcement of the PEPP and, to a lesser degree, of an increase in the programme, had a positive effect on the main stock market indices in the euro area (Eurostoxx 50) and in Spain (Ibex 35), as well as on the banking sector indices, and they also decreased stock market volatility (see Chart 1). Additionally, both announcements prompted sharp falls in sovereign debt yields, especially those of Italy and Spain, and in their spreads over the German Bund (see Chart 2). For example, as a result of the initial announcement of the PEPP, Italian and Spanish bond yields decreased by 84 bp and 43 bp, respectively. The announcement of 4 June had a more limited effect with Italian and Spanish sovereign debt yields falling by 18 bp and 9 bp, respectively. The two announcements had a very limited impact on the euro exchange rate and inflation expectations.

As shown in the charts, in general, the increase in the PEPP on 4 June had a smaller impact than that triggered when this programme was initially announced. This may be due to several factors. On the one hand, unlike the initial announcement, which was largely unexpected, the increase announced on 4 June was discounted by investors, although the additional volume finally approved was higher than expected.[3] On the other, the PEPP was increased against a background of lower financial market tension than that observed in mid-March, prior to the initial announcement, which could also mean a lower impact on financial markets.

3 For example, a survey by Reuters between 11 and 14 May showed that almost half of the respondents expected an increase in the PEPP in June, with the median increase being €375 billion, lower than the €600 billion which were finally announced.

Box 3.4

THE IMPORTANCE OF AN INTERNATIONALLY COORDINATED FISCAL POLICY RESPONSE AND ITS INTERACTION WITH MONETARY POLICY

The impact of a specific discretionary fiscal measure depends on many factors, the foremost of which are the fiscal space of the economy deploying the measure, the fiscal policy reaction of other economies closely related to the first economy, and the response and available leeway in the monetary policy realm.[1] The purpose of this box is to illustrate the various channels through which these factors influence the effectiveness of fiscal policy. To this end, the stochastic general equilibrium model developed in Andrés et al. (2020)[2] is used and the economy's response to a temporary fiscal stimulus, such as that being implemented in most of the countries affected by the COVID-19 pandemic, is analysed under various scenarios.

The model considers a monetary union comprising two countries: one with a high public debt/GDP ratio and another with a more contained level of debt. In this outline of the euro area, the European Central Bank (ECB) sets monetary policy by adjusting the nominal interest rate based on developments in inflation and activity in the euro area as a whole. Each country decides its fiscal policy independently but follows a common budget rule. This rule is an automatic arrangement whereby deviations from each country's deficit and debt thresholds laid down in the EU's Stability and Growth Pact (of 3% of GDP and 60% of GDP, respectively) are corrected gradually over time. Lastly, the two countries cover their net borrowing in each period by issuing government debt.

A key aspect of the model is that issuance costs depend on the sustainability of public finances in each economy. For instance, if the public debt/GDP ratio of a country stands considerably above 60%, investors may consider that there is some risk that the State does not have enough funds to finance this debt and, consequently, they demand a risk premium that is higher than the interest rate which would be compatible with the nominal policy rates set by the common monetary authority. Where, by contrast, the deficit and debt are relatively low, investors do not usually require a positive yield spread and the Treasury of said country can finance itself at the interest rate in keeping with the policy rate set by the central bank. According to the calibration used in the model, an economy has sufficient fiscal space to avoid paying a risk premium on its new issues when its debt/GDP ratio is below 70% of GDP.

In this model, a temporary increase in public spending, such as that arising from the measures adopted to combat the effects of the COVID-19 pandemic, in a country in the monetary union stimulates activity in the short term. Nevertheless, the scale and persistence over time of this stimulus crucially hinges on the monetary policy response, the available fiscal space (which affects the risk premium level) and the fiscal measures adopted in the rest of the union, as illustrated in the simulation exercises below. Bearing in mind that the model used constitutes a highly simplified representation of the various arrangements operating in a monetary union, these simulations should be assessed essentially from a qualitative standpoint.[3]

Chart 1.1 depicts the reaction of the GDP of a country with a small fiscal space to a temporary increase in public spending of around 2.5% of GDP, under two different scenarios of monetary policy response[4]. In particular, the solid line shows changes in GDP where monetary policy operates under normal circumstances (which differ from current circumstances in the euro area) in which the central bank reacts to any rise in inflation by raising its interest rates in line with its conventional rule. In this case, the expansionary effects of fiscal policy peter out relatively rapidly. This outcome is due to increased activity in the short term, on account of the effect of the fiscal stimulus,

---

1 At the theoretical level, see, for example, Christiano, L., M. Eichenbaum and S. Rebelo (2011). "When is the government spending multiplier large?", *Journal of Political Economy,* 119(1), 78-121, The University of Chicago. From an empirical standpoint, see, for example, Ramey, V. A. (2019). "Ten years after the financial crisis: What have we learned from the renaissance in fiscal research?", *Journal of Economic Perspectives,* 33(2), 89-114, American Economic Association. The interactions between monetary and fiscal policies in the context of a monetary union with asymmetrical economies, such as the euro area, have been studied in Arce, O., S. Hurtado and C. Thomas "Policy Spillovers and Synergies in a Monetary Union", *International Journal of Central Banking,* 2016, Vol. 12, No 3, pp. 219-277.

2 Andrés, J., P. Burriel, and W. Shen (2020). "Debt sustainability and fiscal space in a heterogeneous monetary union: normal times vs the zero lower bound", *Working Paper,* No 2001, Banco de España.

3 In particular, the model does not contemplate the effects that the ECB's current sovereign debt purchase programme may have on the risk premium of each country, or on the fragmentation of the monetary policy transmission mechanism.

4 It is assumed that in these two years the other country, which is a member of the monetary union and has larger fiscal space, does not undertake any discretionary fiscal stimulus.

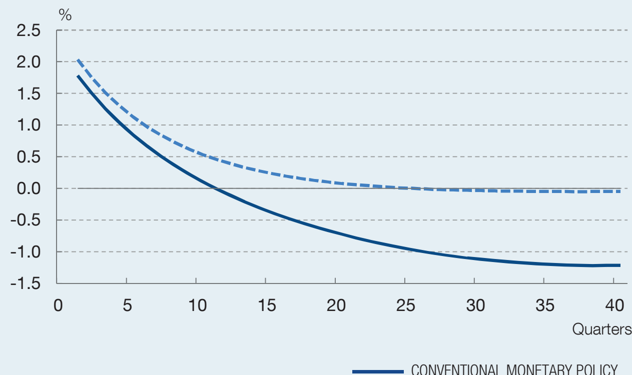
Box 3.4

THE IMPORTANCE OF AN INTERNATIONALLY COORDINATED FISCAL POLICY RESPONSE AND ITS INTERACTION WITH MONETARY POLICY (cont'd.)

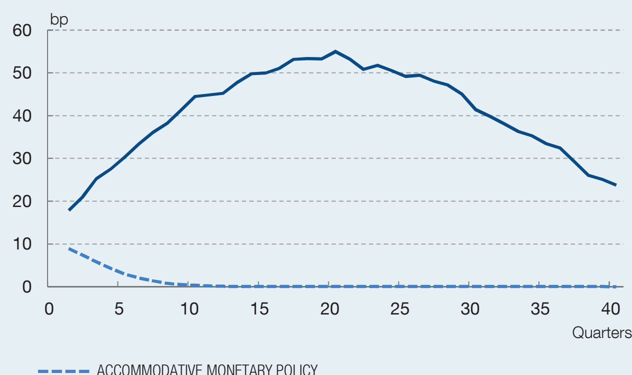
Fiscal stimulus has a greater impact on activity where it is implemented with a higher degree of international coordination and where the monetary policy reaction is accommodative and more fiscal space is available.

Chart 1
RESPONSE OF A COUNTRY WITH A SMALL FISCAL SPACE TO A TEMPORARY INCREASE IN ITS PUBLIC SPENDING BASED ON MONETARY POLICY REACTION

1.1 GDP OF A COUNTRY WITHOUT FISCAL SPACE



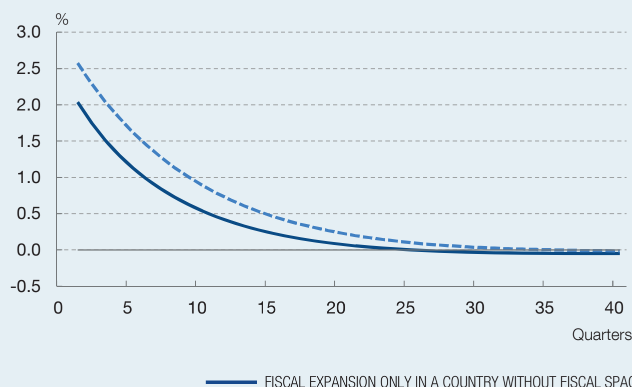
1.2 SOVEREIGN RISK PREMIUM OF A COUNTRY WITHOUT FISCAL SPACE



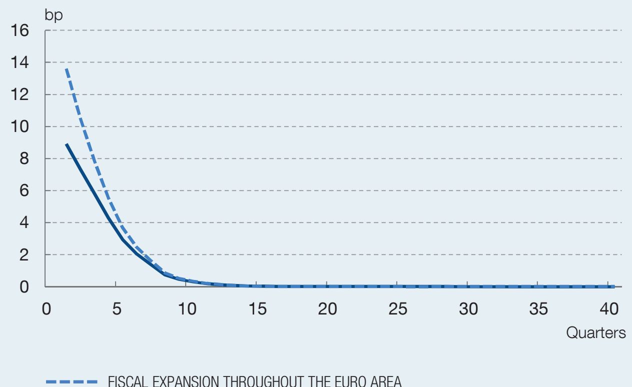
CONVENTIONAL MONETARY POLICY
ACCOMMODATIVE MONETARY POLICY

Chart 2
RESPONSE OF A COUNTRY WITH A SMALL FISCAL SPACE TO A TEMPORARY INCREASE IN PUBLIC SPENDING IN THE EURO AREA AS A WHOLE

2.1 GDP OF A COUNTRY WITHOUT FISCAL SPACE



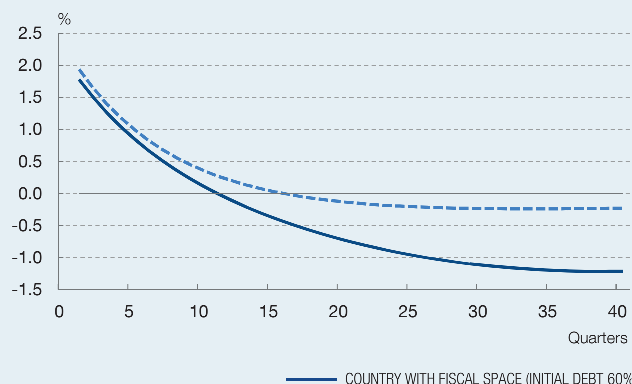
2.2 SOVEREIGN RISK PREMIUM OF A COUNTRY WITHOUT FISCAL SPACE



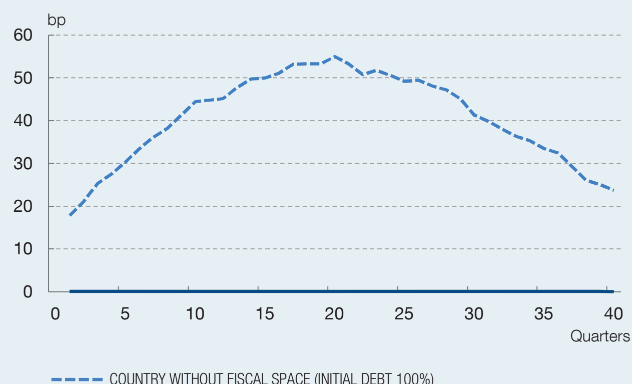
FISCAL EXPANSION ONLY IN A COUNTRY WITHOUT FISCAL SPACE
FISCAL EXPANSION THROUGHOUT THE EURO AREA

Chart 3
RESPONSE OF A COUNTRY TO A TEMPORARY INCREASE IN ITS PUBLIC SPENDING BASED ON THE AVAILABLE FISCAL SPACE

3.1 GDP



3.2 SOVEREIGN RISK PREMIUM



COUNTRY WITH FISCAL SPACE (INITIAL DEBT 60%)
COUNTRY WITHOUT FISCAL SPACE (INITIAL DEBT 100%)

SOURCE: Banco de España calculations using the model described in Andrés, Burriel and Shen (2020).

a The variables are presented as differences with respect to the baseline scenario.

exerting upward pressure on prices, which leads the central bank to raise policy interest rates. This, in turn, causes inflation to ease but, at the same time, it acts as a drag on buoyant activity, resulting in tighter financial conditions for the public and private sectors. Furthermore, fiscal expansion significantly increases the – already high – deficit and public debt ratios. That prompts a rise in the risk premium required by investors, which has an additional adverse effect on activity (see the solid line in Chart 1.2).

The broken lines in Charts 1.1 and 1.2 show the reaction of the selected variables where monetary policy maintains an accommodative stance and does not react to greater inflationary pressure. The foregoing provides the best description of the current situation in the euro area, in the sense that the persistence of systematically lower inflation rates than the medium-term price stability target (represented by an inflation rate below, but close to, 2%) makes a response from the monetary authority unnecessary. Thus, higher prices would trigger a decline in the real interest rate, which would have a greater positive impact on activity in both the short and medium term. At the same time, maintaining policy interest rates unchanged would result in an easing of the real cost of financing the debt of the country with a small fiscal space, which in turn would limit the increase in the risk premium.

Charts 2.1 and 2.2 show how the responses of GDP and the risk premium change when the same temporary fiscal stimulus considered above is deployed in the rest of the monetary union. In particular, the solid lines depict the performance of the selected variables where the aggregate formed by the other euro area countries does not implement any discretionary fiscal stimulus, whereas the broken lines relate to a scenario in which the increase in public spending in these countries is similar to that implemented, on average, in the euro area during this crisis (3.5% of GDP according to the Eurosystem's estimate[5]). It is assumed that in these two years the ECB does not tighten monetary policy in response to these fiscal measures, as in the second case described above.[6] As can be seen in these charts, if public spending were to be increased simultaneously across all the countries in the monetary union, its expansionary effect on the economy without fiscal space would be greater. First, coordinated fiscal stimulus would generate greater inflationary pressure, which, against a background of accommodative monetary policy, would lead to a sharper decline in real interest rates. Second, growth of activity in the rest of the euro area would also stimulate domestic activity through a rise in exports. Both aspects would improve the outlook for the public finances of this country, which would help to reduce the risk premium and, in turn, amplify the expansionary effect of this fiscal measure.

Lastly, Charts 3.1 and 3.2 show the extent to which the effectiveness of fiscal policy is influenced by the fiscal space available in each country. In particular, the solid lines in these charts match a scenario in which only a country with a small fiscal space (with a debt level of approximately 100% of GDP) implements a temporary fiscal stimulus and in which there is a conventional monetary policy response. Therefore, these lines coincide with the solid lines in Chart 1. By contrast, the broken lines show what the reaction of the economy would be to this fiscal impulse in a euro area Member State with a public debt/GDP ratio of 60%. As can be observed in Chart 3, as a result of the risk premium's endogenous response to public debt dynamics, fiscal policy is substantially more effective the lower the starting point of public debt and, consequently, the greater the fiscal space available.

In short, the results presented in this box underline the aggregate positive effects for the monetary union, as a whole, where a coordinated fiscal policy response is implemented across its economies. In a setting in which certain countries' fiscal space is relatively limited, international coordination may require supranational institutions to play a preeminent role. Furthermore, accommodative monetary policy, such as that deployed by the monetary authorities in the vast majority of countries affected by the pandemic, also contributes to increasing the effectiveness of the expansionary fiscal policy response.

5 See Eurosystem staff macroeconomic projections for the euro area, June 2020.

6 Therefore, the broken lines in Chart 1 coincide with the solid lines in Chart 2.